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HEALTHCARE REALTY TRUST INCORPORATED

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NASHVILLE, TENNESSEE 37203

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ANNUAL REPORT

For the Fiscal Year Ended December 31, 2004

2004 Letter to Shareholders

In this Annual Report to Shareholders for the year ended December 31, 2004, I am pleased to report Healthcare Realty Trust's twelfth successful year as a public company. Our growing portfolio of healthcare properties, coupled with the achievements of our services group, generated solid results and a positive total return to shareholders. Healthcare Realty Trust's shareholder return continued to exceed the performance of most market indices in 2004, reflecting, we believe, the quality of the Company's investments, operations and financial transactions during the year, as well as its standing within the REIT industry.

In 2004, we continued to invest in properties related to the steadily rising demand for outpatient healthcare services. While economic indicators may fluctuate from year to year, Americans require and seek medical treatment following consistent historical patterns. As the aged population grows, many healthcare organizations will expand and modify their facilities to accommodate this trend.

Revenues for 2004 totaled \$234.1 million, compared with \$184.1 million for 2003. Net income was \$55.5 million, or \$1.24 per diluted common share, compared with \$60.4 million, or \$1.44 per diluted common share in 2003. Diluted funds from operations, composed primarily of net income and depreciation of real estate, totaled \$110.2 million, or \$2.47 per diluted common share for the twelve months ending December 31, 2004. This compares with \$103.7 million, or \$2.48 per diluted common share for the same period in 2003.

The decline in net income for 2004 is largely related to the application of Financial Accounting Standards Board ("FASB") Statement No. 141, "Business Combinations," in accounting for the acquisition of real estate operations since 2002. FASB Statement No. 141 requires that the purchase price of real estate operations be allocated between the land, the physical building as if the building was vacant when acquired, the lease intangible assets, the goodwill and the customer relationship assets acquired. The purchase price allocated to the physical building continues to be depreciated over 39 years while the purchase price allocated to lease intangible assets is amortized over the remaining lease term, typically one to five years. The accelerated amortization of lease intangibles has reduced net income more significantly for 2004 than in prior years due to the increased volume of acquisitions.

During the year, we strengthened our balance sheet and expanded relationships with leading healthcare providers. We continued to be selective about our acquisitions and remained committed to conservative, long-term investments. In 2004, we were pleased to invest approximately \$335 million in medical office facilities related to high-grade health systems in growing markets.

In the current market for medical office buildings, management has seen relatively low capitalization rates and minimally accretive investment returns. Historically low interest rates and highly leveraged financial buyers have resulted in greater competition for medical office properties at higher prices, as well as asset repurchases by operators with alternative capital financing. While the Company's medical office investments in 2004 were acquired in large portfolios subject to competitive market pricing, we believe these investments served to establish relationships with health systems that enhance prospects for continued investment on their campuses.

The Company distributed \$2.55 per common share during the calendar year 2004, the Company's twelfth consecutive year of dividend payments. We are proud of our accomplishments and believe they reflect our exacting investment standards, the quality of our portfolio and our long-term perspective for meaningful growth.

The Company recently announced its common stock dividend for the third quarter of 2005 in the amount of \$0.66 per share, or \$2.64 per share annualized. Considering that the current market pricing for medical office acquisitions has continued for an extended period of time at capitalization rates that are minimally accretive, and given the recycling of assets brought about by historically low interest rates, the Company decided to maintain the third quarter dividend at the same level as the previous quarter and will determine future dividend policy based upon the ability to make investments meeting the Company's objectives.

We believe the Company is well-positioned to maintain its performance in future years given our operating strength, low business-risk profile, superior capital structure and liquidity position, and dedication to lasting ownership of healthcare real estate.

Healthcare in 2004

The operating fundamentals of acute care hospitals remained strong in 2004. Increases in Medicare reimbursement rates and positive commercial payor pricing created revenue growth for most healthcare providers, despite higher uninsured admissions and bad debt expense. The aging population continues to create demand for healthcare services and a greater need for hospitals to expand their real estate capacity.

The regulatory environment remains stringent for healthcare providers. Fraud and abuse statutes that regulate hospital and physician relationships continue to broaden the industry's awareness of the need for experienced medical real estate management and enhance Healthcare Realty Trust's efforts to create long-term relationships.

The healthcare industry continues to benefit from a favorable Medicare reimbursement environment. Healthcare providers are expected to receive positive payment rate increases through 2007, although speculation is rising about the high federal budget deficit potentially causing cuts to Medicare funding in 2006. Historical data shows no direct correlation between high federal budget deficits and lower rates of Medicare reimbursement growth. Rather, Medicare spending growth seems to be more closely related to hospital profit margins. The highest increases in Medicare spending have occurred in years of low hospital profit margins, which have also happened to be years of high federal deficits. We could likely see a reversion back to smaller increases more in line with average historical rates, which would allow significant savings while still providing solid increases in Medicare funding for healthcare providers.

Despite changes in Medicare reimbursement and other regulatory requirements from year to year, we expect healthcare providers to continue to adjust to new operating challenges, as they have in the past, by developing stronger standards and modifying their strategies for profitable operations and growth. It has been our observation that over time, throughout years of change in the healthcare industry, hospitals in growing communities have proven themselves to be financially resilient with stable cash flow.

Looking Forward

The healthcare industry's fundamental strength and related impact on real estate remain intact. The growth of the aged population, advances in medical technology and a heightened focus on preventive medicine continue to increase demand for healthcare services. Providers are reevaluating their existing medical real estate with a view toward recapitalizing those assets, partnering with outside firms for the development of new properties and outsourcing their property management functions.

As healthcare delivery continues to shift toward outpatient settings, providers are seeking new facilities to enhance their capabilities and create operating efficiencies throughout their network of affiliated clinics and ambulatory care centers. Of the estimated \$23 billion in new healthcare facilities developed annually, approximately 20% are outpatient-related properties. These assets, including ancillary hospital facilities, physician clinics, ambulatory care centers and medical office buildings, remain our primary focus. Currently, outpatient facilities comprise 67% of the Company's investment portfolio and 100% of its construction-in-progress investments.

Nationally, expenditures on healthcare services and products are expected to increase more rapidly than growth in the Gross Domestic Product (GDP). Healthcare expenditures are now estimated to total more than \$1.7 trillion annually, or 15.3% of GDP, and are projected to grow to \$3.6 trillion, or 18.7% of GDP by 2014. The growth of healthcare services provided in the U.S. continues to show that the industry is driven largely by demographics and population demand, rather than by fluctuations in seasonal trends, company-specific changes, or GDP growth. The macro-dynamic of large consumer groups requiring more healthcare services is expected to increase healthcare providers' needs for more capacity. These developments, combined with internal capital needs, should create an environment of strong demand for capital sources and real estate partners in the near future. Moreover, the prominence of healthcare in our

economy affirms our confidence in the industry's stability, non-cyclical nature and compelling fundamentals that support long-term real estate values.

Integrated Real Estate Solutions

In the current healthcare environment, successful health systems realize that access to new capital is critical to accomplishing their long-term mission. Prudent systems are looking to engage experienced real estate partners that offer flexible, lasting alternatives to meet their real estate needs. Healthcare Realty Trust seeks to acquire and develop properties that are strategically integrated with the present and future goals of health systems and physicians. We utilize straightforward, flexible ownership structures that allow health systems to redeploy capital resources away from ancillary medical real estate, while preserving the operational control they desire.

Healthcare Realty Trust is not only a source of capital but is also functionally organized to meet health systems' real estate needs. As one of the largest owners of healthcare-related real estate in the country, the Company provides a continuum of real estate services, including construction and property management. Our ability to integrate internal capital with management and construction expertise adds immediate and continuing value for our clients, ensures the success of long-term investments and differentiates Healthcare Realty Trust from other real estate firms.

When health systems are looking to divest or monetize real estate assets, an over-emphasis can be placed on pricing, often driven by financially leveraged, short-term buyers, particularly in the current market of low interest rates. While pricing is an important consideration, more critically, we have found that health systems are concerned with establishing stable, longstanding relationships on their campuses and value Healthcare Realty Trust's experience, financial autonomy and long-term investment horizon to achieve this optimal investment relationship. We believe that remaining disciplined and patient in our approach to investments serves to maximize value to the shareholder as well as satisfy the real estate objectives of our partner health systems.

Building Relationships

One of the most important factors in our decision to invest capital is our relationship with the related health system. It is our intent to invest capital to acquire or develop a building after understanding how interests will be aligned to best meet a health system's strategic and clinical needs. We have found that successful real estate properties result from a shared mindset regarding medical office buildings as the basis of a long-term relationship, rather than merely a financial transaction. Our relationships tend to be leaders in their markets, and they recognize that their capital is better invested in delivering quality patient care than in owning real estate.

In early 2004, Healthcare Realty Trust initiated its investment relationship with Ascension Health, the nation's largest not-for-profit healthcare provider, with the acquisition of 13 medical office facilities on the campuses of health ministries associated with Ascension. The \$101 million acquisition included three properties in southeast Michigan affiliated with St. John Health; four properties in Tucson, Arizona affiliated with Carondelet Health; and six properties in Nashville, Tennessee affiliated with St. Thomas Healthcare. We are discussing additional investment and construction opportunities with Ascension in 2005.

Healthcare Realty Trust also acquired five medical office facilities from MedStar Health and Advocate Health Care, leaders in the Baltimore, Washington, D.C. and Chicago markets.

In August 2004, Healthcare Realty Trust expanded its relationship with Baylor Health Care System of Dallas, Texas with the acquisition of 20 medical office properties on its campuses in the metropolitan Dallas/Fort Worth area. Our relationship with Baylor was initiated in January 2003 when we began construction of a medical office facility on its new hospital campus in Plano, an outlying city of Dallas. Shortly thereafter, we began construction of another facility on Baylor's Irving campus, also outside of Dallas. With the completion of these facilities in November 2004 and May 2005, respectively, and the acquisition of 20 facilities in 2004, Healthcare Realty Trust now owns and operates more than 1.4 million

square feet of medical office space associated with Baylor. We expect this relationship to continue to grow with the commencement of multiple other construction projects in 2006.

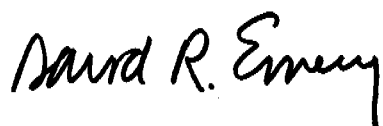
Conservative Financial Management

Healthcare Realty Trust's conservative capital structure differentiates the Company from other REITs and enables the Company to take advantage of worthy investment opportunities. We believe our future growth is best achieved by pursuing investments with leading healthcare providers in order to maximize long-term cash flow growth.

The Company continues to maintain a low business-risk profile through prudent use of debt. The Company's ratio of debt-to-total book capitalization remains among the lowest of its peers — 42.3% at year-end. A recent industry report ranked Healthcare Realty Trust seventh among high-grade REITs of all sectors for its overall liquidity and debt compliance. In addition, our investment-grade ratings continue to validate the Company's investment approach, operational strategies and conservative capital structure.

The management team is pleased with Healthcare Realty Trust's progress and achievements during 2004 and is grateful to the Board of Directors and our employees for their energy and commitment. We appreciate our shareholders, whose support and involvement provide the foundation for the Company's continued growth.

Sincerely yours,

A handwritten signature in black ink that reads "David R. Emery". The signature is written in a cursive, flowing style.

David R. Emery
Chairman of the Board & CEO

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

(Mark One)

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

For the fiscal year ended: December 31, 2004

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: 1-11852

HEALTHCARE REALTY TRUST INCORPORATED

(Exact name of Registrant as specified in its charter)

Maryland

(State or other jurisdiction of
incorporation or organization)

62-1507028

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

3310 West End Avenue

Suite 700

Nashville, Tennessee 37203

(Address of principal executive offices)

(615) 269-8175

(Registrant's telephone number, including area code)

Securities Registered Pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
Common Stock, \$.01 par value per share	New York Stock Exchange

Securities Registered Pursuant to Section 12(g) of the Act:

None

(Title of Class)

Indicate by check mark whether the Registrant (1) has filed all reports 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

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

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

The aggregate market value of the shares of Common Stock (based upon the closing price of these shares on the New York Stock Exchange, Inc. on June 30, 2005) of the Registrant held by non-affiliates on June 30, 2005 was approximately \$1,783,279,568.

As of October 31, 2005, 47,757,000 shares of the Registrant's Common Stock were outstanding.

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PART I

Disclosure Regarding Forward-Looking Statements

This report and other materials the Company has filed or may file with the Securities and Exchange Commission, as well as information included in oral statements or other written statements made, or to be made, by senior management of the Company, contain, or will contain, disclosures which are "forward-looking statements." Forward-looking statements include all statements that do not relate solely to historical or current facts and can be identified by the use of words such as "may," "will," "expect," "believe," "intend," "plan," "estimate," "project," "continue," "should" and other comparable terms. These forward-looking statements are based on the current plans and expectations of management and are subject to a number of risks and uncertainties, including those set forth below, that could significantly affect the Company's current plans and expectations and future financial condition and results.

The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Shareholders and investors are cautioned not to unduly rely on such forward-looking statements when evaluating the information presented in the Company's filings and reports.

Such risks and uncertainties include, among other things, the following risks including those described in more detail below:

- Changes in the financial condition or corporate strategy of the Company's tenants;
- Business conditions and the general economy;
- The availability of debt and equity capital with favorable terms and conditions;
- The ability of the Company to invest its capital in quality properties on a timely basis;
- The federal, state and local regulatory environment; and
- The ability of the Company to maintain its qualification as a REIT.

Item 1. Business

The Company

Healthcare Realty Trust Incorporated ("Healthcare Realty" or the "Company") was incorporated in Maryland in 1993 and is a self-managed and self-administered real estate investment trust ("REIT") that integrates owning, acquiring, managing and developing income-producing real estate properties and mortgages associated with the delivery of healthcare services throughout the United States.

The Company acquires existing healthcare facilities and provides property management, leasing and construction projects for qualified healthcare operators. As of September 30, 2005, the Company had investments of approximately \$1.9 billion in 246 income-producing real estate properties and mortgages associated with the delivery of healthcare services throughout the United States. At September 30, 2005, the Company's owned real estate portfolio contained approximately 12.5 million square feet and was comprised of six major facility types located in 27 states. Also, the Company's mortgage portfolio was comprised of two major facility types, containing approximately 400,000 square feet. At September 30, 2005, the Company provided property management services for 142 healthcare-related properties nationwide, totaling approximately 7.6 million square feet. The Company intends to maintain a portfolio of properties that are focused predominantly on the outpatient services and medical office segments of the healthcare industry and are diversified by tenant, geographic location and facility type.

The Company is one of the largest fully-integrated real estate companies focused on income-producing real estate properties related to the delivery of healthcare services and is one of the largest healthcare REITs focused primarily on medical office buildings and outpatient facilities.

Healthcare Realty's strategy is to be a full-service provider of integrated real estate solutions to quality healthcare providers. Consistent with this strategy, the Company seeks to provide a broad spectrum of services needed to own, acquire, manage and develop healthcare properties, including: leasing, construction, property management, market research, tenant coordination and financial services.

The Company acquires income-producing real estate properties associated with a diverse group of quality healthcare providers in markets where the respective healthcare provider maintains a strong presence. Management believes that the Company has a strategic advantage in providing its services to a more diverse group of healthcare providers because the Company is not affiliated with any healthcare provider and does not expect to be affiliated with any healthcare provider.

Management believes that diversification reduces the Company's potential exposure to unsuccessful healthcare service strategies and to a concentration of credit with any one healthcare provider. Only one healthcare provider (HealthSouth at 11%) accounted for more than 10% of the Company's revenues during the year ended December 31, 2004.

As of September 30, 2005, approximately 56% of the Company's real estate investments consist of properties leased to unaffiliated lessees pursuant to long-term net master lease agreements or financial support agreements. Approximately 44% are multi-tenanted properties with occupancy leases, but without other financial support agreements. The Company's master leases and financial support agreements are generally designed to ensure the continuity of revenues and coverage of costs and expenses relating to the properties by the tenants and the sponsoring healthcare operators. The Company's recent medical office real estate acquisitions have not had master lease or financial support arrangements with the health systems on whose campuses the acquired properties are located. Rather, the income from such investments is derived solely from rents paid by the occupying tenant which include physician practices and hospital outpatient operations under leases of varying terms. While such arrangements do not provide the Company with the ability to seek recourse from a healthcare sponsor, they generally allow the Company to manage rents more profitably. The Company expects this trend to continue.

As of September 30, 2005, the weighted average remaining lease term pursuant to the long-term master lease and financial support agreements was approximately 6.3 years, with expiration dates through 2022.

Base rent or support payments under master leases or financial support agreements vary by agreement taking into consideration various factors, including the credit of the property lessee, the healthcare operator, and the operating performance, location, and physical condition of the property. Many of the property agreements contain provisions for additional rent or support payment increases. The existence and nature of provisions for additional payments in any given agreement relate to, among other factors, the financial strength of the respective property lessee, the healthcare operator, or both, as well as other lease terms.

The Company focuses predominantly on outpatient healthcare facilities, which are designed to provide medical services outside of traditional inpatient hospital settings. Management believes the outpatient services segment of the healthcare industry provides the most cost-effective delivery setting and, because of increasing cost pressures, along with technological advances and a heightened focus on preventive medicine, this segment of the healthcare-related real estate market offers the greatest potential for future growth. The Company also invests in properties associated with the senior living and nursing home industries.

Construction projects require the Company to provide funding to build facilities on property owned or leased by the Company. In most construction transactions, the Company acts as developer and owner and has approval authority with regard to plans, specifications, budgets and time schedules for the completion of the construction of the property.

The Company operates so as to qualify as a REIT for federal income tax purposes. If so qualified, with limited exceptions, the Company will not be subject to corporate federal income tax with respect to net income distributed to its shareholders. See "Federal Income Tax Information" below.

Purchase Options

A number of the Company's properties are subject to options in favor of the operator to purchase the properties for the amount of the Company's investment. Completion of the purchase is contingent upon the operator having access to funding and certain other matters covered by the applicable contracts. Though purchases have historically been infrequent, the Company sold ten senior living properties to an operator in 2005 for approximately \$71.0 million, including the repayment of certain receivables. The ten properties covered by the purchase options exercised by this operator comprise approximately \$74.9 million (\$61.2 million, net) of the Company's real estate properties and accounted for approximately 3.5% of the Company's revenues for the year ended December 31, 2004. The Company recognized a gain of approximately \$6.1 million in the first quarter of 2005 from the sale of nine of the properties and recognized a gain of approximately \$1.2 million from the sale of the tenth property in the second quarter of 2005.

Also, on April 20, 2005, another senior living operator purchased five properties it leased from the Company producing net sale proceeds to the Company totaling approximately \$53.2 million, including the repayment of certain receivables. The five properties covered by the purchase options exercised by this operator comprise approximately \$50.3 million (\$42.1 million, net) of the Company's real estate assets and accounted for approximately 2.5% of the Company's revenues for the year ended December 31, 2004. The Company recognized a gain of approximately \$0.2 million from the sale of the five properties.

As of September 30, 2005, the Company has reinvested all of the proceeds from the two purchase transactions discussed in the preceding paragraphs by acquiring approximately \$128.9 million of new properties and mortgages.

On September 29, 2005, a sponsor under a property operating agreement gave notice to the Company of its intent to purchase three properties under property operating agreements with the Company with a target closing date in December 2005. The three properties covered by the purchase options exercised by this operator comprise approximately \$9.7 million (\$8.2 million, net) of the Company's real estate properties and accounted for approximately 0.6% of the Company's revenues for the year ended December 31, 2004. The Company expects to recognize a gain from the sale of these properties.

On November 15, 2005, a lessee gave notice to the Company of its intent to purchase, during the second quarter of 2006, a medical office building it leases from the Company under a master lease agreement. Based on the master lease agreement, the lessee's purchase price will be equal to the fair market value of the property, to be determined by an appraisal process specified in the master lease. The property comprised approximately \$16.4 million (\$13.8 million, net) of the Company's real estate properties at December 31, 2004 and accounted for approximately 1.1% of the Company's revenues for the year ended December 31, 2004. The Company believes it will recognize a gain on the transaction.

The exercise of the purchase options above is largely a function of the historically low interest rate environment. In each case, the operator or sponsor was able to replace higher rate lease or support obligations to the Company with lower rate mortgage debt. The Company cannot predict whether additional purchase options will be exercised, but the Company has not received notice of exercise of any other purchase options through November 15, 2005.

Acquisitions and Dispositions during the Fourth Quarter of 2004 and the First Three Quarters of 2005

During the fourth quarter of 2004, the Company sold a 69,200 square foot physician clinic in Florida for \$5.0 million, converted a \$1.6 million mortgage note into full equity ownership of a skilled nursing facility in Michigan, and a \$18.8 million mortgage note receivable was repaid in full.

During the first quarter of 2005, the Company invested in three mortgages totaling \$50.4 million. The mortgages are secured by two groups of skilled nursing facilities and a group of assisted living facilities. Also, during the first quarter of 2005, a senior living operator purchased nine of the ten properties it leased from the Company producing net proceeds to the Company totaling \$58.9 million, including the repayment of certain receivables. These nine properties covered by the purchase options exercised by this operator

comprised approximately \$62.5 million (\$50.8 million, net) of the Company's real estate properties. The Company recognized a gain of approximately \$6.1 million from the sale of these nine properties. Finally, the Company sold a comprehensive ambulatory care center in Florida for net proceeds totaling \$4.8 million. The Company recognized an impairment charge related to the sale of approximately \$25,000. The proceeds received by the Company from the property dispositions were used to fund the three mortgage investments made during the quarter.

During the second quarter of 2005, the Company acquired seven senior living properties in Tennessee and South Carolina totaling \$45.3 million; invested \$11.1 million in a joint venture related to three medical office buildings in Washington; and invested in a \$10.8 million mortgage secured by leasehold interests in a group of assisted living facilities. Also, during the second quarter, as discussed in Purchase Options above, a senior living operator exercised its remaining purchase option on 10 properties it leased from the Company by purchasing the tenth property for net proceeds to the Company of \$12.1 million, including the repayment of certain receivables. This property comprised approximately \$12.4 million (\$10.4 million, net) of the Company's real estate properties as of December 31, 2004. The Company recognized a gain of approximately \$1.2 million from the sale of this property. Also, as discussed in Purchase Options above, a second senior living operator exercised its purchase options on five properties it leased from the Company producing net proceeds to the Company totaling \$53.2 million, including the repayment of certain receivables. The five properties covered by the purchase comprised approximately \$50.3 million (\$42.1 million, net) of the Company's real estate properties as of December 31, 2004. The Company recognized a gain of approximately \$0.2 million from the sale of the five properties. Finally, during the second quarter of 2005, a \$2.9 million mortgage note receivable secured by an assisted living facility in South Carolina was repaid in full, a 19,000 square foot comprehensive ambulatory care center in Florida was sold for \$1.9 million, and the Company sold a land parcel in Texas for \$2.0 million.

During the third quarter of 2005, the Company acquired an assisted living facility in Florida for \$11.2 million. Also, a \$1.3 million mortgage note receivable secured by a physician clinic in Florida was repaid in full.

Contractual Obligations

As of December 31, 2004, the Company had long-term contractual obligations of approximately \$1.4 billion. For a more detailed description of these contractual obligations, see "Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources — Contractual Obligations," included elsewhere in this report on Form 10-K. As of September 30, 2005, there have been no significant changes in the amount of the Company's contractual obligations.

Mortgage Notes Receivable Portfolio

As of December 31, 2004, the Company's mortgage notes receivable portfolio totaled \$40.3 million. Approximately 65% of the mortgage notes receivable were secured by assisted living facilities, 32% were secured by skilled nursing facilities, and 3% are secured by a medical office building.

As of September 30, 2005, the Company's mortgage notes receivable portfolio totaled \$95.6 million. Approximately 58% of the mortgage notes receivable were secured by assisted living facilities and 42% were secured by skilled nursing facilities. The increase in mortgage investments between December 31, 2004 and September 30, 2005 occurred as a result of the Company's reinvestment of proceeds from properties sold pursuant to purchase options in the first and second quarters of 2005.

As of December 31, 2004, the weighted average maturity of the mortgage notes receivable portfolio was approximately 4.4 years, with maturity dates through 2013. Interest rates ranged from 8.75% to 11.7% and are generally adjustable each year to reflect increases in the Consumer Price Index.

As of September 30, 2005, the weighted average maturity of the mortgage notes receivable portfolio was approximately 3.3 years, with maturity dates through 2013, and interest rates ranging from 9.54% to 12.69%.

Competition

The Company competes for property acquisitions with private investors, healthcare providers, other healthcare-related REITs, real estate partnerships, and financial institutions, among others. The Company also competes for the construction of new healthcare facilities. The business of acquiring and constructing new healthcare facilities is highly competitive and is subject to price, construction and operating costs, and other competitive pressures.

The financial performance of all of the Company's properties is subject to competition from similar properties. Certain operators of other properties may have capital resources in excess of those of the Company or the operators of the Company's properties. In addition, the extent to which the Company's properties are utilized depends upon several factors, including the number of physicians using the healthcare facilities or referring patients there, competitive systems of healthcare delivery, and the area's population, size and composition. Private, federal and state payment programs and other laws and regulations may also have a significant effect on the utilization of the properties. Virtually all of the Company's properties operate in a competitive environment, and patients and referral sources, including physicians, may change their preferences for a healthcare facility from time to time.

Government Regulation

The investments made by the Company are with active participants in the healthcare industry. The healthcare industry continues to face rising costs in the delivery of healthcare services, increased competition for patients, a growing population of uninsured patients and higher bad debt expense, constant evaluation of reimbursement levels by private and governmental payors, and scrutiny by federal and state legislative and administrative authorities, thus presenting the industry and its individual participants with uncertainty. The Company believes that these uncertainties present opportunities for the Company to assist in providing solutions to some of these pressures; however, these various changes can affect the economic performance of some or all of its tenants and clients. The Company cannot predict the degree to which these changes may affect the economic performance of the Company, positively or negatively.

The facilities owned by the Company and the manner in which they are operated are affected by changes in the reimbursement, licensing and certification policies of federal, state and local governments. Facilities may also be affected by changes in accreditation standards or procedures of accrediting agencies that are recognized by governments in the certification process. In addition, expansion (including the addition of new beds or services or acquisition of medical equipment) and occasionally the discontinuation of services of healthcare facilities are, in some states, subjected to state regulatory approval through "certificate of need" laws and regulations.

Although the Company is not a healthcare provider or in a position to influence the referral of patients or ordering of services reimbursable by the federal government, its leases and subleases must be negotiated at arm's length for fair market value rental rates. To the extent that a healthcare facility leases space from the Company and, in turn, subleases space to physicians or other referral sources at less than fair market rental rate, the Anti-Kickback Statute (a provision of the Social Security Act addressing illegal remuneration) and the Stark Law (the federal physician self-referral law) could be implicated. The Company's leases require the lessees to covenant that they will comply with all applicable laws.

A significant portion of the revenue of healthcare providers is derived from government reimbursement programs, such as the federal Medicare program and the joint federal and state Medicaid program. Although lease payments to the Company are not directly affected by the level of government reimbursement, to the extent that changes in these programs adversely affect healthcare providers, such changes could have an impact on their ability to make lease payments to the Company. The Medicare program is highly regulated and subject to frequent evaluation and change. Fundamental changes in the

Medicare program (including the implementation of a prospective payment system for hospital inpatient, hospital outpatient, inpatient rehabilitation and skilled nursing services in which facilities are reimbursed generally a flat or fixed amount based on the classification system for the service provided) have resulted in a challenging operating environment for healthcare providers. Despite changes in Medicare reimbursement and other regulatory requirements from year to year, the Company expects healthcare providers to continue to adjust to new operating challenges, as they have in the past, by developing stronger standards and modifying their strategies for profitable operations and growth.

Considerable uncertainties surround the future growth of payment levels under government reimbursement programs. Medicaid growth rates have been lowered in some states with budgetary concerns, and the policy for federal contributions to states may undergo reform in 2006 with Congress currently looking to reduce federal Medicaid spending growth. The Medicare Modernization Act of 2003 set positive increases in annual Medicare reimbursement rates for healthcare providers through 2007. However, Congress may amend this policy if pressured to curb high rates of growth in Medicare spending (versus GDP growth), and if the Medicare operating margins of healthcare providers are deemed high enough to absorb a lower rate of growth.

While conjecture has risen regarding the pressure to implement Medicare savings to ease the federal budget deficit, the Company believes that historical data shows no direct correlation between high federal budget deficits and lower rates of Medicare reimbursement growth. Rather, Medicare spending growth seems to be more closely related to hospital profit margins. The highest increases in Medicare spending have occurred in years of low hospital profit margins, which have also happened to be years of high federal deficits. The Company believes that there could be a reversion back to smaller increases, which would allow significant savings while still providing increases in Medicare funding for healthcare providers. It is possible that future payment rates will not be sufficient to cover cost increases in providing services to patients. Reductions in the growth of government payments could have an adverse impact on healthcare providers financial condition and, therefore, could adversely affect the ability of providers to make rental payments.

Loss by a facility of its ability to participate in government-sponsored programs because of licensing, certification or accreditation deficiencies or because of program exclusion resulting from violations of law would have material adverse effects on facility revenues.

Legislative Developments

Each year, legislative proposals are introduced in Congress and in some state legislatures that would effect significant change in the delivery of healthcare services, either nationally or at the state level, if implemented. Among the proposals under consideration are cost controls on state and federal Medicaid reimbursements, healthcare provider cost-containment and quality-control initiatives by public and private payors, refinements to Medicare payment rates and the expiration of certain temporary Medicare add-on reimbursements for skilled nursing facilities, heightened restrictions on admissions to inpatient rehabilitation facilities, a permanent moratorium on physician ownership of new specialty hospitals, healthcare coverage for the uninsured, increased scrutiny of medical errors, implementation of the prescription drug benefit for Medicare recipients, tax credits for Health Savings Accounts, re-importation of pharmaceutical drugs, improvements in healthcare information technology, and limits on damages claimed in physician malpractice lawsuits. The Company cannot predict whether any proposals will be adopted or, if adopted, what effect, if any, such proposals would have on the Company's business.

Environmental Matters

Under various federal, state and local environmental laws, ordinances and regulations, an owner of real property (such as the Company) may be liable for the costs of removal or remediation of certain hazardous or toxic substances at, under or disposed of in connection with such property, as well as certain other potential costs relating to hazardous or toxic substances (including government fines and injuries to persons and adjacent property). Most, if not all, of these laws, ordinances and regulations contain stringent

enforcement provisions including, but not limited to, the authority to impose substantial administrative, civil and criminal fines and penalties upon violators. Such laws often impose liability without regard to whether the owner knew of, or was responsible for, the presence or disposal of such substances and may be imposed on the owner in connection with the activities of an operator of the property. The cost of any required remediation, removal, fines or personal or property damages and the owner's liability therefore could exceed the value of the property and/or the aggregate assets of the owner. In addition, the presence of such substances, or the failure to properly dispose of or remediate such substances, may adversely affect the owner's ability to sell or lease such property or to borrow using such property as collateral.

A property can also be negatively impacted either through physical contamination or by virtue of an adverse effect on value, from contamination that has or may have emanated from other properties. Certain of the properties owned by the Company or managed or developed by its property management subsidiary are adjacent to or near properties that contain underground storage tanks or that have released petroleum products or other hazardous or toxic materials into the soils or groundwater.

Operations of the properties owned, developed or managed by the Company are and will continue to be subject to numerous federal, state, and local environmental laws, ordinances and regulations, including those relating to the following: the generation, segregation, handling, packaging and disposal of medical wastes; air quality requirements related to operations of generators, incineration devices, or sterilization equipment; facility siting and construction; disposal of non-medical wastes and ash from incinerators; and underground storage tanks. Certain properties owned, developed or managed by the Company contain, and others may contain or at one time may have contained, underground storage tanks that are or were used to store waste oils, petroleum products or other hazardous substances. Such underground storage tanks can be the source of releases of hazardous or toxic materials. Operations of nuclear medicine departments at some properties also involve the use and handling, and subsequent disposal of, radioactive isotopes and similar materials, activities which are closely regulated by the Nuclear Regulatory Commission and state regulatory agencies. In addition, several of the properties were built during the period asbestos was commonly used in building construction and other such facilities may be acquired by the Company in the future. The presence of such materials could result in significant costs in the event that any asbestos-containing materials requiring immediate removal and/or encapsulation are located in or on any facilities or in the event of any future renovation activities.

The Company has had limited environmental site assessments conducted on substantially all of the properties currently owned. These site assessments are limited in scope and provide only an evaluation of potential environmental conditions associated with the property, not compliance assessments of ongoing operations. The Company is not aware of any environmental condition or liability that management believes would have a material adverse effect on the Company's financial position, earnings, expenditures or continuing operations. While it is the Company's policy to seek indemnification relating to environmental liabilities or conditions, even where sale and purchase agreements do contain such provisions there can be no assurances that the seller will be able to fulfill its indemnification obligations. In addition, the terms of the Company's leases or financial support agreements do not give the Company control over the operational activities of its lessees or healthcare operators, nor will the Company monitor the lessees or healthcare operators with respect to environmental matters.

Insurance

Under their leases, the Company's tenants are required to maintain, at their expense, certain insurance coverages relating to their operations at the leased facilities. In addition, the Company maintains appropriate liability and casualty insurance on its assets and operations. The Company has also obtained title insurance with respect to each of the properties it owns, insuring that the Company holds title to each of the properties free and clear of all liens and encumbrances except those approved by the Company. In the opinion of management of the Company, each of the properties owned by the Company is adequately covered by hazard, liability and business interruption rent insurance.

Employees

As of September 30, 2005, the Company employed 214 people. The employees are not members of any labor union, and the Company considers its relations with its employees to be excellent.

Federal Income Tax Information

The Company is and intends to remain qualified as a REIT under the Internal Revenue Code of 1986, as amended (the "Code"). As a REIT, the Company's net income will be exempt from federal taxation to the extent that it is distributed as dividends to shareholders. Distributions to the Company's shareholders generally will be includable in their income; however, dividends distributed that are in excess of current and/or accumulated earnings and profits will be treated for tax purposes as a return of capital to the extent of a shareholder's basis and will reduce the basis of the shareholder's shares.

Introduction

The Company is qualified and intends to remain qualified as a REIT for federal income tax purposes under Sections 856 through 860 of the Code. The following discussion addresses the material tax considerations relevant to the taxation of the Company and summarizes certain federal income tax consequences that may be relevant to certain shareholders. However, the actual tax consequences of holding particular securities issued by the Company may vary in light of a securities holder's particular facts and circumstances. Certain holders, such as tax-exempt entities, insurance companies and financial institutions, are generally subject to special rules. In addition, the following discussion does not address issues under any foreign, state or local tax laws. The tax treatment of a holder of any of the securities issued by the Company will vary depending upon the terms of the specific securities acquired by such holder, as well as the holder's particular situation, and this discussion does not attempt to address aspects of federal income taxation relating to holders of particular securities of the Company. This summary is qualified in its entirety by the applicable Code provisions, rules and regulations promulgated thereunder, and administrative and judicial interpretations thereof. The Code, rules, regulations, and administrative and judicial interpretations are all subject to change at any time (possibly on a retroactive basis).

The Company is organized and is operating in conformity with the requirements for qualification and taxation as a REIT and intends to continue operating so as to enable it to continue to meet the requirements for qualification and taxation as a REIT under the Code. The Company's qualification and taxation as a REIT depend upon its ability to meet, through actual annual operating results, the various income, asset, distribution, stock ownership and other tests discussed below. Accordingly, the Company cannot guarantee that the actual results of operations for any one taxable year will satisfy such requirements.

If the Company were to cease to qualify as a REIT, and the statutory relief provisions were found not to apply, the Company's income that it distributed to shareholders would be subject to the "double taxation" on earnings (once at the corporate level and again at the shareholder level) that generally results from an investment in the equity securities of a corporation. However, the distributions would then qualify for the reduced dividend rates created by the Jobs and Growth Tax Relief Reconciliation Act of 2003. Failure to maintain qualification as a REIT would force the Company to significantly reduce its distributions and possibly incur substantial indebtedness or liquidate substantial investments in order to pay the resulting corporate taxes. In addition, the Company, once having obtained REIT status and having thereafter lost such status, would not be eligible to reelect REIT status for the four subsequent taxable years, unless its failure to maintain its qualification was due to reasonable cause and not willful neglect and certain other requirements were satisfied. In order to elect again to be taxed as a REIT, just as with its original election, the Company would be required to distribute all of its earnings and profits accumulated in any non-REIT taxable year.

Taxation of the Company

As long as the Company remains qualified to be taxed as a REIT, it generally will not be subject to federal income taxes on that portion of its ordinary income or capital gain that is currently distributed to shareholders.

However, the Company will be subject to federal income tax as follows:

- The Company will be taxed at regular corporate rates on any undistributed "real estate investment trust taxable income," including undistributed net capital gains.
- Under certain circumstances, the Company may be subject to the "alternative minimum tax" on its items of tax preference, if any.
- If the Company has (i) net income from the sale or other disposition of "foreclosure property" that is held primarily for sale to customers in the ordinary course of business, or (ii) other non-qualifying income from foreclosure property, it will be subject to tax on such income at the highest regular corporate rate.
- Any net income that the Company has from prohibited transactions (which are, in general, certain sales or other dispositions of property, other than foreclosure property, held primarily for sale to customers in the ordinary course of business) will be subject to a 100% tax.
- If the Company should fail to satisfy either the 75% or 95% gross income test (as discussed below), and has nonetheless maintained its qualification as a REIT because certain other requirements have been met, it will be subject to a percentage tax calculated by the ratio of REIT taxable income to gross income with certain adjustments multiplied by the gross income attributable to the greater of the amount by which the Company fails the 75% or 95% gross income test.
- If the Company fails to distribute during each year at least the sum of (i) 85% of its REIT ordinary income for such year, (ii) 95% of its REIT capital gain net income for such year, and (iii) any undistributed taxable income from preceding periods, then the Company will be subject to a 4% excise tax on the excess of such required distribution over the amounts actually distributed.
- To the extent that the Company recognizes gain from the disposition of an asset with respect to which there existed "built-in gain" upon its acquisition by the Company from a C corporation in a carry-over basis transaction and such disposition occurs within a maximum ten-year recognition period beginning on the date on which it was acquired by the Company, the Company will be subject to federal income tax at the highest regular corporate rate on the amount of its "net recognized built-in gain."
- To the extent that the Company has net income from a taxable REIT subsidiary ("TRS"), the TRS will be subject to federal corporate income tax in much the same manner as other non-REIT C corporations, with the exceptions that the deductions for interest expense on debt and rental payments made by the TRS to the Company will be limited and a 100% excise tax may be imposed on transactions between the TRS and the Company or the Company's tenants that are not conducted on an arm's length basis. A TRS is a corporation in which a REIT owns stock, directly or indirectly, and for which both the REIT and the corporation have made TRS elections.

Requirements for Qualification as a REIT

To qualify as a REIT for a taxable year, the Company must have no earnings and profits accumulated in any non-REIT year. The Company also must elect or have in effect an election to be taxed as a REIT and must meet other requirements, some of which are summarized below, including percentage tests relating to the sources of its gross income, the nature of the Company's assets and the distribution of its income to shareholders. Such election, if properly made and assuming continuing compliance with the qualification tests described herein, will continue in effect for subsequent years.

Organizational Requirements and Share Ownership Tests

Section 856(a) of the Code defines a REIT as a corporation, trust or association:

- (1) that is managed by one or more trustees or directors;
- (2) the beneficial ownership of which is evidenced by transferable shares or by transferable certificates of beneficial interest;
- (3) that would be taxable, but for Sections 856 through 860 of the Code, as a domestic corporation;
- (4) that is neither a financial institution nor an insurance company subject to certain provisions of the Code;
- (5) the beneficial ownership of which is held by 100 or more persons, determined without reference to any rules of attribution (the "share ownership test");
- (6) that during the last half of each taxable year not more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by five or fewer individuals (as defined in the Code to include certain entities) (the "five or fewer test"); and
- (7) that meets certain other tests, described below, regarding the nature of its income and assets.

Section 856(b) of the Code provides that conditions (1) through (4), inclusive, must be met during the entire taxable year and that condition (5) must be met during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of fewer than 12 months. The five or fewer test and the share ownership test do not apply to the first taxable year for which an election is made to be treated as a REIT.

The Company is also required to request annually (within 30 days after the close of its taxable year) from record holders of specified percentages of its shares written information regarding the ownership of such shares. A list of shareholders failing to fully comply with the demand for the written statements is required to be maintained as part of the Company's records required under the Code. Rather than responding to the Company, the Code allows the shareholder to submit such statement to the IRS with the shareholder's tax return.

The Company has issued shares to a sufficient number of people to allow it to satisfy the share ownership test and the five or fewer test. In addition, to assist in complying with the five or fewer test, the Company's Articles of Incorporation contain provisions restricting share transfers where the transferee (other than specified individuals involved in the formation of the Company, members of their families and certain affiliates, and certain other exceptions) would, after such transfer, own (a) more than 9.9% either in number or value of the outstanding common stock of the Company or (b) more than 9.9% either in number or value of any outstanding preferred stock of the Company. Pension plans and certain other tax-exempt entities have different restrictions on ownership. If, despite this prohibition, stock is acquired increasing a transferee's ownership to over 9.9% in value of either the outstanding common stock or any preferred stock of the Company, the stock in excess of this 9.9% in value is deemed to be held in trust for transfer at a price that does not exceed what the purported transferee paid for the stock, and, while held in trust, the stock is not entitled to receive dividends or to vote. In addition, under these circumstances, the Company also has the right to redeem such stock.

For purposes of determining whether the five or fewer test (but not the share ownership test) is met, any stock held by a qualified trust (generally, pension plans, profit-sharing plans and other employee retirement trusts) is, generally, treated as held directly by the trust's beneficiaries in proportion to their actuarial interests in the trust and not as held by the trust.

Income Tests

In order to maintain qualification as a REIT, two gross income requirements must be satisfied annually.

- First, at least 75% of the Company's gross income (excluding gross income from certain sales of property held as inventory or primarily for sale in the ordinary course of business) must be derived from "rents from real property;" "interest on obligations secured by mortgages on real property or on interests in real property;" gain (excluding gross income from certain sales of property held as inventory or primarily for sale in the ordinary course of business) from the sale or other disposition of, and certain other gross income related to, real property (including interests in real property and in mortgages on real property); and income received or accrued within one year of the Company's receipt of, and attributable to the temporary investment of, "new capital" (any amount received in exchange for stock other than through a dividend reinvestment plan or in a public offering of debt obligations having maturities of at least five years).
- Second, at least 95% of the Company's gross income (excluding gross income from certain sales of property held as inventory or primarily for sale in the ordinary course of business) must be derived from dividends; interest; "rents from real property;" gain (excluding gross income from certain sales of property held as inventory or primarily for sale in the ordinary course of business) from the sale or other disposition of, and certain other gross income related to, real property (including interests in real property and in mortgages on real property); and gain from the sale or other disposition of stock and securities.

The Company may temporarily invest its working capital in short-term investments. Although the Company will use its best efforts to ensure that income generated by these investments will be of a type that satisfies the 75% and 95% gross income tests, there can be no assurance in this regard (see the discussion above of the "new capital" rule under the 75% gross income test).

For an amount received or accrued to qualify for purposes of an applicable gross income test as "rents from real property" or "interest on obligations secured by mortgages on real property or on interests in real property," the determination of such amount must not depend in whole or in part on the income or profits derived by any person from such property (except that such amount may be based on a fixed percentage or percentages of receipts or sales). In addition, for an amount received or accrued to qualify as "rents from real property," such amount may not be received or accrued directly or indirectly from a person in which the Company owns directly or indirectly 10% or more of, in the case of a corporation, the total voting power of all voting stock or the total value of all stock, and, in the case of an unincorporated entity, the assets or net profits of such entity (except for certain amounts received or accrued from a TRS in connection with property substantially rented to persons other than TRS of the Company and other 10%-or-more owned persons). The Company leases and intends to lease property only under circumstances such that substantially all, if not all, rents from such property qualify as "rents from real property." Although it is possible that a tenant could sublease space to a sublessee in which the Company is deemed to own directly or indirectly 10% or more of the tenant, the Company believes that as a result of the provisions of the Company's Articles of Incorporation that limit ownership to 9.9%, such occurrence would be unlikely. Application of the 10% ownership rule is, however, dependent upon complex attribution rules provided in the Code and circumstances beyond the control of the Company. Ownership, directly or by attribution, by an unaffiliated third party of more than 10% of the Company's stock and more than 10% of the stock of any tenant or subtenant would result in a violation of the rule.

In addition, the Company must not manage its properties or furnish or render services to the tenants of its properties, except through an independent contractor from whom the Company derives no income unless (i) the Company is performing services that are usually or customarily furnished or rendered in connection with the rental of space for occupancy only and the services are of the sort that a tax-exempt organization could perform without being considered in receipt of unrelated business taxable income or (ii) the income earned by the Company for other services furnished or rendered by the Company to tenants of a property or for the management or operation of the property does not exceed a de minimis

threshold generally equal to 1% of the income from such property. The Company self-manages some of its properties, but does not believe it provides services to tenants that are outside the exception. Should the Company want to provide additional services other than through an independent contractor, it could use a TRS entity and not jeopardize its REIT status.

If rent attributable to personal property leased in connection with a lease of real property is greater than 15% of the total rent received under the lease, then the portion of rent attributable to such personal property will not qualify as "rents from real property." Generally, this 15% test is applied separately to each lease. The portion of rental income treated as attributable to personal property is determined according to the ratio of the fair market value of the personal property to the total fair market value of the property that is rented. The determination of what fixtures and other property constitute personal property for federal tax purposes is difficult and imprecise. The Company does not have 15% by value of any of its properties classified as personal property. If, however, rent payments do not qualify, for reasons discussed above, as rents from real property for purposes of Section 856 of the Code, it will be more difficult for the Company to meet the 95% and 75% gross income tests and continue to qualify as a REIT.

The Company is and expects to continue performing third-party management and development services. If the gross income to the Company from this or any other activity producing disqualified income for purposes of the 95% or 75% gross income tests approaches a level that could potentially cause the Company to fail to satisfy these tests, the Company intends to take such corrective action as may be necessary to avoid failing to satisfy the 95% or 75% gross income tests.

If the Company were to fail to satisfy one or both of the 75% or 95% gross income tests for any taxable year, it may nevertheless qualify as a REIT for such year if it is entitled to relief under certain provisions of the Code. These relief provisions would generally be available if (i) the Company's failure to meet such test or tests was due to reasonable cause and not to willful neglect and (ii) following its identification of its failure to meet these tests, the Company files a description of each item of income that fails to meet these tests in a schedule in accordance with Treasury Regulations. It is not possible, however, to know whether the Company would be entitled to the benefit of these relief provisions since the application of the relief provisions is dependent on future facts and circumstances. If these provisions were to apply, the Company would be subjected to tax equal to a percentage tax calculated by the ratio of REIT taxable income to gross income with certain adjustments multiplied by the gross income attributable to the greater of the amount by which the Company failed either of the 75% or the 95% gross income tests.

Asset Tests

At the close of each quarter of its taxable year, the Company must also satisfy four tests relating to the nature of its assets.

- At least 75% of the value of the Company's total assets must consist of real estate assets (including interests in real property and interests in mortgages on real property as well as its allocable share of real estate assets held by joint ventures or partnerships in which the Company participates), cash, cash items and government securities.
- Not more than 25% of the Company's total assets may be represented by securities other than those includable in the 75% asset class.
- Not more than 20% of the Company's total assets may be represented by securities of one or more TRS.
- Of the investments included in the 25% asset class, except for TRS, (i) the value of any one issuer's securities owned by the Company may not exceed 5% of the value of the Company's total assets, (ii) the Company may not own more than 10% of any one issuer's outstanding voting securities and (iii) the Company may not hold securities having a value of more than 10% of the total value of the outstanding securities of any one issuer. Securities issued by affiliated qualified REIT subsidiaries ("QRS"), which are corporations wholly owned by the Company, either directly

or indirectly, that are not TRS, are not subject to the 25% of total assets limit, the 5% of total assets limit or the 10% of a single issuer's voting securities limit or the 10% of a single issuer's value limit. Additionally, "straight debt" and certain other exceptions are not "securities" for purposes of the 10% of a single issuer's value test. The existence of QRS are ignored, and the assets, income, gain, loss and other attributes of the QRS are treated as being owned or generated by the Company, for federal income tax purposes. The Company currently has 50 subsidiaries and other affiliates that it employs in the conduct of its business.

If the Company meets the 25% requirement at the close of any quarter, it will not lose its status as a REIT because of a change in value of its assets unless the discrepancy exists immediately after the acquisition of any security or other property that is wholly or partly the result of an acquisition during such quarter. Where a failure to satisfy the 25% asset test results from an acquisition of securities or other property during a quarter, the failure can be cured by disposition of sufficient nonqualifying assets within 30 days after the close of such quarter. The Company maintains adequate records of the value of its assets to maintain compliance with the 25% asset test and to take such action as may be required to cure any failure to satisfy the test within 30 days after the close of any quarter.

Distribution Requirement

In order to qualify as a REIT, the Company is required to distribute dividends (other than capital gain dividends) to its shareholders in an amount equal to or greater than the excess of (a) the sum of (i) 90% of the Company's "real estate investment trust taxable income" (computed without regard to the dividends paid deduction and the Company's net capital gain) and (ii) 90% of the net income (after tax on such income), if any, from foreclosure property, over (b) the sum of certain non-cash income (from certain imputed rental income and income from transactions inadvertently failing to qualify as like-kind exchanges). These requirements may be waived by the Internal Revenue Service ("IRS") if the Company establishes that it failed to meet them by reason of distributions previously made to meet the requirements of the 4% excise tax described below. To the extent that the Company does not distribute all of its net long-term capital gain and all of its "real estate investment trust taxable income," it will be subject to tax thereon. In addition, the Company will be subject to a 4% excise tax to the extent it fails within a calendar year to make "required distributions" to its shareholders of 85% of its ordinary income and 95% of its capital gain net income plus the excess, if any, of the "grossed up required distribution" for the preceding calendar year over the amount treated as distributed for such preceding calendar year. For this purpose, the term "grossed up required distribution" for any calendar year is the sum of the taxable income of the Company for the taxable year (without regard to the deduction for dividends paid) and all amounts from earlier years that are not treated as having been distributed under the provision. Dividends declared in the last quarter of the year and paid during the following January will be treated as having been paid and received on December 31 of such earlier year. The Company's distributions for 2004 were adequate to satisfy its distribution requirement.

It is possible that the Company, from time to time, may have insufficient cash or other liquid assets to meet the 90% distribution requirement due to timing differences between the actual receipt of income and the actual payment of deductible expenses or dividends on the one hand and the inclusion of such income and deduction of such expenses or dividends in arriving at "real estate investment trust taxable income" on the other hand. The problem of not having adequate cash to make required distributions could also occur as a result of the repayment in cash of principal amounts due on the Company's outstanding debt, particularly in the case of "balloon" repayments or as a result of capital losses on short-term investments of working capital. Therefore, the Company might find it necessary to arrange for short-term, or possibly long-term, borrowing or new equity financing. If the Company were unable to arrange such borrowing or financing as might be necessary to provide funds for required distributions, its REIT status could be jeopardized.

Under certain circumstances, the Company may be able to rectify a failure to meet the distribution requirement for a year by paying "deficiency dividends" to shareholders in a later year, which may be included in the Company's deduction for dividends paid for the earlier year. The Company may be able to

avoid being taxed on amounts distributed as deficiency dividends; however, the Company might in certain circumstances remain liable for the 4% excise tax described above.

Federal Income Tax Treatment of Leases

The availability to the Company of, among other things, depreciation deductions with respect to the facilities owned and leased by the Company depends upon the treatment of the Company as the owner of the facilities and the classification of the leases of the facilities as true leases, rather than as sales or financing arrangements, for federal income tax purposes. The Company has not requested nor has it received an opinion that it will be treated as the owner of the portion of the facilities constituting real property and that the leases will be treated as true leases of such real property for federal income tax purposes.

Other Issues

With respect to property acquired from and leased back to the same or an affiliated party, the IRS could assert that the Company realized prepaid rental income in the year of purchase to the extent that the value of the leased property exceeds the purchase price paid by the Company for that property. In litigated cases involving sale-leasebacks which have considered this issue, courts have concluded that buyers have realized prepaid rent where both parties acknowledged that the purported purchase price for the property was substantially less than fair market value and the purported rents were substantially less than the fair market rentals. Because of the lack of clear precedent and the inherently factual nature of the inquiry, the Company cannot give complete assurance that the IRS could not successfully assert the existence of prepaid rental income in such circumstances. The value of property and the fair market rent for properties involved in sale-leasebacks are inherently factual matters and always subject to challenge.

Additionally, it should be noted that Section 467 of the Code (concerning leases with increasing rents) may apply to those leases of the Company that provide for rents that increase from one period to the next. Section 467 provides that in the case of a so-called "disqualified leaseback agreement," rental income must be accrued at a constant rate. If such constant rent accrual is required, the Company would recognize rental income in excess of cash rents and, as a result, may fail to have adequate funds available to meet the 90% dividend distribution requirement. "Disqualified leaseback agreements" include leaseback transactions where a principal purpose of providing increasing rent under the agreement is the avoidance of federal income tax. Since the Section 467 regulations provide that rents will not be treated as increasing for tax avoidance purposes where the increases are based upon a fixed percentage of lessee receipts, additional rent provisions of leases containing such clauses should not result in these leases being disqualified leaseback agreements. In addition, the Section 467 regulations provide that leases providing for fluctuations in rents by no more than a reasonable percentage, which is 15% for long-term real property leases, from the average rent payable over the term of the lease will be deemed to not be motivated by tax avoidance. The Company does not believe it has rent subject to the disqualified leaseback provisions of Section 467.

Subject to a safe harbor exception for annual sales of up to seven properties (or properties with a basis of up to 10% of the REIT's assets) that have been held for at least four years, gain from sales of property held for sale to customers in the ordinary course of business is subject to a 100% tax. The simultaneous exercise of options to acquire leased property that may be granted to certain tenants or other events could result in sales of properties by the Company that exceed this safe harbor. However, the Company believes that in such event, it will not have held such properties for sale to customers in the ordinary course of business.

Depreciation of Properties

For federal income tax purposes, the Company's real property is being depreciated over 31.5, 39 or 40 years using the straight-line method of depreciation and its personal property over various periods utilizing accelerated and straight-line methods of depreciation.

Failure to Qualify as a REIT

If the Company were to fail to qualify for federal income tax purposes as a REIT in any taxable year, and the relief provisions were found not to apply, the Company would be subject to tax on its taxable income at regular corporate rates (plus any applicable alternative minimum tax). Distributions to shareholders in any year in which the Company failed to qualify would not be deductible by the Company nor would they be required to be made. In such event, to the extent of current and/or accumulated earnings and profits, all distributions to shareholders would be taxable as qualified dividend income, including, presumably, subject to the 15% maximum rate on dividends created by the Jobs and Growth Tax Relief Reconciliation Act of 2003, and, subject to certain limitations in the Code, eligible for the 70% dividends received deduction for corporations that are REIT shareholders. Unless entitled to relief under specific statutory provisions, the Company would also be disqualified from taxation as a REIT for the following four taxable years. It is not possible to state whether in all circumstances the Company would be entitled to statutory relief from such disqualification. Failure to qualify for even one year could result in the Company's incurring substantial indebtedness (to the extent borrowings were feasible) or liquidating substantial investments in order to pay the resulting taxes.

Taxation of Tax-Exempt Shareholders

The IRS has issued a revenue ruling in which it held that amounts distributed by a REIT to a tax-exempt employees' pension trust do not constitute "unrelated business taxable income," even though the REIT may have financed certain of its activities with acquisition indebtedness. Although revenue rulings are interpretive in nature and are subject to revocation or modification by the IRS, based upon the revenue ruling and the analysis therein, distributions made by the Company to a U.S. shareholder that is a tax-exempt entity (such as an individual retirement account ("IRA") or a 401(k) plan) should not constitute unrelated business taxable income unless such tax-exempt U.S. shareholder has financed the acquisition of its shares with "acquisition indebtedness" within the meaning of the Code, or the shares are otherwise used in an unrelated trade or business conducted by such U.S. shareholder.

Special rules apply to certain tax-exempt pension funds (including 401(k) plans but excluding IRAs or government pension plans) that own more than 10% (measured by value) of a "pension-held REIT." Such a pension fund may be required to treat a certain percentage of all dividends received from the REIT during the year as unrelated business taxable income. The percentage is equal to the ratio of the REIT's gross income (less direct expenses related thereto) derived from the conduct of unrelated trades or businesses determined as if the REIT were a tax-exempt pension fund (including income from activities financed with "acquisition indebtedness"), to the REIT's gross income (less direct expenses related thereto) from all sources. The special rules will not require a pension fund to recharacterize a portion of its dividends as unrelated business taxable income unless the percentage computed is at least 5%.

A REIT will be treated as a "pension-held REIT" if the REIT is predominantly held by tax-exempt pension funds and if the REIT would otherwise fail to satisfy the five or fewer test discussed above. A REIT is predominantly held by tax-exempt pension funds if at least one tax-exempt pension fund holds more than 25% (measured by value) of the REIT's stock or beneficial interests, or if one or more tax-exempt pension funds (each of which owns more than 10% (measured by value) of the REIT's stock or beneficial interests) own in the aggregate more than 50% (measured by value) of the REIT's stock or beneficial interests. The Company believes that it will not be treated as a pension-held REIT. However, because the shares of the Company will be publicly traded, no assurance can be given that the Company is not or will not become a pension-held REIT.

Taxation of Non-U.S. Shareholders

The rules governing United States federal income taxation of any person other than (i) a citizen or resident of the United States, (ii) a corporation or partnership created in the United States or under the laws of the United States or of any state thereof, (iii) an estate whose income is includable in income for U.S. federal income tax purposes regardless of its source or (iv) a trust if a court within the United States

is able to exercise primary supervision over the administration of the trust and one or more United States fiduciaries have the authority to control all substantial decisions of the trust ("Non-U.S. Shareholders") are highly complex, and the following discussion is intended only as a summary of such rules. Prospective Non-U.S. Shareholders should consult with their own tax advisors to determine the impact of United States federal, state, and local income tax laws on an investment in stock of the Company, including any reporting requirements.

In general, Non-U.S. Shareholders are subject to regular United States income tax with respect to their investment in stock of the Company in the same manner as a U.S. shareholder if such investment is "effectively connected" with the Non-U.S. Shareholder's conduct of a trade or business in the United States. A corporate Non-U.S. Shareholder that receives income with respect to its investment in stock of the Company that is (or is treated as) effectively connected with the conduct of a trade or business in the United States also may be subject to the 30% branch profits tax imposed by the Code, which is payable in addition to regular United States corporate income tax. The following discussion addresses only the United States taxation of Non-U.S. Shareholders whose investment in stock of the Company is not effectively connected with the conduct of a trade or business in the United States.

Ordinary Dividends

Distributions made by the Company that are not attributable to gain from the sale or exchange by the Company of United States real property interests and that are not designated by the Company as capital gain dividends will be treated as ordinary income dividends to the extent made out of current or accumulated earnings and profits of the Company. Generally, such ordinary income dividends will be subject to United States withholding tax at the rate of 30% on the gross amount of the dividend paid unless reduced or eliminated by an applicable United States income tax treaty. The Company expects to withhold United States income tax at the rate of 30% on the gross amount of any such dividends paid to a Non-U.S. Shareholder unless a lower treaty rate applies and the Non-U.S. Shareholder has filed an IRS Form W-8BEN with the Company, certifying the Non-U.S. Shareholder's entitlement to treaty benefits.

Non-Dividend Distributions

Distributions made by the Company in excess of its current and accumulated earnings and profits to a Non-U.S. Shareholder who holds 5% or less of the stock of the Company (after application of certain ownership rules) will not be subject to U.S. income or withholding tax. If it cannot be determined at the time a distribution is made whether or not such distribution will be in excess of the Company's current and accumulated earnings and profits, the distribution will be subject to withholding at the rate applicable to a dividend distribution. However, the Non-U.S. Shareholder may seek a refund from the IRS of any amount withheld if it is subsequently determined that such distribution was, in fact, in excess of the Company's then current and accumulated earnings and profits.

Capital Gain Dividends

As long as the Company continues to qualify as a REIT, distributions made by the Company after December 31, 2004, that are attributable to gain from the sale or exchange by the Company of any United States real property interests ("USRPI") will not be treated as effectively connected with the conduct of a trade or business in the United States. Instead, such distributions will be treated as REIT dividends that are not capital gains and will not be subject to the branch profits tax as long as the Non-U.S. Shareholder does not hold greater than 5% of the stock of the Company at any time during the taxable year in which the distribution is received. Non-U.S. Shareholders who hold more than 5% of the stock of the Company will be treated as if such gains were effectively connected with the conduct of a trade or business in the United States and generally subject to the same capital gains rates applicable to U.S. Shareholders. In addition, corporate Non-U.S. Shareholders may also be subject to the 30% branch profits tax and to withholding at the rate of 35% of the gross distribution.

Disposition of Stock of the Company

Gain recognized by a Non-U.S. Shareholder upon the sale or exchange of stock of the Company generally will not be subject to United States taxation unless such stock constitutes a USRPI within the meaning of the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). The stock of the Company will not constitute a USRPI so long as the Company is a "domestically controlled REIT." A "domestically controlled REIT" is a REIT in which at all times during a specified testing period less than 50% in value of its stock or beneficial interests are held directly or indirectly by Non-U.S. Shareholders. The Company believes that it will be a "domestically controlled REIT," and therefore that the sale of stock of the Company will not be subject to taxation under FIRPTA. However, because the stock of the Company is publicly traded, no assurance can be given that the Company is or will continue to be a "domestically controlled REIT."

If the Company did not constitute a "domestically controlled REIT," gain arising from the sale or exchange by a Non-U.S. Shareholder of stock of the Company would be subject to United States taxation under FIRPTA as a sale of a USRPI unless (i) the stock of the Company is "regularly traded" (as defined in the applicable Treasury regulations) and (ii) the selling Non-U.S. Shareholder's interest (after application of certain constructive ownership rules) in the Company is 5% or less at all times during the five years preceding the sale or exchange. If gain on the sale or exchange of the stock of the Company were subject to taxation under FIRPTA, the Non-U.S. Shareholder would be subject to regular United States income tax with respect to such gain in the same manner as a U.S. Shareholder (subject to any applicable alternative minimum tax, a special alternative minimum tax in the case of nonresident alien individuals and the possible application of the 30% branch profits tax in the case of foreign corporations), and the purchaser of the stock of the Company (including the Company) would be required to withhold and remit to the IRS 10% of the purchase price. Additionally, in such case, distributions on the stock of the Company to the extent they represent a return of capital or capital gain from the sale of the stock of the Company, rather than dividends, would be subject to a 10% withholding tax.

Capital gains not subject to FIRPTA will nonetheless be taxable in the United States to a Non-U.S. Shareholder in two cases:

- if the Non-U.S. Shareholder's investment in the stock of the Company is effectively connected with a U.S. trade or business conducted by such Non-U.S. Shareholder, the Non-U.S. Shareholder will be subject to the same treatment as a U.S. shareholder with respect to such gain, or
- if the Non-U.S. Shareholder is a nonresident alien individual who was present in the United States for 183 days or more during the taxable year and has a "tax home" in the United States, the nonresident alien individual will be subject to a 30% tax on the individual's capital gain.

Information Reporting Requirements and Backup Withholding Tax

The Company will report to its U.S. shareholders and to the IRS the amount of dividends paid during each calendar year and the amount of tax withheld, if any, with respect thereto. Under the backup withholding rules, a U.S. shareholder may be subject to backup withholding, currently at a rate of 28% on dividends paid unless such U.S. shareholder

- is a corporation or falls within certain other exempt categories and, when required, can demonstrate this fact, or
- provides a taxpayer identification number, certifies as to no loss of exemption from backup withholding, and otherwise complies with applicable requirements of the backup withholding rules. A U.S. shareholder who does not provide the Company with his correct taxpayer identification number also may be subject to penalties imposed by the IRS. Any amount paid as backup withholding will be creditable against the U.S. shareholder's federal income tax liability. In addition, the Company may be required to withhold a portion of any capital gain distributions made to U.S. shareholders who fail to certify their non-foreign status to the Company.

Additional issues may arise pertaining to information reporting and backup withholding with respect to Non-U.S. Shareholders, and Non-U.S. Shareholders should consult their tax advisors with respect to any such information reporting and backup withholding requirements.

State and Local Taxes

The Company and its shareholders may be subject to state or local taxation in various state or local jurisdictions, including those in which it or they transact business or reside. The state and local tax treatment of the Company and its shareholders may not conform to the federal income tax consequences discussed above. Consequently, prospective holders should consult their own tax advisors regarding the effect of state and local tax laws on an investment in the stock of the Company.

Real Estate Investment Trust Tax Proposals

Investors must recognize that the present federal income tax treatment of the Company may be modified by future legislative, judicial or administrative actions or decisions at any time, which may be retroactive in effect, and, as a result, any such action or decision may affect investments and commitments previously made. The rules dealing with federal income taxation are constantly under review by persons involved in the legislative process and by the IRS and the Treasury Department, resulting in statutory changes as well as promulgation of new, or revisions to existing, regulations and revised interpretations of established concepts. No prediction can be made as to the likelihood as to passage of any new tax legislation or other provisions either directly or indirectly affecting the Company or its shareholders.

Other Tax Proposals and Legislation

On May 28, 2003, President Bush signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003. This tax legislation reduces the maximum individual tax rate for long-term capital gains generally from 20% to 15% (for sales occurring after May 6, 2003 through December 31, 2008) and for dividends generally from 38.6% to 15% (for tax years from 2003 through 2008). Without future congressional action, the maximum tax rate on long-term capital gains will return to 20% in 2009, and the maximum rate on dividends will move to 35% in 2009 and 39.6% in 2011. Because a REIT is not generally subject to federal income tax on the portion of its REIT taxable income or capital gains distributed to its shareholders, distributions of dividends by a REIT are generally not eligible for the new 15% tax rate on dividends. As a result the Company's ordinary REIT dividends will continue to be taxed at the higher tax rates (currently, a maximum of 35%) applicable to ordinary income.

Additionally, the American Jobs Creation Act of 2004 was signed into law on October 22, 2004. The most significant changes affecting REITs provide for additional safe harbors and tests should a REIT determine that it is not in compliance with certain REIT qualification requirements. These changes make it easier for a REIT to maintain REIT status should there be any current qualification issues as of a specific test date.

ERISA Considerations

The following is a summary of material considerations arising under ERISA and the prohibited transaction provisions of Section 4975 of the Code that may be relevant to a holder of stock of the Company. This discussion does not propose to deal with all aspects of ERISA or Section 4975 of the Code or, to the extent not preempted, state law that may be relevant to particular employee benefit plan shareholders (including plans subject to Title I of ERISA, other employee benefit plans and IRAs subject to the prohibited transaction provisions of Section 4975 of the Code, and governmental plans and church plans that are exempt from ERISA and Section 4975 of the Code but that may be subject to state law requirements) in light of their particular circumstances.

A fiduciary making the decision to invest in stock of the Company on behalf of a prospective purchaser which is an ERISA plan, a tax-qualified retirement plan, an IRA or other employee benefit plan is advised to consult its own legal advisor regarding the specific considerations arising under ERISA,

Section 4975 of the Code, and (to the extent not preempted) state law with respect to the purchase, ownership or sale of stock by such plan or IRA.

Employee Benefit Plans, Tax-Qualified Retirement Plans and IRAs

Each fiduciary of an employee benefit plan subject to Title I of ERISA (an "ERISA Plan") should carefully consider whether an investment in stock of the Company is consistent with its fiduciary responsibilities under ERISA. In particular, the fiduciary requirements of Part 4 of Title I of ERISA require (i) an ERISA Plan's investments to be prudent and in the best interests of the ERISA Plan, its participants and beneficiaries, (ii) an ERISA Plan's investments to be diversified in order to reduce the risk of large losses, unless it is clearly prudent not to do so, (iii) an ERISA Plan's investments to be authorized under ERISA and the terms of the governing documents of the ERISA Plan and (iv) that the fiduciary not cause the ERISA Plan to enter into transactions prohibited under Section 406 of ERISA. In determining whether an investment in stock of the Company is prudent for purposes of ERISA, the appropriate fiduciary of an ERISA Plan should consider all of the facts and circumstances, including whether the investment is reasonably designed, as a part of the ERISA Plan's portfolio for which the fiduciary has investment responsibility, to meet the objectives of the ERISA Plan, taking into consideration the risk of loss and opportunity for gain (or other return) from the investment, the diversification, cash flow and funding requirements of the ERISA Plan and the liquidity and current return of the ERISA Plan's portfolio. A fiduciary should also take into account the nature of the Company's business, the length of the Company's operating history and other matters described below under "Risk Factors."

The fiduciary of an IRA or of an employee benefit plan not subject to Title I of ERISA because it is a governmental or church plan or because it does not cover common law employees (a "Non-ERISA Plan") should consider that such an IRA or Non-ERISA Plan may only make investments that are authorized by the appropriate governing documents, not prohibited under Section 4975 of the Code and permitted under applicable state law.

Status of the Company under ERISA

A prohibited transaction may occur if the assets of the Company are deemed to be assets of the investing Plans and "parties in interest" or "disqualified persons" as defined in ERISA and Section 4975 of the Code, respectively, deal with such assets. In certain circumstances where a Plan holds an interest in an entity, the assets of the entity are deemed to be Plan assets (the "look-through rule"). Under such circumstances, any person that exercises authority or control with respect to the management or disposition of such assets is a Plan fiduciary. Plan assets are not defined in ERISA or the Code, but the United States Department of Labor issued regulations in 1987 (the "Regulations") that outline the circumstances under which a Plan's interest in an entity will be subject to the look-through rule.

The Regulations apply only to the purchase by a Plan of an "equity interest" in an entity, such as common stock or common shares of beneficial interest of a REIT. However, the Regulations provide an exception to the look-through rule for equity interests that are "publicly-offered securities."

Under the Regulations, a "publicly-offered security" is a security that is (i) freely transferable, (ii) part of a class of securities that is widely-held and (iii) either (a) part of a class of securities that is registered under section 12(b) or 12(g) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), or (b) sold to a Plan as part of an offering of securities to the public pursuant to an effective registration statement under the Securities Act and the class of securities of which such security is a part is registered under the Exchange Act within 120 days (or such longer period allowed by the Securities and Exchange Commission) after the end of the fiscal year of the issuer during which the offering of such securities to the public occurred. Whether a security is considered "freely transferable" depends on the facts and circumstances of each case. Generally, if the security is part of an offering in which the minimum investment is \$10,000 or less, any restriction on or prohibition against any transfer or assignment of such security for the purposes of preventing a termination or reclassification of the entity for

federal or state tax purposes will not of itself prevent the security from being considered freely transferable. A class of securities is considered "widely-held" if it is a class of securities that is owned by 100 or more investors independent of the issuer and of one another.

The Company believes that the stock of the Company will meet the criteria of the publicly-offered securities exception to the look-through rule in that the stock of the Company is freely transferable, the minimum investment is less than \$10,000 and the only restrictions upon its transfer are those required under federal income tax laws to maintain the Company's status as a REIT. Second, stock of the Company is held by 100 or more investors and at least 100 or more of these investors are independent of the Company and of one another. Third, the stock of the Company has been and will be part of offerings of securities to the public pursuant to an effective registration statement under the Securities Act and will be registered under the Exchange Act within 120 days after the end of the fiscal year of the Company during which an offering of such securities to the public occurs. Accordingly, the Company believes that if a Plan purchases stock of the Company, the Company's assets should not be deemed to be Plan assets and, therefore, that any person who exercises authority or control with respect to the Company's assets should not be treated as a Plan fiduciary for purposes of the prohibited transaction rules of ERISA and Section 4975 of the Code.

Available Information

The Company makes available to the public free of charge through its internet website the Company's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after the Company electronically files such reports with, or furnishes such reports to, the Securities and Exchange Commission. The Company's internet website address is <http://www.healthcarerealty.com>.

The public may read and copy any materials that the Company files with the SEC at the SEC's Public Reference Room located at 450 Fifth Street NW, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains electronic versions of the Company's reports on its website at www.sec.gov.

Corporate Governance Guidelines

The Company has adopted Corporate Governance Guidelines. The Corporate Governance Guidelines are posted on the Company's website (www.healthcarerealty.com) and are available in print to any shareholder who requests a copy.

Committee Charters

The Board of Directors has an Audit Committee, Compensation Committee and Corporate Governance Committee. The Board of Directors has adopted written charters for each committee, which are posted on the Company's website (www.healthcarerealty.com) and are available in print to any shareholder who requests a copy.

Risk Factors

The following are some of the risks and uncertainties that could cause the Company's actual financial condition, results of operations, business and prospects to differ materially from those contemplated by the forward-looking statements contained in this report or the Company's other filings with the SEC. If any of the following risks actually occurred, the Company's business, financial condition and operating results could suffer, and the trading price of its common stock could decline.

At times, the Company may have excess cash. A delay in investing cash available to it in suitable properties could adversely affect the Company's future revenues and its ability to maintain or increase dividends to shareholders; there is considerable competition in the Company's market for attractive investments.

From time to time, the Company will have cash available from various sources, including (1) the proceeds of sales of shares of its securities, (2) principal payments on its mortgage investments, and (3) the sale of its properties, including non-elective dispositions under the terms of master leases or similar financial support arrangements. The Company must invest these proceeds, on a timely basis and at comparable yields, in other healthcare investments or in qualified short-term investments. The Company competes for real estate investments with a broad variety of potential investors. This competition for investments may negatively affect the Company's ability to make timely investments on acceptable terms. While funds are unused for property investments, they are invested in short-term obligations which have been at historically low yields. Accordingly, delays in utilizing excess cash to acquire properties will negatively impact revenues and perhaps the Company's ability to maintain or increase its distributions to shareholders.

At other times, the Company may have limited access to capital, which will slow the Company's growth.

A REIT is required to make dividend distributions and retains little capital for growth. As a result, a REIT is required to grow through the steady investment of new capital in real estate assets. Presently, the Company has sufficient capital availability. However, there will be times when the Company will have limited access to capital from the equity and/or debt markets. During such periods, virtually all of the Company's available capital will be required to meet existing commitments and to reduce existing debt. The Company may not be able to obtain additional equity or debt capital or dispose of assets on favorable terms, if at all, at the time it requires additional capital to acquire healthcare properties on a competitive basis or to meet its obligations.

A failure to maintain the Company's dividend could reduce the market price of its stock.

The ability of the Company to pay dividends is dependent upon its ability to maintain funds from operations and cash flow and to make accretive new investments. In addition, the Company is subject to financial covenant restrictions with its lenders that limit dividend payments as a percentage of FFO. The Company, though historically having increased the dividend each quarter, decided to maintain the quarterly dividend for the third quarter of 2005 at the same level as the previous quarter. There can be no assurance that the Company will be able to resume its practice of increasing quarterly dividends or that it will be able to maintain dividend payments.

If the Company fails to maintain an effective system of internal control over financial reporting, it may not be able to accurately or timely report its financial results.

Management of the Company determined that internal control over financial reporting was ineffective as of December 31, 2004, because material weaknesses in the Company's system of internal control over financial reporting existed as of such date. While the Company has taken remedial measures to correct these material weaknesses (which measures are more fully described in Item 9A of this report), the Company can give no assurance that it will not have material weaknesses or significant deficiencies in its internal control over financial reporting in the future. The Company cannot be sure the remedial measures it has taken will ensure that the Company maintains adequate controls over its financial reporting processes in the future. An ineffective control environment, if not remediated, could result in a misstatement of the Company's financial statements that could cause a delay in periodic filings with the SEC and such delay could cause a violation of debt covenants.

Adverse trends in the healthcare service industry may negatively affect the Company's lease revenues and the values of its investments.

The healthcare service industry is currently experiencing:

- Changing trends in the method of delivery of healthcare services;
- Competition among healthcare providers for patients;
- Increased expense for uninsured patients;
- Increased liability insurance expense;
- Continuing pressure by private and governmental payors to contain costs and reimbursements; and
- Increased scrutiny and formal investigations by federal and state authorities.

These changes can adversely affect the economic performance of some or all of the tenants and sponsors who provide financial support to the Company's investments and, in turn, negatively affect the lease revenues and the value of the Company's property investments.

If a healthcare tenant lost its licensure or certification, the Company would have to obtain another provider for the affected facility.

If the Company could not attract another healthcare provider on a timely basis or on acceptable terms, the Company's revenues would suffer. In addition, many of the Company's properties are special-purpose facilities that may not be easily adaptable to uses unrelated to healthcare. Transfers of operations of healthcare facilities are often subject to regulatory approvals not required for transfers of other types of commercial operations and real estate.

The Company owns facilities that are operated by companies that have experienced regulatory and legal problems.

The Company's tenants and sponsors are subject to a complex system of federal and state regulations relating to the delivery of healthcare services. If a tenant or sponsor experiences regulatory or legal problems, the Company could be at risk for amounts owed to it by the tenant under leases or financial support agreements.

The United States Department of Justice and Securities and Exchange Commission have accused HealthSouth Corporation and several of its former officers of overstating earnings and assets included in HealthSouth's financial statements. The Company owns 27 facilities that are affiliated with HealthSouth, of which 16 are multi-tenanted and master leased, nine are inpatient rehabilitation facilities and two are multi-tenanted facilities in which HealthSouth is a tenant providing surgery, diagnostic and related services. As of September 30, 2005, HealthSouth occupied approximately 643,000 square feet of the Company's inpatient rehabilitation facilities and 105,000 square feet of medical office/outpatient facilities, or 6% of the Company's total square footage. Approximately 11% and 10% of the Company's revenues, including revenues from discontinued operations, for the year ended December 31, 2004 and the nine months ended September 30, 2005, respectively, were received from HealthSouth.

Tenet Healthcare Corporation and its subsidiaries are subject to several federal and state civil and criminal enforcement actions and several related civil lawsuits. These claims involve allegations against Tenet and several of its hospitals of illegal kickbacks to induce referrals to the hospitals, improper Medicare coding practices, including on Medicare cost reports non-reimbursable costs related to physicians' practices, physician recruiting, improper outlier payments, and inflating charges for medical services, pharmaceutical supplies and prescription drugs. The Company owns 12 facilities that are operated by Tenet, of which five are master leased, six are subject to financial support agreements whereby Tenet guarantees the Company a certain return on its investments, and one is a multi-tenanted facility in which Tenet is a tenant. As of December 31, 2004, Tenet occupied approximately 96,000 square feet of medical office and outpatient facilities, or 0.8% of the Company's total square footage. Approximately 8% and 7%

of the Company's revenues, including revenues from discontinued operations, for the year ended December 31, 2004 and the nine months ended September 30, 2005, respectively, were received from Tenet.

The Company has received all material amounts due from both HealthSouth and Tenet and has received no indication from either company that it will be unable to continue paying amounts owed to the Company under its current leases and financial support agreements, but the Company can give no assurance that receipt of such amounts will continue.

Failure to maintain its status as a REIT, even in one taxable year, could cause the Company to reduce its dividends dramatically.

The Company intends to qualify at all times as a REIT under the Code. If in any taxable year the Company does not qualify as a REIT, it would be taxed as a corporation. As a result, the Company could not deduct its distributions to the shareholders in computing its taxable income. Depending upon the circumstances, a REIT that loses its qualification in one year may not be eligible to re-qualify during the four succeeding years. Further, certain transactions or other events could lead to the Company being taxed at rates ranging from four to 100 percent on certain income or gains.

Item 2. Properties

In addition to the properties described under Item 1, "Business" and in Schedule III of Item 15 hereto, the Company leases its headquarters office space.

The Company's headquarters, located in offices at 3310 West End Avenue in Nashville, Tennessee, are leased from an unrelated third party. The Company's current lease agreement, which commenced on November 1, 2003, covers approximately 24,969 square feet of rented space and expires on October 31, 2010, with two five-year renewal options. Annual base rent was approximately \$451,900 in 2004 and increases approximately 3.25% annually. Effective September 1, 2004, the lease agreement was amended to include the addition of 5,965 square feet of rented space. The amendment contains the same expiration and option terms as the original lease agreement. Total base rent related to the amendment in 2004 was approximately \$40,000, is approximately \$111,500 for 2005 and is increased approximately 3.25% annually thereafter.

Item 3. Legal Proceedings

On October 9, 2003, HR Acquisition I Corporation (f/k/a Capstone Capital Corporation, "Capstone"), a wholly-owned affiliate of the Company, was served with the Third Amended Verified Complaint in a shareholder derivative suit which was originally filed on August 28, 2002 in the Jefferson County, Alabama Circuit Court by a shareholder of HealthSouth Corporation. The allegations in the suit relate to activities which occurred before the Company acquired Capstone in 1998. The suit alleges that certain officers and directors of HealthSouth, who were also officers and directors of Capstone, sold real estate properties from HealthSouth to Capstone and then leased the properties back to HealthSouth at artificially high values, in violation of their fiduciary obligations to HealthSouth. The Company acquired Capstone in a merger transaction in October, 1998. None of the Capstone officers and directors remained in his or her position following the Company's acquisition of Capstone. The complaint seeks an accounting and disgorgement of monies obtained by the allegedly wrongful conduct and other unspecified compensatory and punitive damages. There is currently a stay on discovery in the case that is expected to be in effect through the remainder of 2005. The Company will defend itself vigorously and believes that the claims brought by the plaintiff are not meritorious.

The Company is not aware of any other pending or threatened litigation that, if resolved against the Company, would have a material adverse effect on the Company's financial condition or results of operations.

Item 4. Submission of Matters to a Vote of Securityholders

No matter was submitted to a vote of shareholders during the fourth quarter of 2004 or during the first three quarters of 2005.

PART II**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Shares of the Company's Common Stock are traded on The New York Stock Exchange under the symbol "HR." As of September 30, 2005, there were approximately 1,945 shareholders of record. The following table sets forth the high and low sales prices per common share and the distributions declared per common share in the periods indicated.

	<u>High</u>	<u>Low</u>	<u>Distributions Declared per Share</u>
2005			
First Quarter	\$41.03	\$35.25	\$0.650
Second Quarter	39.91	35.83	0.655
Third Quarter	41.36	37.36	0.660
Fourth Quarter (through November 11, 2005)	40.19	36.30	0.660
2004			
First Quarter	\$43.15	\$35.16	\$0.630
Second Quarter	44.03	32.45	0.635
Third Quarter	40.03	35.47	0.640
Fourth Quarter	42.11	38.40	0.645
2003			
First Quarter	\$29.93	\$22.96	\$0.610
Second Quarter	31.24	24.42	0.615
Third Quarter	33.00	29.17	0.620
Fourth Quarter	36.74	31.86	0.625

The dividend policy is reviewed each quarter by the Board of Directors. Future distributions will be declared and paid at the discretion of the Board of Directors and will depend upon cash generated by operating activities, the Company's financial condition, relevant financing instruments, capital requirements, annual distribution requirements under the REIT provisions of the Code and such other factors as the Board of Directors deems relevant.

Equity Compensation Plan Information

The following table provides information about the Company's Common Stock that may be issued upon grants of restricted stock and the exercise of options, warrants and rights under all of the Company's existing compensation plans as of September 30, 2005, including the 2003 Employees Restricted Stock

Incentive Plan, the 2000 Employee Stock Purchase Plan, the 1994 Dividend Reinvestment Plan, and the 1995 Restricted Stock Plan for Non-Employee Directors.

<u>Plan Category</u>	<u>Number of Securities to Be Issued upon Exercise of Outstanding Options, Warrants and Rights(1)</u>	<u>Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights(1)</u>	<u>Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in the First Column)</u>
Equity compensation plans approved by security holders	219,992	—	1,336,267(2)
Equity compensation plans not approved by security holders	<u>0</u>	—	<u>2,032,075(3)</u>
Total	<u>219,992</u>	—	<u>3,368,342</u>

- (1) The Company is unable to ascertain with specificity the number of securities to be issued upon exercise of outstanding rights under the 2000 Employee Stock Purchase Plan or the weighted average exercise price of outstanding rights under that plan. The 2000 Employee Stock Purchase Plan provides that shares of Common Stock may be purchased at a per share price equal to 85% of the fair market value of the Common Stock at the beginning of the offering period or a purchase date applicable to such offering period, whichever is lower.
- (2) Includes securities available for future issuance under the 2000 Employee Stock Purchase Plan, the 1994 Dividend Reinvestment Plan, and the 1995 Restricted Stock Plan for Non-Employee Directors.
- (3) Includes securities available for future issuance under the 2003 Employees Restricted Stock Incentive Plan.

All of the Company's equity compensation plans were approved by the shareholders, except the 2003 Employees Restricted Stock Incentive Plan, which provides for awards of restricted shares of the Company's Common Stock to full-time salaried employees of the Company or its subsidiaries and affiliates on such terms and conditions, and subject to such restrictions, as the Compensation Committee may determine. Such conditions may be based on continuing employment or achievement of pre-established financial objectives or both. The 2003 plan covers a fixed number of shares and terminates on December 1, 2012. Subject to the risk of forfeiture and transfer restrictions, eligible employees shall have all rights as shareholders with respect to the shares issued pursuant to the plan, including the right to vote and receive dividends or other distributions on such shares. For employees under employment agreements, upon certain merger, change in control, or liquidation events involving the Company, all shares covered by outstanding awards under the plan will immediately vest, unless provisions are made in connection with such transaction for the continuance of the plan. Moreover, all shares covered by outstanding awards to employees under employment agreements will immediately vest if a participant's employment with the Company is terminated without cause or, in the case of the Company's executive officers, upon that officer's retirement.

Item 6. Selected Financial Data

SELECTED FINANCIAL INFORMATION

The following table sets forth financial information for the Company, which is derived from the Consolidated Financial Statements of the Company (dollars in thousands, except per share data):

	Years Ended December 31,				
	2004(1)	2003(1)	2002(1)	2001(1)	2000(1)
	(Restated)	(Restated)	(Restated)	(Restated)	(Restated)
STATEMENT OF INCOME DATA:					
Total revenues	\$ 234,069	\$ 184,082	\$ 170,928	\$ 168,409	\$ 171,737
Interest expense	\$ 43,899	\$ 34,640	\$ 34,274	\$ 38,205	\$ 43,114
Income from continuing operations	\$ 49,750	\$ 52,713	\$ 47,048	\$ 59,663	\$ 61,683
Discontinued operations	\$ 5,783	\$ 7,689	\$ 15,335	\$ 14,676	\$ 13,879
Net income	\$ 55,533	\$ 60,402	\$ 62,383	\$ 74,339	\$ 75,562
Income from continuing operations per common share — Basic	\$ 1.14	\$ 1.28	\$ 1.02	\$ 1.33	\$ 1.39
Discontinued operations per common share — Basic	\$ 0.13	\$ 0.19	\$ 0.38	\$ 0.37	\$ 0.35
Net income per common share — Basic	\$ 1.27	\$ 1.47	\$ 1.40	\$ 1.70	\$ 1.74
Income from continuing operations per common share — Diluted	\$ 1.11	\$ 1.26	\$ 1.00	\$ 1.31	\$ 1.36
Discontinued operations per common share — Diluted	\$ 0.13	\$ 0.18	\$ 0.37	\$ 0.36	\$ 0.34
Net income per common share — Diluted	\$ 1.24	\$ 1.44	\$ 1.37	\$ 1.67	\$ 1.70
Weighted average common shares outstanding — Basic	43,706,528	41,142,619	40,701,516	39,849,734	39,540,752
Weighted average common shares outstanding — Diluted	44,627,475	41,840,188	41,487,780	40,608,681	40,648,371
BALANCE SHEET DATA (AS OF THE END OF THE PERIOD):					
Real estate properties, net	\$ 1,562,794	\$ 1,331,323	\$ 1,287,113	\$ 1,361,008	\$ 1,368,487
Assets held for sale	\$ 61,246	\$ 0	\$ 0	\$ 0	\$ 0
Total assets	\$ 1,750,810	\$ 1,501,802	\$ 1,473,806	\$ 1,546,931	\$ 1,583,326
Notes and bonds payable	\$ 719,264	\$ 590,281	\$ 545,063	\$ 505,222	\$ 536,781
Total stockholders' equity	\$ 980,616	\$ 876,130	\$ 891,452	\$ 1,002,609	\$ 1,003,618
OTHER DATA:					
Funds from operations — Basic(2)	\$ 110,172	\$ 103,716	\$ 94,261	\$ 106,513	\$ 107,966
Funds from operations — Diluted(2) ..	\$ 110,172	\$ 103,716	\$ 94,261	\$ 106,513	\$ 108,241
Funds from operations per common share — Basic(2)	\$ 2.52	\$ 2.52	\$ 2.32	\$ 2.67	\$ 2.73
Funds from operations per common share — Diluted(2)	\$ 2.47	\$ 2.48	\$ 2.27	\$ 2.62	\$ 2.66
Dividends declared and paid per common share	\$ 2.55	\$ 2.47	\$ 2.39	\$ 2.31	\$ 2.23

- (1) The Consolidated Financial Statements have been restated from the unaudited financial statements furnished on Form 8-K dated June 24, 2005. The Consolidated Financial Statements for years ended December 31, 2003, 2002, 2001, and 2000 were previously restated as disclosed in the unaudited financial statements furnished on Form 8-K dated June 24, 2005. See Note 2 to the Consolidated

Financial Statements for a detail of the restatement items. For the years ended December 31, 2004, 2003, 2002, 2001 and 2000, the restatements reduced (increased) income from continuing operations approximately (\$0.8) million, \$16.5 million, \$14.0 million, \$12.6 million and \$11.9 million, respectively; reduced (increased) net income approximately (\$0.8) million, \$10.1 million, \$7.7 million, \$5.6 million and \$4.2 million, respectively; and reduced (increased) net income per common share on a diluted basis approximately (\$0.01), \$0.25, \$0.18, \$0.14 and \$0.12, respectively.

- (2) See "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of Funds From Operations ("FFO"), including why the Company presents FFO and a reconciliation of FFO to net income.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

OVERVIEW

Business Overview

Healthcare Realty Trust Incorporated (the "Company") operates under the Internal Revenue Code of 1986, as amended (the "Code"), as an indefinite life real estate investment trust ("REIT"). The Company, a self-managed and self-administered REIT, integrates owning, managing and developing income-producing real estate properties and mortgages associated with the delivery of healthcare services throughout the United States. Management believes that by providing related real estate services, the Company can differentiate its competitive market position, expand its asset base and increase revenues over time.

Substantially all of the Company's revenues are derived from rentals on its healthcare real estate properties, from interest earned on mortgage loans, and from revenues from the consolidation of variable interest entities ("VIEs") related to the operations of six senior living facilities owned by the Company. See Note 1 to the Consolidated Financial Statements regarding these VIEs. The Company typically incurs operating and administrative expenses, including compensation expense, office rental and other related occupancy costs, as well as various expenses incurred in connection with managing the existing portfolio and acquiring additional properties. The Company also incurs interest expense on its various debt instruments and depreciation expense on its real estate portfolio.

Executive Overview

The Company continues to be well-positioned from a capital structure and liquidity viewpoint by maintaining a conservative debt-to-book capitalization ratio, by maintaining capacity on its unsecured credit facility due 2006 (\$9.0 million outstanding with \$248.0 million remaining capacity as of December 31, 2004 under its financial covenants), and by continuing to review and restructure maturities on its debt commitments (no significant repayments on long-term debt until the year 2011). As of September 30, 2005, the Company had \$49.0 million outstanding on its unsecured credit facility due 2006 and had borrowing capacity remaining, under its financial covenants, of \$179.0 million.

Since the Company's inception, it has been selective about the properties it acquires. Management believes that by selecting conservative, long-term investments with healthcare providers, the Company will enhance its prospects for long-term stability and maintenance of the dividend. The Company's portfolio, diversified by facility type, geography, and tenant concentration, helps mitigate its exposure to ever-changing economic conditions and tenant and sponsor credit risks.

In the current market for medical office buildings, management has seen low capitalization rates and minimally accretive investment returns. Historically low interest rates and highly leveraged financial buyers have increased competition for medical office properties at higher prices. Several health systems have offered large portfolios of properties for sale, seeking to capitalize on these higher prices. The properties acquired by the Company during 2004 were mainly medical office buildings, on or near hospital campuses, and were part of large portfolios subject to competitive pricing.

During 2004, the Company purchased approximately \$299.0 million of real estate assets, began operating two medical office buildings that were previously under construction, publicly issued \$300.0 million of 5.125% senior notes, and publicly issued 4,600,000 shares of Common Stock. While these activities positioned the Company very well from a liquidity and capital structure standpoint and developed and furthered relationships with healthcare systems, the combination of these 2004 activities will not have a significantly positive impact on funds from operations ("FFO") or FFO per share for 2005, largely because of the increased number of outstanding shares and the thin margin on medical office investments.

Though the Company is in discussions with healthcare systems on several development projects, its volume of acquisitions of existing medical office properties will not be as significant in 2005 as in 2004. Offerings of large medical office portfolios have declined in 2005 as a result of rising interest rates affecting sales pricing. With the acquisition and capital market activities consummated during 2004 and the reduced volume of acquisition activity in 2005, management anticipates very little, if any, growth in its FFO per share during 2005 from property acquisitions.

The Company, though historically having increased the dividend each quarter, decided to maintain the quarterly dividend for the third quarter of 2005 at the same level as the previous quarter. The Company will determine future dividend policy based upon cash generated by operating activities, the Company's financial condition, relevant financing instruments, capital requirements, annual distribution requirements under the REIT provisions of the Code, and other such factors deemed relevant.

The Company has concluded that previously issued financial statements should be restated. The restatement will have no impact on cash flows in future periods. The results of operations for the three years in the period ended December 31, 2004 have been restated from the unaudited financial statements furnished on Form 8-K dated June 24, 2005. The results for the years ended December 31, 2003 and 2002 had previously been restated as disclosed in the unaudited financial statements furnished on Form 8-K dated June 24, 2005. These restatements impacted net income as shown in the table below. See Note 2 to the Consolidated Financial Statements for a more detailed discussion of the restatement.

(Dollars in thousands)	Year Ended December 31,		
	2004(1)	2003(2)	2002(2)
Net income as previously reported	\$54,757	\$ 70,507	\$70,091
Restatement adjustments			
Restatement adjustments reported on Form 8-K dated June 24, 2005		(11,690)	(7,008)
Subsequent changes to restatement adjustments	776	1,585	(700)
Total Restatement adjustments	776	(10,105)	(7,708)
Net income, as restated	<u>\$55,533</u>	<u>\$ 60,402</u>	<u>\$62,383</u>

(1) As previously reported amounts represent amounts furnished on Form 8-K dated June 24, 2005.

(2) As previously reported amounts represent amounts reported in the financial statements previously filed in the 2003 Annual Report on Form 10-K.

TRENDS AND MATTERS IMPACTING OPERATING RESULTS

Management monitors factors and trends important to the Company and REIT industry in order to gauge the potential impact on the operations of the Company. Discussed below are some of the factors and trends that management believes may impact future operations of the Company.

Acquisitions

The Company acquired approximately \$299.0 million of real estate properties during 2004. The Company's volume of acquisitions for 2005, however, will not be as high as in 2004. As of September 30,

2005, the Company had invested in \$128.7 million of new properties or mortgages and had disposed of \$125.2 million of properties due to purchase options exercised.

Purchase Options Exercised Subsequent to Year End

On January 18, 2005, a senior living operator purchased nine of the ten properties it leased from the Company producing net sales proceeds to the Company totaling \$58.9 million, including the repayment of certain receivables, and purchased the tenth property in May 2005 producing net sales proceeds to the Company totaling \$12.1 million, including the repayment of certain receivables. The ten properties covered by the purchase options exercised by this operator comprise approximately \$74.9 million (\$61.2 million, net) of the Company's real estate properties and accounted for approximately 3.5% of the Company's revenues for the year ended December 31, 2004. The Company recognized a gain of approximately \$6.1 million in the first quarter of 2005 from the sale of the nine properties and recognized a gain of approximately \$1.2 million from the sale of the tenth property in the second quarter of 2005.

On April 20, 2005, a second senior living operator purchased five properties it leased from the Company producing net sales proceeds to the Company totaling \$53.2 million, including the repayment of certain receivables. The five properties covered by the purchase options exercised by this operator comprise approximately \$50.3 million (\$42.1 million, net) of the Company's real estate assets and accounted for approximately 2.5% of the Company's revenues for the year ended December 31, 2004. The Company recognized a gain of approximately \$0.2 million from the sale of the five properties.

As of September 30, 2005, the Company had reinvested all of the proceeds from these two purchases by acquiring approximately \$128.7 million of new properties or mortgages. However, since the proceeds were not reinvested immediately, net income for 2005 may be negatively impacted.

On September 29, 2005, a sponsor under a property operating agreement gave notice to the Company of its intent to purchase three properties under property operating agreements with the Company with a target closing date in December 2005. The three properties covered by the purchase options exercised by this operator comprise approximately \$9.7 million (\$8.2 million, net) of the Company's real estate properties and accounted for approximately 0.6% of the Company's revenues for the year ended December 31, 2004. The Company expects to recognize a gain from the sale of these properties.

On November 15, 2005, a lessee gave notice to the Company of its intent to purchase, during the second quarter of 2006, a medical office building it leases from the Company under a master lease agreement. Based on the master lease agreement, the lessee's purchase price will be equal to the fair market value of the property, to be determined by an appraisal process specified in the master lease. The property comprised approximately \$16.4 million (\$13.8 million, net) of the Company's real estate properties at December 31, 2004 and accounted for approximately 1.1% of the Company's revenues for the year ended December 31, 2004. The Company believes it will recognize a gain on the transaction.

The exercise of the purchase options noted above is largely a function of the historically low interest rate environment. In each case, the operator or sponsor who able to replace higher rate lease or support obligations to the Company with lower rate mortgage debt. The Company cannot predict whether additional purchase options will be exercised, but the Company has not received notice of exercise of any other purchase options through November 15, 2005.

Investment Trends

As of September 30, 2005, approximately 56% of the Company's real estate investments consisted of properties currently leased to unaffiliated lessees pursuant to long-term net lease agreements or subject to financial support agreements with the healthcare sponsors that provide guarantees of the return on the Company's investment in the properties. Approximately 44% are multi-tenanted properties with shorter-term occupancy leases, but without other financial support agreements. The Company's recent medical office real estate acquisitions have not included master lease or financial support arrangements with the health systems on whose campuses the acquired properties are located. The income from these recent

investments is derived solely from rents paid by the occupying tenants, which include physician practices and hospital operations. The Company expects future medical office investments to follow this trend, which the Company believes gives it greater opportunity to manage long-term revenue growth. In addition to its medical office investments, the Company also continues to see investment opportunities in the senior living sector of the healthcare industry. The Company may make additional acquisitions of senior living properties or invest in mortgage loans secured by senior living properties.

FAS 144, "Discontinued Operations"

As discussed in more detail in Note 2 to the Consolidated Financial Statements, Financial Accounting Standards Board Statement No. 144 ("FAS 144"), which has significantly impacted REITs, requires that the Company present all significant real estate disposals since December 31, 2001 as discontinued operations. As a result, each time the Company disposes of a significant real estate asset, the results of operations from that asset will be classified as discontinued operations for the current period, and all prior periods presented will be restated to conform to the current period presentation. As a result, readers of the Company's financial statements should be aware that each future disposal may result in a change to the presentation of the Company's operations in the historical statements of income as previously filed. Such income statement reclassifications will have no impact on previously reported net income.

FAS 141, "Business Combinations"

As discussed in Application of Critical Accounting Policies and in Note 1 to the Company's Consolidated Financial Statements, when a building is acquired with in-place leases, FAS 141 requires that the cost of the acquisition be allocated between the tangible real estate and the intangible assets related to in-place leases based on their fair values. Where appropriate, the intangible assets recorded could include goodwill or customer relationship assets. The value of above- or below-market in-place leases is amortized against rental income or property operating expense over the average remaining term of the in-place leases upon acquisition, which is typically a shorter period than the ordinary depreciation period for the building. The value of at-market in-place leases is amortized and reflected in amortization expense in the Company's Consolidated Statements of Income. For the buildings acquired in 2003 and 2004, the remaining lives of the in-place leases ranged from 8 to 101 months.

Variable Interest Entities

Included in the Company's Consolidated Financial Statements for the years ended December 31, 2003 and 2004 are the assets, liabilities and results of operations of variable interest entities ("VIEs") related to six senior living properties owned by the Company. The Company did not previously consolidate VIEs in its previously issued financial statements. Instead, the Company reported depreciation on the real estate assets, which are included on the Company's balance sheet, and reported rental income and interest income on the leases and notes receivable related to these assets, respectively. The assets, liabilities and results of operations of the VIEs, not previously identified or reported in previous filings to be VIEs by Company management, were not consolidated in the Company's Consolidated Financial Statements, and are part of the restatement (see Note 2 to the Consolidated Financial Statements).

Due to prior operator defaults, the Company placed new operators in the six senior living facilities during 2003 and 2004 and signed lease agreements with the new operators, in addition to loan agreements with one of the operators. The Company anticipated that the properties would not generate positive cash flows until the operations of the properties were stabilized. As such, both parties agreed that the Company would finance the estimated cash flow deficits, but in return would receive some or all of the economic benefits of the entities once the properties were stabilized and had positive cash flows. These arrangements created a "variable interest entity", as defined in FASB Interpretation 46R, and in those cases where the Company has subsequently determined that it is the primary beneficiary as defined by FASB Interpretation 46R, the Company is required to consolidate the VIE in its Consolidated Financial Statements. This generally means that the note receivable, if any, from the VIE on the books of the

Company, and the note payable, if any, to the Company on the books of the VIE, are eliminated in consolidation. Likewise, the interest income and rental income on the books of the Company is eliminated against the corresponding interest expense and rental expenses on the books of the VIE. What remains in the Consolidated Financial Statements of the Company are the results of operations of the VIE (the properties), which are now included in the Company's income statements in the lines other operating income and other operating expense, and the related assets and liabilities of the VIE entity, which are included on the Company's balance sheet.

If circumstances dictate, the structure of future transactions with operators may also create VIEs, resulting in consolidation of the entity's results of operations.

Impairment Charges

As required by Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("FAS 144"), the Company must assess the potential for impairment of our long-lived assets, including real estate properties, whenever events occur or a change in circumstances indicate that the net carrying value might not be fully recoverable. The Company recorded impairment charges of \$1.2 million, \$0, and \$0.3 million, respectively, for the years ended December 31, 2004, 2003 and 2002. The impairment charges in 2004 were recorded upon the disposition of real estate assets and included the write-off of non-cash straight-line rent receivables. The impairment charge in 2002 of \$0.3 million represents the difference between the net carrying value of \$0.5 million and the estimated fair value of \$0.2 million relating to a skilled nursing facility in Oklahoma, which the Company closed in 2002 and does not expect to reopen. In 2003, the SEC issued a statement that impairment charges could not be added back to net income in calculating FFO. As such, the \$1.2 million impairment charge recognized in 2004 related to the dispositions of real estate assets negatively impacted FFO. Impairment charges will be recognized from time to time and will negatively impact FFO.

FUNDS FROM OPERATIONS

FFO and FFO per share are operating performance measures adopted by the National Association of Real Estate Investment Trusts, Inc. ("NAREIT"). NAREIT defines FFO as the most commonly accepted and reported measure of a REIT's operating performance equal to "net income (computed in accordance with generally accepted accounting principles), excluding gains (or losses) from sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures."

Management believes FFO and FFO per share to be supplemental measures of a REIT's performance that provide an understanding of the operating performance of the Company's properties without giving effect to significant non-cash items, primarily depreciation of real estate. Management uses FFO and FFO per share to compare and evaluate its own operating results from period to period, and to monitor the operating results of the Company's peers in the REIT industry. The Company reports FFO and FFO per share because these measures are observed by management to also be the predominant measures used by the REIT industry and by industry analysts to evaluate REITs; because FFO per share is consistently and regularly reported, discussed, and compared by research analysts in their notes and publications about REITs; and finally, because research analysts publish their earnings estimates and consensus estimates for healthcare REITs only in terms of fully-diluted FFO per share and not in terms of net income or earnings per share. For these reasons, management has deemed it appropriate to disclose and discuss FFO and FFO per share.

However, FFO does not represent cash generated from operating activities determined in accordance with accounting principles generally accepted in the United States of America and is not necessarily indicative of cash available to fund cash needs. FFO should not be considered as an alternative to net income as an indicator of the Company's operating performance or as an alternative to cash flow from operating activities as a measure of liquidity.

FFO for the years ended December 31, 2004, 2003, and 2002 has been restated. The restatement, discussed further in Note 2 to the Consolidated Financial Statements, decreased (increased) FFO for the years ended December 31, 2004, 2003, and 2002 by (\$0.6) million; \$10.3 million and \$7.8 million, respectively, and decreased (increased) FFO per diluted common share by (\$0.01); \$0.25 and \$0.18, respectively. The table below reconciles FFO to net income for the three years ended December 31, 2004.

(Dollars in thousands, except per share data)	Year Ended December 31,		
	2004 (Restated)	2003 (Restated)	2002 (Restated)
Net income	\$ 55,533	\$ 60,402	\$ 62,383
Net (gain) loss on sales of real estate properties ..	0	1,109	(3,388)
Preferred stock dividend	0	0	(4,992)
Real estate depreciation and amortization	54,639	42,205	40,258
Total adjustments	54,639	43,314	31,878
Funds From Operations — Basic and Diluted	\$ 110,172	\$ 103,716	\$ 94,261
Weighted average common shares outstanding —			
Basic	43,706,528	41,142,619	40,701,516
Weighted average common shares outstanding —			
Diluted	44,627,475	41,840,188	41,487,780
Funds From Operations Per Common Share —			
Basic	\$ 2.52	\$ 2.52	\$ 2.32
Funds From Operations Per Common Share —			
Diluted	\$ 2.47	\$ 2.48	\$ 2.27

RESULTS OF OPERATIONS

2004 Compared to 2003

The results of operations for the year ended December 31, 2004 have been restated from the unaudited financial statements furnished on Form 8-K dated June 24, 2005. The results of operations for the year ended December 31, 2003 have also been restated. The impact of the restatement reduced (increased) net income by (\$0.8) million and \$10.1 million, respectively, for the years ended December 31, 2004 and 2003. See Note 2 to the Consolidated Financial Statements for a discussion of the restatement.

As discussed in Application of Critical Accounting Policies to Accounting Estimates and in Note 1 to the Consolidated Financial Statements, when acquiring a real estate property, the Company allocates a portion of the purchase price to lease intangibles in-place upon acquisition as well as to the building. The lease intangibles are amortized over the weighted average remaining lives of the leases in-place upon acquisition, which is generally a much shorter life than the depreciation on the building asset. The lease intangible amortization for the twelve months ended December 31, 2004 and 2003 was \$8.2 million and \$1.3 million, respectively, thereby significantly reducing net income for 2004.

For the year ended December 31, 2004, net income was \$55.5 million, or \$1.27 per basic common share (\$1.24 per diluted common share), on total revenues from continuing operations of \$234.1 million compared to net income of \$60.4 million, or \$1.47 per basic common share (\$1.44 per diluted common share), on total revenues from continuing operations of \$184.1 million for the year ended December 31, 2003. FFO was \$110.2 million, or \$2.52 per basic common share (\$2.47 per diluted common share), for

the year ended December 31, 2004 compared to \$103.7 million, or \$2.52 per basic common share (\$2.48 per diluted common share), in 2003.

<u>(Dollars in thousands)</u>	<u>2004</u> <u>(Restated)</u>	<u>2003</u> <u>(Restated)</u>
REVENUES		
Master lease rental income	\$ 78,355	\$ 76,477
Property operating income	111,016	73,078
Straight-line rent	1,592	2,116
Mortgage interest income	8,765	10,441
Other operating income	<u>34,341</u>	<u>21,970</u>
	234,069	184,082
EXPENSES		
General and administrative	13,691	11,825
Property operating expenses	58,187	34,645
Other operating expenses	14,517	9,265
Interest	43,899	34,640
Depreciation	45,870	39,679
Amortization	<u>8,155</u>	<u>1,315</u>
	184,319	131,369
Income from continuing operations	49,750	52,713
Discontinued operations		
Operating income from discontinued operations	6,993	8,798
Gain (loss) on sale of real estate properties and impairments	<u>(1,210)</u>	<u>(1,109)</u>
	5,783	7,689
Net income	<u>\$ 55,533</u>	<u>\$ 60,402</u>

Total revenues from continuing operations for the year ended December 31, 2004 increased \$50.0 million, or 27.2%, compared to 2003 for primarily the following reasons:

- Property operating income increased \$37.9 million, or 51.9%, due mainly to the acquisition of 45 revenue-producing properties under property management during 2004 and 2003 and the commencement of operations during 2004 and 2003 of four properties that were previously under construction.
- Straight-line rent decreased \$0.5 million, or 24.8%, from 2003 to 2004. Many of the leases that require straight-line rent accruals have reached or are nearing the mid-point of their terms and the straight-line rent accruals previously recorded are beginning to reverse, with the effect of decreasing straight-line rental income.
- Mortgage interest income decreased \$1.7 million, or 16.0%, for 2004 compared to 2003 due mainly to the repayment of 18 mortgages during 2004 and 2003, offset partially by three new mortgages acquired during 2004 and 2003.
- Other operating income increased \$12.4 million, or 56.3%, due mainly to shortfall income recognized under the provisions of property operating agreements and operating income of Variable Interest Entities ("VIEs") that are consolidated in the financial statements of the Company. In 2004, the Company reclassified the shortfall income recognized under the provisions of its property operating agreements (see Note 1 to the Consolidated Financial Statements) from property operating income to other operating income for all periods presented. The shortfall income included in other operating income totaled \$14.8 million and \$10.4 million, respectively, for the years ended

December 31, 2004 and 2003. The operating income of the six VIEs that are consolidated in the financial statements of the Company was \$15.5 million in 2004 compared to \$7.8 million in 2003. The six VIEs were consolidated beginning in the second and fourth quarters of 2003; therefore, income for 2003 does not include a full year's income for the VIEs.

Total expenses for the year ended December 31, 2004 compared to the year ended December 31, 2003 increased \$53.0 million, or 40.3%, as discussed below:

- General and administrative expenses increased \$1.9 million, or 15.8%, for 2004 compared to 2003 due mainly to increases in compensation and related benefits of approximately 14% due primarily to new employees as well as annual salary increases, increases in state franchise taxes of approximately 110% related to new properties acquired in 2003 and 2004, and increases of approximately 210% in audit and other fees related to the Company's compliance efforts with Sarbanes-Oxley Section 404 reporting for the year ended December 31, 2004.
- Property operating expenses increased \$23.5 million, or 68.0%, due mainly to the acquisition of 45 revenue-producing properties under property management during 2004 and 2003 and the commencement of operations during 2004 and 2003 of four properties that were previously under construction.
- Other operating expenses increased \$5.3 million, or 56.7%, for 2004 compared to 2003 due to increases in property operating expenses of VIEs that are consolidated in the Consolidated Financial Statements of the Company. The six VIEs were consolidated beginning in the second and fourth quarters of 2003; therefore, income for 2003 does not include a full year's income for the VIEs.
- Depreciation and amortization expense increased \$13.0 million, or 31.8%, due mainly to the acquisition of 50 revenue-producing properties during 2004 and 2003 and the commencement of operations during 2004 and 2003 of four properties that were previously under construction. Further, as discussed above and in Note 1 to the Consolidated Financial Statements, when acquiring a real estate property, the Company must allocate a portion of the purchase price to lease intangibles in place upon acquisition as well as to the building. The lease intangibles are amortized over the weighted average remaining lives of the leases in place upon acquisition, which is generally a much shorter life than the depreciation on the building asset. The lease intangible amortization expense increased \$6.9 million from 2003 to 2004.

Income from discontinued operations totaled \$5.8 million and \$7.7 million for the years ended December 31, 2004 and 2003, respectively, which includes the results of operations and gains, losses, and impairments related to property disposals during 2003 and 2004, as well as from assets classified as held for sale. The Company disposed of four properties during 2003, sold two properties during 2004, and classified 10 properties as held for sale as of December 31, 2004, which were subsequently sold in 2005.

2003 Compared to 2002

The results of operations for the years ended December 31, 2003 and 2002 have been restated. The impact of the restatement reduced net income for 2003 and 2002 by \$10.1 million and \$7.7 million, respectively. See Note 2 to the Consolidated Financial Statements for a discussion of the restatement.

Net income for 2002 includes an \$11.6 million charge recorded in the fourth quarter, which is comprised of the accelerated vesting of deferred compensation relating to the retirement of an executive officer as well as severance-related, project and other costs associated with the elimination of other officer and employee positions.

For the year ended December 31, 2003, net income was \$60.4 million, or \$1.47 per basic common share (\$1.44 per diluted common share), on total revenues from continuing operations of \$184.1 million compared to net income of \$62.4 million, or \$1.40 per basic common share (\$1.37 per diluted common share), on total revenues from continuing operations of \$170.9 million for the year ended December 31, 2002. FFO was \$103.7 million, or \$2.52 per basic common share (\$2.48 per diluted common share), for

the year ended December 31, 2003 compared to \$94.3 million, or \$2.32 per basic common share (\$2.27 per diluted common share), in 2002.

<u>(Dollars in thousands)</u>	<u>2003 (Restated)</u>	<u>2002 (Restated)</u>
REVENUES		
Master lease rental income	\$76,477	\$83,062
Property operating income	73,078	61,494
Straight-line rent	2,116	1,947
Mortgage interest income	10,441	13,308
Other operating income	<u>21,970</u>	<u>11,117</u>
	184,082	170,928
EXPENSES		
General and administrative	11,825	22,665
Property operating expenses	34,645	29,069
Other operating expenses	9,265	305
Interest	34,640	34,274
Depreciation	39,679	37,441
Amortization	<u>1,315</u>	<u>126</u>
	131,369	123,880
Income from continuing operations	52,713	47,048
Discontinued operations		
Operating income from discontinued operations	8,798	11,947
Gain (loss) on sale of real estate properties	<u>(1,109)</u>	<u>3,388</u>
	7,689	15,335
Net income	<u>\$60,402</u>	<u>\$62,383</u>

Total revenues from continuing operations for the year ended December 31, 2003 increased \$13.2 million, or 7.7%, compared to 2002 for primarily the following reasons:

- Master lease rental income decreased \$6.6 million, or 7.9%. This reduction was generally due to a reduction in rental accruals on properties related to certain operators as well as a reduction in lease rates on leases signed with two new tenants on 14 properties formerly leased and operated by another tenant. Also, during 2003, rental income on three buildings, upon expiration of the master lease agreements, began to be included in property operating income rather than master lease rental income as the Company began managing the buildings and consolidating the full operations of these buildings into the Company's financial statements.
- Property operating income increased \$11.6 million, or 18.8%, due mainly to the acquisition of 8 revenue-producing properties under property management during 2003 and 2002, the commencement of operations during 2003 and 2002 of four properties that were previously under construction and the conversion of three properties that were previously master-leased.
- Mortgage interest income decreased \$2.9 million, or 21.5%, for 2003 compared to 2002 due mainly to the repayment of 24 mortgages during 2003 and 2002, offset partially by interest earned on two mortgages acquired in 2003.
- Other operating income increased \$10.9 million, or 97.6%, due mainly to operating income of VIEs that are consolidated in the Consolidated Financial Statements of the Company and increases in the shortfall income accrued related to the properties having property operating agreements. The shortfall income included in other operating income totaled \$10.4 million and \$7.7 million, respectively, for the years ended December 31, 2003 and 2002. The operating income of VIEs that

are consolidated in the Consolidated Financial Statements of the Company was \$7.8 million and \$0, respectively for the years ended December 31, 2003 and 2002, as the Company began consolidating the VIEs during 2003.

Total expenses for the year ended December 31, 2003 compared to the year ended December 31, 2002 increased \$7.5 million, or 6.0% as discussed below:

- General and administrative expenses decreased \$10.8 million, or 47.8%, for 2003 compared to 2002 due mainly to an \$11.6 million charge recorded in the fourth quarter of 2002 related to the retirement of an executive officer. See Note 10 to the Consolidated Financial Statements for further details.
- Property operating expenses increased \$5.6 million, or 19.2%, due mainly to the acquisition of 8 revenue-producing properties under property management during 2003 and 2002, the commencement of operations during 2003 and 2002 of four properties that were previously under construction and the conversion of three properties that were previously master-leased.
- Other operating expenses increased \$9.0 million from 2002 to 2003. Other operating expenses for 2003 and 2002 include property operating expenses of VIEs that are consolidated in the Consolidated Financial Statements of the Company totaling \$9.3 million and \$0, respectively, as the Company began consolidating the VIEs during 2003. Other operating expenses for 2002 include a \$0.3 million impairment charge which represents the difference between the net carrying value of \$0.5 million and the estimated fair value of \$0.2 million relating to a skilled nursing facility in Oklahoma, which the Company closed in 2002 and does not expect to reopen.
- Depreciation and amortization expense increased \$3.4 million, or 9.1%, due mainly to the amortization of lease intangible assets recorded related to the acquisition of 10 revenue-producing properties during 2003 and 2002 and the commencement of operations during 2003 and 2002 of four properties that were previously under construction.

Income from discontinued operations totaled \$7.7 million and \$15.3 million for the years ended December 31, 2003 and 2002, respectively, which includes the results of operations and gains and losses related to property disposals from January 1, 2002 through December 31, 2004, as well as from assets classified as held for sale as of December 31, 2004. The Company disposed of 13 properties during 2002, four properties during 2003, two properties during 2004, and classified 10 properties as held for sale as of December 31, 2004, which were subsequently sold in 2005.

LIQUIDITY AND CAPITAL RESOURCES

Key Indicators

The Company monitors its liquidity and capital resources and relies on several key indicators, including the following:

- Debt metrics;
- Dividend payout ratio with respect to the dividend;
- Interest rates, underlying treasury rates, debt market spreads and equity markets in its assessment of capital markets to ensure funds are available for acquisitions and other operating activities as needed.

The Company uses these indicators and others to compare its operations to its peers and to help identify areas in which the Company may need to focus its attention.

Contractual Obligations

The Company monitors its contractual obligations to ensure funds are available to meet obligations when due. The following table represents the Company's long-term contractual obligations for which the

Company is making payments as of December 31, 2004, which includes interest payments due. The Company had no long-term capital lease or purchase obligations as of December 31, 2004.

(Dollars in thousands)	Payments Due by Period				
	Total	Less Than 1 Year	1 - 3 Years	3 - 5 Years	More Than 5 Years
Long-term debt obligations(4)	\$1,041,148	\$72,510	\$134,376	\$141,825	\$692,437
Operating lease commitments(1)	254,938	3,110	6,397	9,966	235,465
Construction in progress(2)	11,421	6,521	4,900	0	0
Tenant improvements(3)	7,731	7,731	0	0	0
Total Contractual Obligations	<u>\$1,315,238</u>	<u>\$89,872</u>	<u>\$145,673</u>	<u>\$151,791</u>	<u>\$927,902</u>

- (1) Includes two office leases, one automobile lease and ground leases related to 31 properties for which the Company is currently making payments.
- (2) Includes commitments remaining on the construction of one building.
- (3) Includes tenant improvement allowance obligations remaining on seven properties constructed by the Company.
- (4) The amounts shown include estimated interest, but exclude the fair value of the interest rate swaps of \$3.4 million, the premium on the Senior Notes due 2011 of \$14.0 million, and the discount on the Senior Notes due 2014 of \$1.4 million which are included in notes and bonds payable on the Company's balance sheet. The Company's long-term debt principal obligations are presented in more detail in the table below.

(Dollars in millions)	Principal Balance at December 31, 2004	Principal Balance at December 31, 2003	Maturity Date	Contractual Interest Rates at Dec. 31, 2004	Interest Payments	Principal Payments
Unsecured credit facility due 2006(1)	\$ 9.0	\$154.0	10/06	LIBOR + 1.10%	Quarterly	At maturity
Senior notes due 2006 ...	49.7	70.0	4/06	9.49%	Semi-Annual	\$20.3 million in 2005 and \$29.4 million in 2006
Senior notes due 2011 ...	300.0	300.0	5/11	8.125%	Semi-Annual	At maturity
Senior notes due 2014 ...	300.0	0.0	4/14	5.125%	Semi-Annual	At maturity
Mortgage notes payable	50.2	53.4	5/11-7/26	7.22%-8.50%	Monthly	Monthly
Other note payable	<u>1.2</u>	<u>2.3</u>	7/05	7.53%	Semi-Annual	Semi-Annual
	\$710.1	\$579.7				

- (1) The Company incurs an annual facility fee of 0.35% on the unsecured credit facility due 2006 commitment.

In October 2003, the Company replaced its existing \$150.0 million unsecured credit facility with a new \$300.0 million unsecured credit facility. The \$300.0 million credit facility (the "Unsecured Credit Facility due 2006") was entered into with a syndicate of 12 banks and could be increased to \$350.0 million during the first two years at the Company's option subject to the availability of additional capital commitments from the banks; and the term could be extended one additional year. Rates for borrowings under the Unsecured Credit Facility due 2006 are, at the Company's option, based on London Interbank Offered Rates ("LIBOR") or the higher of the Federal Funds Rate plus 1/2 of 1% or the agent bank's prime rate and can vary based on the Company's debt rating. The weighted average rate on borrowings outstanding as of December 31, 2004 was 3.5%. In addition, the Company pays a facility fee of 0.35% on the commitment that may also fluctuate based on the Company's debt rating. The Company had borrowing capacity remaining, under its financial covenants, of \$248.0 million under the facility as of December 31, 2004. Further, as of December 31, 2004, substantially all (88.5%) of the Company's principal debt balances are due after 2010. Interest rates for the past three years were at historically low levels; however, interest rates began increasing during 2004, and many economists are projecting that rates

will continue to rise. As of December 31, 2004, with only \$9.0 million outstanding under its Unsecured Credit Facility due 2006, only 19% of the Company's debt was variable rate debt, including the interest rate swaps, with interest rates based on LIBOR.

However, as the Company begins to draw under its Unsecured Credit Facility due 2006 to fund developments, acquisitions, and other items, the Company's income from operations and cash flows would be negatively impacted if interest rates increase as anticipated. As of September 30, 2005, the Company had \$49.0 million outstanding on its unsecured credit facility due 2006 and had borrowing capacity remaining, under its financial covenants, of \$179.0 million.

On March 30, 2004, the Company publicly issued \$300.0 million of unsecured senior notes due 2014 (the "Senior Notes due 2014"). The Senior Notes due 2014 bear interest at 5.125%, payable semi-annually on April 1 and October 1, and are due on April 1, 2014, unless redeemed earlier by the Company. The notes were issued at a discount of approximately \$1.5 million, yielding a 5.19% interest rate per annum. The notes were used to fund acquisitions and to repay substantially all of the then outstanding balance on the Unsecured Credit Facility due 2006. Repaying the Unsecured Credit Facility due 2006 with the higher-rate Senior Notes due 2014 negatively impacted interest expense in 2004.

Moody's Investors Service, Standard and Poor's, and Fitch Ratings rate the Company's senior debt Baa3, BBB-, and BBB, respectively. For the year ended December 31, 2004, the Company's earnings covered fixed charges at a ratio of 2.05 to 1.00; the Company's stockholders' equity totaled approximately \$1.0 billion; and its debt-to-total capitalization ratio, on a book basis, was approximately 0.42 to 1.

As of December 31, 2004, the Company was in compliance with all covenant requirements under its various debt instruments. Subsequent to December 31, 2004, the Company did not timely report financial information as required under covenants relating to its various debt instruments. The Company obtained a waiver from its lenders under its Unsecured Credit Facility due 2006 to waive the financial reporting requirements through November 30, 2005 but was not required to obtain waivers under its other debt instruments.

The Company's practice and objective is to protect itself against changes in fair value of its debt due to changes in market interest rates by maintaining a mix of variable and fixed rate debt. In order to accomplish this objective, in 2001, the Company entered into interest rate swap agreements for notional amounts totaling \$125.0 million to offset changes in the fair value of \$125.0 million of the Senior Notes due 2011. In the interest rate swaps, the Company received an 8.125% fixed rate and paid a variable rate of six month LIBOR plus 1.99%. In March 2003, the Company terminated these interest rate swap agreements and entered into new swaps under terms identical to those of the 2001 swap agreements except that the equivalent rate was adjusted to 4.12% over six month LIBOR. The Company received cash equal to the fair value of the terminated swaps of \$18.4 million. The fair value of the terminated swaps is combined with the principal balance of the Senior Notes due 2011 on the Company's Consolidated Balance Sheet. The fair value gain of \$18.4 million is being amortized against interest expense over the remaining term of the notes, offsetting the increase in the spread over LIBOR. As of December 31, 2004, the aggregate fair value of the swaps totaling \$3.4 million is reported in other liabilities with an offsetting decrease to the Senior Notes due 2011 included in notes and bonds payable on the Company's Consolidated Balance Sheet. The derivative instruments meet all requirements of a fair value hedge and have been accounted for using the "shortcut method" as set forth in FAS No. 133. As such, changes in fair value have had no impact on the Company's Consolidated Statements of Income.

Shelf Registration

The Company may from time to time raise additional capital or make investments by issuing, in public or private transactions, its equity and debt securities, but the availability and terms of any such issuance will depend upon market and other conditions. Due to the Company's untimely filing of its Form 10-K for the year ended December 31, 2004 and Form 10-Q's during 2005, the Company will not be eligible to issue securities under a Form S-3 for twelve months after the Company is current on its filings with the Securities and Exchange Commission. During that twelve-month period, the Company will

not be able to issue securities under its existing shelf registration statements but it may access the capital markets using other forms of registration statements.

Security Deposits and Letters of Credit

As of December 31, 2004, the Company held approximately \$4.8 million in letters of credit, security deposits, debt service reserves and capital replacement reserves for the benefit of the Company in the event the obligated lessee or borrower fails to perform under the terms of its respective lease or mortgage. Generally, the Company may, at its discretion and upon notification to the operator or tenant, draw upon these instruments if there are any defaults under the leases or mortgage notes.

Acquisitions, Dispositions and Mortgage Repayments during 2004

2004 Acquisitions

During the first quarter of 2004, the Company invested \$18.0 million in a 141,765 square foot medical office building on an Advocate Healthcare hospital campus in Illinois and invested \$30.0 million in seven medical office buildings totaling 283,452 square feet on Ascension Health hospital campuses in Michigan and Arizona. The Company provides property management services to the buildings on Ascension Health campuses. During the second quarter of 2004, the Company acquired six medical office buildings located in Tennessee from affiliates of Ascension Health, Inc. for \$70.8 million with an aggregate square footage of approximately 711,198. The Company also acquired four medical office buildings from affiliates of MedStar Health, two of which are located in Washington, D.C., and two of which are located in Maryland, for \$41.3 million with an aggregate square footage of approximately 269,539. The Company provides property management services for these ten buildings. Finally, the Company acquired a 27,895 square foot assisted living facility in Florida for \$4.8 million, purchased land in Hawaii for \$5.8 million for the construction of a medical office building, acquired a parcel of land in Texas for \$1.8 million, and a \$4.7 million mortgage note was converted into full equity ownership of a skilled nursing facility in Tennessee.

During the third quarter of 2004, the Company acquired from Baylor Health Care System 20 medical office buildings in and around Dallas, Texas for \$133.0 million with an aggregate square footage of approximately 1.1 million.

During the fourth quarter of 2004, a \$1.6 million mortgage note was converted into full equity ownership of a skilled nursing facility in Michigan.

These transactions were funded with proceeds from the Unsecured Credit Facility due 2006, from the issuance of the Senior Notes due 2014 and from the equity offering described in Note 7 to the Consolidated Financial Statements.

2004 Dispositions, Mortgage Repayments and Foreclosures

During the first quarter of 2004, the Company sold the annex portion of a physician clinic in Florida for \$1.8 million, equal to the Company's basis in the property. In this transaction, the Company received \$0.5 million in cash proceeds and a \$1.3 million mortgage note.

During the second quarter of 2004, the Company sold a 25,000 square foot assisted living facility in Georgia for \$4.5 million. Also, two mortgage notes receivable totaling \$6.4 million were repaid in full and a \$4.7 million mortgage note was converted into full equity ownership of a skilled nursing facility in Tennessee.

During the third quarter, two mortgage notes receivable were repaid totaling \$21.2 million. The proceeds from the repayments were used to partially repay the outstanding balance on the unsecured credit facility and for general corporate purposes. The Company also sold three ancillary hospital facilities in Pennsylvania with an aggregate square footage of 3,200 for \$0.2 million in net proceeds.

During the fourth quarter, the Company sold a 69,200 square foot physician clinic in Florida for \$5.0 million, a \$1.6 million mortgage note was converted into full equity ownership of a skilled nursing facility in Michigan, and an \$18.8 million mortgage note was repaid in full.

The proceeds from these transactions were used to partially repay the outstanding balance on the unsecured credit facility and for general corporate purposes.

Purchase Options Exercised

On January 18, 2005, a senior living operator purchased nine of the ten properties it leased from the Company producing net sales proceeds to the Company totaling \$58.9 million, including the repayment of certain receivables, and purchased the tenth property in May 2005 producing net sales proceeds to the Company totaling \$12.1 million, including the repayment of certain receivables. The ten properties covered by the purchase options exercised by this operator comprise approximately \$74.9 million (\$61.2 million, net) of the Company's real estate properties and accounted for approximately 3.5% of the Company's revenues for the year ended December 31, 2004. The Company recognized a gain of approximately \$6.1 million in the first quarter of 2005 from the sale of the nine properties and recognized a gain of approximately \$1.2 million from the sale of the tenth property in the second quarter of 2005.

On April 20, 2005, a second senior living operator purchased five properties it leased from the Company producing net sales proceeds to the Company totaling \$53.2 million, including the repayment of certain receivables. The five properties covered by the purchase options exercised by this operator comprise approximately \$50.3 million (\$42.1 million, net) of the Company's real estate assets and accounted for approximately 2.5% of the Company's revenues for the year ended December 31, 2004. The Company recognized a gain of approximately \$0.2 million from the sale of the five properties.

As of September 30, 2005, the Company had reinvested all of the proceeds from these two purchases by acquiring approximately \$128.7 million of new properties or mortgages. However, since the proceeds were not reinvested immediately, net income for 2005 may be negatively impacted.

On September 29, 2005, a sponsor under a property operating agreement gave notice to the Company of its intent to purchase three properties under property operating agreements with the Company with a target closing date in December 2005. The three properties covered by the purchase options exercised by this operator comprise approximately \$9.7 million (\$8.2 million, net) of the Company's real estate properties and accounted for approximately 0.6% of the Company's revenues for the year ended December 31, 2004. The Company expects to recognize a gain from the sale of these properties.

On November 15, 2005, a lessee gave notice to the Company of its intent to purchase, during the second quarter of 2006, a medical office building it leases from the Company under a master lease agreement. Based on the master lease agreement, the lessee's purchase price will be equal to the fair market value of the property, to be determined by an appraisal process specified in the master lease. The property comprised approximately \$16.4 million (\$13.8 million, net) of the Company's real estate properties at December 31, 2004 and accounted for approximately 1.1% of the Company's revenues for the year ended December 31, 2004. The Company believes it will recognize a gain on the transaction.

The exercise of the purchase options noted above is largely a function of the historically low interest rate environment. In each case, the operator or sponsor was able to replace higher rate lease or support obligations to the Company with lower rate mortgage debt. The Company cannot predict whether additional purchase options will be exercised, but the Company has not received notice of exercise of any other significant purchase options through November 15, 2005.

Construction in Progress

As of December 31, 2004, the Company had a net investment of approximately \$12.5 million in one development in progress, which has a total remaining funding commitment of approximately \$11.4 million. The Company received the certificate of occupancy during the second quarter of 2005 and is proceeding with construction of tenant improvements. The Company also has an investment in a land parcel of \$6.3 million in Hawaii. The Company anticipates it will begin construction during 2006 on a medical office

building on the land. The Company intends to fund these commitments with internally generated cash flows, proceeds from the Unsecured Credit Facility due 2006, proceeds from the sale of additional assets, proceeds from additional repayments of mortgage notes receivable, or additional capital market financing.

Dividends

On January 25, 2005, the Company declared an increase in its quarterly common stock dividend from \$0.645 per share (\$2.58 annualized) to \$0.650 per share (\$2.60 annualized) payable to shareholders of record on February 14, 2005. This dividend was paid on March 3, 2005.

On April 26, 2005, the Company declared an increase in its quarterly common stock dividend from \$0.650 per share (\$2.60 annualized) to \$0.655 per share (\$2.62 annualized) payable to shareholders of record on May 16, 2005. This dividend was paid on June 2, 2005.

On July 26, 2005, the Company declared an increase in its quarterly common stock dividend from \$0.655 per share (\$2.62 annualized) to \$0.660 per share (\$2.64 annualized) payable to shareholders of record on August 15, 2005. This dividend was paid on September 1, 2005.

On November 3, 2005, the Company declared its quarterly common stock dividend in the amount of \$0.660 per share (\$2.64 annualized) payable on December 2, 2005 to shareholders of record on November 17, 2005.

The Company, though historically having increased the dividend each quarter, decided to maintain the quarterly dividend for the third quarter of 2005 at the same level as the previous quarter. The Company will determine future dividend policy based upon cash generated by operating activities, the Company's financial condition, relevant financing instruments, capital requirements, annual distributions required under the REIT provisions of the Code and other such factors deemed relevant.

Liquidity

The Company plans to continue to meet its liquidity needs, including funding additional investments in 2005, paying quarterly dividends, and funding debt service, with cash flows from operations, with proceeds from the Unsecured Credit Facility due 2006, proceeds of mortgage notes receivable repayments, and sales of real estate investments or additional capital market financing. The Company believes that its liquidity and sources of capital are adequate to satisfy its cash requirements. The Company cannot, however, be certain that these sources of funds will be available at a time and upon terms acceptable to the Company in sufficient amounts to meet its liquidity needs.

Impact of Inflation

Inflation has not significantly affected the Company's earnings due to the moderate inflation rate in recent years and the fact that most of the Company's leases and financial support arrangements require tenants and sponsors to pay all or some portion of the increases in operating expenses, thereby reducing the Company's risk of the adverse effects of inflation. Because most of the Company's leases and financial support arrangements also provide for annual increases equal to the rate of inflation, inflation will have the effect of increasing gross revenues under the terms of such leases and financial support arrangements. Leases and financial support arrangements vary in the remaining terms of obligations from one to twenty years, further reducing the Company's risk of any adverse effects of inflation. Interest payable under the interest rate swaps and the Unsecured Credit Facility due 2006 is calculated at a variable rate; therefore, the amount of interest payable under the swaps and the unsecured credit facility will be influenced by changes in short-term rates, which tend to be sensitive to inflation. Generally, changes in inflation and interest rates tend to move in the same direction. During periods where interest rate increases outpace inflation, the Company's operating results should be negatively impacted. Likewise, when increases in inflation outpace increases in interest rates, the Company's operating results should be positively impacted.

Market Risk

The Company is exposed to market risk in the form of changing interest rates on its debt and mortgage notes receivable. Management uses regular monitoring of market conditions and analytical techniques to manage this risk. The Company has no market risk with respect to foreign currency fluctuations.

In 2003, the Company entered into interest rate swap agreements with two lending institutions which are expected to offset changes in the fair value of \$125 million of the Senior Notes due 2011. As of December 31, 2004 and 2003, the fair value of the hedge is reported in other liabilities with an offsetting decrease to the Senior Notes due 2011 included in notes and bonds payable on the Company's Balance Sheets. (See Note 6 to the Consolidated Financial Statements for further details.)

As of December 31, 2004 and 2003, the fair value of the Company's variable rate debt approximated its carrying value of \$136.5 million and \$280.4 million, respectively. Because the interest rate is variable with market interest rates, the carrying amount of variable rate debt will always approximate its fair value. Assuming the December 31, 2004 and 2003 carrying values of \$136.5 million and \$280.4 million, respectively, are held constant, the hypothetical increase in interest expense resulting from a one percentage point increase in interest rates, would be \$1.37 million and \$2.80 million, respectively. The interest rate on variable rate debt is based on and variable with LIBOR.

As of December 31, 2004 and 2003, the carrying value of the Company's fixed rate debt was \$582.8 million and \$309.9 million, respectively, and the fair value of the Company's fixed rate debt was approximately \$592.1 million and \$336.4 million, respectively. The fair value is based on the present value of future cash flows discounted at the market rate of interest. Market risk, expressed as the hypothetical decrease in fair value resulting from a one percentage point increase in interest rates is \$32.8 million and \$13.1 million for December 31, 2004 and 2003, respectively, for aggregate fixed rate debt.

As of December 31, 2004 and 2003, the carrying value of the Company's fixed rate mortgage notes receivable was \$40.3 million and \$91.8 million, respectively, and the fair value was approximately \$46.4 million and \$104.7 million, respectively. The fair value is based on the present value of future cash flows discounted at an assumed market rate of interest. Because no market rates of interest are published for these assets, the market rate of interest is assumed to be the same spread to U.S. Treasury yields for comparable maturities that existed when the mortgage notes receivable were acquired, adjusted to published U.S. Treasury yields. Market risk, expressed as the hypothetical decrease in fair value resulting from a one percentage point increase in interest rates, is \$8.1 million and \$13.7 million for December 31, 2004 and 2003, respectively, on the aggregate portfolio of fixed rate mortgage notes receivable.

As of December 31, 2004 and 2003, the carrying value of the Company's fixed rate notes receivable was \$17.3 million and \$14.9 million, respectively, and the fair value was approximately \$16.6 million and \$13.6 million, respectively. The fair value is based on the present value of future cash flows discounted at an assumed market rate of interest. Because no market rates of interest are published for these assets, the market rate of interest is assumed to be approximately 10.5%, the interest rate of many of the notes entered into between the Company and its operators in the past 12 to 18 months. Market risk, expressed as the hypothetical increase in fair value resulting from a one percentage point increase in interest rates, is approximately \$33,000 and \$45,000 for December 31, 2004 and 2003, respectively, on the aggregate portfolio of fixed rate notes receivable.

Off-Balance Sheet Arrangements

The Company has no off-balance sheet arrangements that are reasonably likely to have a current or future material effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Cautionary Language Regarding Forward-Looking Statements

This Annual report on Form 10-K and other materials the Company has filed or may file with the Securities and Exchange Commission, as well as information included in oral statements or other written statements made, or to be made, by senior management of the Company, contain, or will contain, disclosures which are "forward-looking statements." Forward-looking statements include all statements that do not relate solely to historical or current facts and can be identified by the use of words such as "may," "will," "expect," "believe," "intend," "plan," "estimate," "project," "continue," "should," "anticipate" and other comparable terms. These forward-looking statements are based on the current plans and expectations of management and are subject to a number of risks and uncertainties that could significantly affect the Company's current plans and expectations and future financial condition and results. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Shareholders and investors are cautioned not to unduly rely on such forward-looking statements when evaluating the information presented in the Company's filings and reports. For a detailed discussion of the risk factors associated with the Company, please refer to the Company's filings with the Securities and Exchange Commission.

APPLICATION OF CRITICAL ACCOUNTING POLICIES TO ACCOUNTING ESTIMATES

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission. In preparing the financial statements, management is required to exercise judgments and make assumptions that impact the carrying amount of assets and liabilities and the reported amounts of revenues and expenses reflected in the financial statements.

Management routinely evaluates the estimates and assumptions used in the preparation of financial statements. These regular evaluations consider historical experience and other reasonable factors and use the seasoned judgment of management personnel. Management has reviewed the Company's critical accounting policies with the Audit Committee of the Board of Directors.

Management believes the following paragraphs in this section describe the application of critical accounting policies by management to arrive at the critical accounting estimates reflected in the consolidated financial statements. The Company's accounting policies are more fully discussed in Note 1 to the Consolidated Financial Statements.

Allowance for Uncollectible Accounts

The Company is a real estate investment trust that owns, manages and develops income-producing real estate properties and mortgages throughout the United States. Many of the Company's investments are subject to long-term leases or other financial support arrangements with hospital systems and healthcare providers affiliated with the properties (see Note 1 to the Consolidated Financial Statements for further details). Due to the nature of the Company's agreements, the Company's accounts receivable, notes receivable and interest receivables result mainly from monthly billings of contractual tenant rents, lease guaranty amounts, note principal and interest amounts, mortgage interest, late fees and additional rent and interest.

Payments on the Company's accounts receivable are normally collected within 30 days of billing, and payments on its mortgage notes and notes receivable are based on each note agreement. When receivables remain uncollected, management must decide whether to provide an allowance for all or a portion of these receivables as uncollectible. Unlike a financial institution with a large volume of homogeneous retail receivables such as credit card loans or automobile loans that have a predictable loss pattern over time, the Company's receivable losses have historically been infrequent and are tied to a unique or specific event. The Company's allowance for doubtful accounts is generally based on specific identification and is recorded for a specific receivable amount once determined that such an allowance is needed.

Management monitors the aging and collectibility of accounts receivable on an ongoing basis. At least monthly, a report is produced whereby all receivables are "aged" or placed into groups based on the number of days that have elapsed since the receivable was billed. Management reviews the aging report for evidence of deterioration in the timeliness of payment from a tenant or sponsor. Whenever deterioration is noted, management investigates and determines the reason(s) for the delay, which may include discussions with the delinquent tenant, sponsor, or borrower. Considering all information gathered, management's judgment must be exercised in determining whether a receivable is potentially uncollectible and, if so, how much or what percentage may be uncollectible. Among the factors management considers in determining uncollectibility are the:

- Type of contractual arrangement under which the receivable was recorded, e.g., a mortgage note, a triple net lease, a gross lease, a sponsor guaranty agreement or some other type of agreement;
- Tenant's or debtor's reason for slow payment;
- Industry influences and healthcare segment under which the tenant or debtor operates;
- Evidence of willingness and ability of the tenant or debtor to pay the receivable;
- Credit-worthiness of the tenant or debtor;
- Collateral, security deposit, letters of credit or other monies held as security;
- Tenant's or debtor's historical payment pattern;
- State in which the tenant or debtor operates; and
- Existence of a guarantor and the willingness and ability of the guarantor to pay the receivable.

Considering these factors and others, management must conclude whether all or some of the aged receivable balance is likely uncollectible. Upon determining that some portion of the receivable is likely uncollectible, the Company records a provision for bad debt expense for the amount it expects will be uncollectible. There is a risk that management's estimate is over- or under-stated; however, the Company believes that this risk is mitigated by the fact that management re-evaluates the allowance at least once each quarter and bases its estimates on the most current information available. As such, any over- or under-statements in the allowance should be adjusted for as soon as new and better information becomes available.

The Company monitors its mortgage notes and notes receivable balances much like it does a long-lived asset. If an event occurs, such as an operator risk profile change, or other circumstances indicate that the recorded value might not be fully recoverable, then the Company would consider the need to reserve all or a portion of the note balance.

Included in the Company's Consolidated Financial Statements are also receivables related to the Company's VIEs. These receivables consist primarily of patient receivables of the assisted living and skilled nursing facilities, which are billed and maintained by the operators of those facilities. A significant portion of these receivables are due from Medicare and Medicaid and are generally collected within 60 to 90 days of billing, while the receivables due from private payors are generally collected in a shorter period of time. The Company reviews the aged delinquency reports, which age the receivables by patient or type of payor, to determine whether the Company believes an allowance for uncollectible accounts in addition to the allowance provided for on the property's financial statements is needed in the Company's financial statements.

As of December 31, 2004 and 2003, the Company's accounts receivable balances were approximately \$18.8 million and \$22.5 million, respectively, with allowances for uncollectible accounts of approximately \$1.9 million and \$1.7 million, respectively. For the years ended December 31, 2004 and 2003, the Company recorded provisions for bad debt expense of (\$0.2) million and \$1.0 million, respectively, and collected or wrote off receivables against the provision of \$0.3 million and \$1.3 million, respectively. The Company's notes receivable balances were approximately \$17.3 million and \$14.9 million, respectively as of

December 31, 2004 and 2003. The Company's receivables, notes receivable and related allowances are included in other assets on the Company's Consolidated Balance Sheets. The Company's mortgage notes receivable balances were approximately \$40.3 million and \$91.8 million, respectively, as of December 31, 2004 and 2003. If management had used different estimates, or its methodology for determining and recording the allowance had been different, then the amount of bad debt expense included in the Company's financial statements may have been different.

Currently, the Company has no collectibility issues with its two largest tenants, HealthSouth and HCA Inc. However, should a collectibility problem arise with respect to these large tenants, the allowance for doubtful accounts would be increased which could have a material impact on the Company's financial statements in future periods.

Depreciation of Real Estate Assets and Amortization of Related Intangible Assets

As of December 31, 2004, the Company had invested approximately \$1.9 billion in real estate assets and related intangible assets. When these real estate assets and related intangible assets are acquired or placed in service, they must be depreciated or amortized. Management's judgment involves determining which depreciation method to use, estimating the economic life of the building and improvement components of real estate assets, and estimating the value of intangible assets acquired when real estate assets are purchased that have in-place leases.

As described more fully in Note 1 to the Consolidated Financial Statements, for real estate acquisitions subsequent to December 31, 2001, the Company accounts for acquisitions of real estate properties with in-place leases in accordance with the provisions of Financial Accounting Standards Board ("FASB") FAS No. 141, "Business Combinations." FAS 141 requires that when a building is acquired with in-place leases, the cost of the acquisition be allocated between the acquired tangible real estate assets "as if vacant" and any acquired intangible assets. Such intangible assets could include above- (or below-) market in-place leases and at-market in-place leases, which could include the opportunity costs associated with absorption period rentals, direct costs associated with obtaining new leases such as tenant improvements, and customer relationship assets. Any remaining excess purchase price is then allocated to goodwill. The identifiable tangible and intangible assets are then subject to depreciation and amortization. Goodwill is evaluated for impairment on an annual basis unless circumstances suggest that a more frequent evaluation is warranted.

If management erred in its estimates of the "as if vacant" value of the building or in its estimates of the intangible asset values, the pro-ration of the purchase price between building and intangibles and resulting depreciation and amortization could be incorrect. The amortization period for the intangible assets is the average remaining term of the actual in-place leases as of the acquisition date. To help prevent errors in its estimates from occurring, management applies consistent assumptions with regard to the elements of estimating the "as if vacant" values of the building and the intangible assets, including the absorption period, occupancy increases during the absorption period, and tenant improvement amounts. The Company uses the same absorption period and occupancy assumptions for similar building types, adding the future cash flows expected to occur over the next 10 years as a fully occupied building. The net present value of these future cash flows, discounted using a market rate of return, becomes the estimated "as if vacant" value of the building.

With respect to the building component, there are several depreciation methods available under accounting principles generally accepted in the United States of America. Some methods record relatively more depreciation expense on an asset in the early years of the asset's economic life, and relatively less depreciation expense on the asset in the later years of its economic life. The "straight-line" method of depreciating real estate assets is the method we follow because, in the opinion of management, it is the method that most accurately and consistently allocates the cost of the asset over its estimated life.

The Company has assigned a useful life of either 39 or 31.5 years depending on the age of the property when acquired as well as other factors. The weighted average remaining life of the Company's real estate assets as of December 31, 2004 was 34.3 years. Many companies depreciate new non-residential

real estate assets over longer useful lives. The Company uses a shorter, more conservative, economic life because it believes it more appropriately reflects the economic life of the properties.

Capitalization of Costs

Accounting principles generally accepted in the United States of America allow for capitalization of various types of costs. The rules and regulations on capitalizing costs and the subsequent depreciation or amortization of those costs versus expensing them in the period vary depending on the type of costs and the reason for capitalizing the costs.

Direct costs generally include construction costs, professional services such as architectural and legal costs, travel expenses, land acquisition costs as well as other types of fees and expenses. These costs are capitalized as part of the basis of an asset to which such costs relate. Indirect costs include capitalized interest and overhead costs. The Company's overhead costs are based on overhead load factors that are charged to a project based on direct time incurred. The Company computes the overhead load factors annually for its acquisition and development departments, which have employees who are involved in the projects. The overhead load factors are computed to absorb that portion of indirect employee costs (payroll and benefits, training, occupancy and similar costs) that are attributable to the productive time the employee incurs working directly on projects. The employees in the Company's acquisitions and development departments who work on these projects maintain and track their hours daily, by project. Employee costs that are administrative, such as vacation time, sick time, or general and administrative time, are expensed in the period incurred. The Company capitalizes overhead based on direct hours worked on each project. Therefore, each constructed asset and pursuit project will have both direct and indirect costs capitalized to it as part of the overall costs.

Management's judgment is also exercised in determining whether costs that have been previously capitalized in pursuit of an acquisition or development project should be reserved for or written off if the project is abandoned or should circumstances otherwise change that cause the project's viability to become questionable. The Company follows a standard and consistently applied policy of classifying pursuit activity as well as reserving for those types of costs based on their classification.

The Company classifies its pursuit projects into four categories. The first category of pursuits is essentially "cold calls" that have a remote chance of producing new business. Costs for these projects are expensed in the period incurred. The second category includes those that might reasonably be expected to produce new business opportunities although there can be no assurance that they will result in a new project or contract. Costs for these projects are capitalized but, due to the uncertainty of projects in this category, these costs are reserved at 50% which means that 50% of the costs are expensed in the period incurred. The third category are those pursuits that are either highly probable to result in a project or contract or already have resulted in a project or contract in which the contract requires the operator to reimburse our costs. Many times, these are pursuits involving operators with which the Company is already doing business. Since the Company believes it is probable that these pursuits will result in a project or contract, it capitalizes these costs in full and records no reserve. The fourth category includes those pursuits that are acquisitions of existing buildings. As required by the Emerging Issues Task Force ("E.I.T.F.") Issue No. 97-11, the Company expenses in the period incurred all internal costs related to those types of acquisitions. Each quarter, all capitalized pursuit costs are again reviewed carefully for viability or a change in classification and a management decision is made as to whether any additional reserve is deemed necessary. If necessary and considered appropriate, management would record an additional reserve at that time.

Capitalized pursuit costs, net of the reserve, are carried in other assets in the balance sheet and any reserve recorded is charged to general and administrative expenses on the income statement. These pursuit costs will ultimately be written off to expense or will be capitalized as part of the constructed real estate asset.

As of December 31, 2004 and 2003, the Company had capitalized pursuit costs totaling \$1.0 million and \$1.5 million, respectively, and had provided reserves against these capitalized pursuit costs of \$0.4 million and \$0.5 million, respectively.

Valuation of Long-Lived and Intangible Assets and Goodwill

The Company assesses the potential for impairment of identifiable intangible assets and long-lived assets, including real estate properties, whenever events occur or a change in circumstances indicate that the recorded value might not be fully recoverable. Important factors that could cause management to review for impairment include significant underperformance of an asset relative to historical or expected operating results; significant changes in the Company's use of assets or the strategy for its overall business; plans to sell an asset before its depreciable life has ended; or significant negative economic trends or negative industry trends for the Company or its operators. In addition, the Company reviews for possible impairment to its assets subject to purchase options and those impacted by casualties, such as hurricanes. As required by Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," if management determined that the carrying value of the Company's assets may not be fully recoverable based on the existence of any of the factors above, or others, management would measure and record impairment based on projected future cash flows. The Company recorded impairment charges of \$1.2 million, \$0, and \$0.3 million, respectively, for the years ended December 31, 2004, 2003 and 2002. The impairment charges in 2004 were recorded upon the disposition of real estate assets and included the write-off of non-cash straight-line rent receivables. The impairment charge in 2002 of \$0.3 million represents the difference between the net carrying value of \$0.5 million and the estimated fair value of \$0.2 million relating to a skilled nursing facility in Oklahoma, which the Company closed in 2002 and does not expect to reopen.

As required by Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," the Company ceased amortizing goodwill as of January 1, 2002. In lieu of continued amortization, the Company performs an annual goodwill impairment review. The 2004 and 2003 reviews indicated no impairment in the \$3.5 million goodwill asset.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

The information set forth under the heading "Market Risk" in "Management's Discussion and Analysis of Financial Condition and Results of Operations," set forth in Item 7 above, is incorporated herein by reference.

Item 8. Financial Statements and Supplementary Data

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Healthcare Realty Trust Incorporated
Nashville, Tennessee

We have audited the accompanying consolidated balance sheets of Healthcare Realty Trust Incorporated as of December 31, 2004 and 2003 and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Healthcare Realty Trust Incorporated at December 31, 2004 and 2003, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

We were also engaged to audit, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Healthcare Realty Trust Incorporated's internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated November 23, 2005 disclaimed an opinion thereon. Our engagement to audit the effectiveness of internal control over financial reporting as of December 31, 2004, commenced subsequent to December 31, 2004. As a result, we were unable to obtain sufficient contemporaneous evidence necessary to express an opinion on the effectiveness of internal control over financial reporting.

/s/ BDO Seidman, LLP

Memphis, Tennessee
November 23, 2005

**Consolidated
BALANCE SHEETS**

(Dollars in thousands)	December 31,	
	2004 (Restated)	2003 (Restated)
ASSETS		
Real estate properties:		
Land	\$ 137,470	\$ 139,732
Buildings, improvements and lease intangibles	1,660,690	1,396,322
Personal property	16,327	14,607
Construction in progress	18,826	13,198
	1,833,313	1,563,859
Less accumulated depreciation	(270,519)	(232,536)
Total real estate properties, net	1,562,794	1,331,323
Cash and cash equivalents	2,683	4,917
Mortgage notes receivable	40,321	91,835
Assets held for sale, net	61,246	—
Other assets, net	83,766	73,727
Total assets	<u>\$1,750,810</u>	<u>\$1,501,802</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Notes and bonds payable	\$ 719,264	\$ 590,281
Accounts payable and accrued liabilities	28,279	16,780
Other liabilities	22,651	18,611
Total liabilities	770,194	625,672
Commitments and contingencies	—	—
Stockholders' equity:		
Preferred stock, \$.01 par value; 50,000,000 shares authorized; none issued and outstanding	—	—
Common stock, \$.01 par value; 150,000,000 shares authorized; issued and outstanding 2004 — 47,701,108; 2003 — 42,991,416	477	430
Additional paid-in capital	1,218,137	1,056,205
Deferred compensation	(15,153)	(17,827)
Cumulative net income	542,733	487,200
Cumulative dividends	(765,578)	(649,878)
Total stockholders' equity	980,616	876,130
Total liabilities and stockholders' equity	<u>\$1,750,810</u>	<u>\$1,501,802</u>

See accompanying notes.

**Consolidated
STATEMENTS OF INCOME**

	Year Ended December 31,		
	2004 (Restated)	2003 (Restated)	2002 (Restated)
(Dollars in thousands, except per share data)			
REVENUES			
Master lease rental income	\$ 78,355	\$ 76,477	\$ 83,062
Property operating income	111,016	73,078	61,494
Straight-line rent	1,592	2,116	1,947
Mortgage interest income	8,766	10,441	13,308
Other operating income	34,340	21,970	11,117
	<u>234,069</u>	<u>184,082</u>	<u>170,928</u>
EXPENSES			
General and administrative	13,691	11,825	22,665
Property operating expenses	58,187	34,645	29,069
Other operating expenses	14,517	9,265	305
Interest	43,899	34,640	34,274
Depreciation	45,870	39,679	37,441
Amortization	8,155	1,315	126
	<u>184,319</u>	<u>131,369</u>	<u>123,880</u>
INCOME FROM CONTINUING OPERATIONS	49,750	52,713	47,048
DISCONTINUED OPERATIONS			
Income from discontinued operations	6,993	8,798	11,947
Gain (loss) on sale of real estate properties and (impairments), net	(1,210)	(1,109)	3,388
	<u>5,783</u>	<u>7,689</u>	<u>15,335</u>
NET INCOME	<u>\$ 55,533</u>	<u>\$ 60,402</u>	<u>\$ 62,383</u>
BASIC EARNINGS PER COMMON SHARE:			
Income from continuing operations per common share	\$ 1.14	\$ 1.28	\$ 1.02
Discontinued operations per common share	\$ 0.13	\$ 0.19	\$ 0.38
Net income per common share	<u>\$ 1.27</u>	<u>\$ 1.47</u>	<u>\$ 1.40</u>
DILUTED EARNINGS PER COMMON SHARE:			
Income from continuing operations per common share	\$ 1.11	\$ 1.26	\$ 1.00
Discontinued operations per common share	\$ 0.13	\$ 0.18	\$ 0.37
Net income per common share	<u>\$ 1.24</u>	<u>\$ 1.44</u>	<u>\$ 1.37</u>
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING — BASIC	<u>43,706,528</u>	<u>41,142,619</u>	<u>40,701,516</u>
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING — DILUTED	<u>44,627,475</u>	<u>41,840,188</u>	<u>41,487,780</u>
DIVIDEND DECLARED, PER COMMON SHARE, DURING THE PERIOD	<u>\$ 2.55</u>	<u>\$ 2.47</u>	<u>\$ 2.39</u>

See accompanying notes.

Consolidated
STATEMENTS OF STOCKHOLDERS' EQUITY

(Dollars in thousands, except per share data)	Preferred Stock	Common Stock	Additional Paid-In Capital	Deferred Compensation	Cumulative Net Income	Cumulative Dividends	Total Stockholders' Equity
Balance at December 31, 2001, as previously reported	\$ 30	\$414	\$1,089,127	\$(12,852)	\$375,061	\$(439,693)	\$1,012,087
Restatement adjustments reported on Form 8-K dated June 24, 2005	—	3	4,607	(3,442)	(9,118)	—	(7,950)
Subsequent changes to restatement adjustments	—	—	—	—	(1,528)	—	(1,528)
Balance at December 31, 2001, as restated	30	417	1,093,734	(16,294)	364,415	(439,693)	1,002,609
Issuance of stock	—	3	6,068	—	—	—	6,071
Preferred stock redemption ..	(30)	—	(74,970)	—	—	—	(75,000)
Common stock redemption ..	—	(4)	(10,898)	—	—	—	(10,902)
Shares awarded as deferred stock compensation	—	5	16,762	(16,767)	—	—	—
Accelerated vesting of deferred compensation	—	—	—	8,674	—	—	8,674
Deferred stock compensation amortization	—	—	—	3,511	—	—	3,511
Net income	—	—	—	—	62,383	—	62,383
Dividends — common (\$2.39 per share)	—	—	—	—	—	(100,335)	(100,335)
Dividends — preferred (\$1.85 per share)	—	—	—	—	—	(5,559)	(5,559)
Balance at December 31, 2002, as restated	—	421	1,030,696	(20,876)	426,798	(545,587)	891,452
Issuance of stock	—	9	25,092	—	—	—	25,101
Shares awarded as deferred stock compensation	—	—	417	(417)	—	—	—
Deferred stock compensation amortization	—	—	—	3,466	—	—	3,466
Net income	—	—	—	—	60,402	—	60,402
Dividends — common (\$2.47 per share)	—	—	—	—	—	(104,291)	(104,291)
Balance at December 31, 2003, as restated	—	430	1,056,205	(17,827)	487,200	(649,878)	876,130
Issuance of stock	—	47	161,052	—	—	—	161,099
Shares awarded as deferred stock compensation	—	—	880	(880)	—	—	—
Deferred stock compensation amortization	—	—	—	3,554	—	—	3,554
Net income	—	—	—	—	55,533	—	55,533
Dividends — common (\$2.55 per share)	—	—	—	—	—	(115,700)	(115,700)
Balance at December 31, 2004, as restated	<u>\$ —</u>	<u>\$477</u>	<u>\$1,218,137</u>	<u>\$(15,153)</u>	<u>\$542,733</u>	<u>\$(765,578)</u>	<u>\$ 980,616</u>

See accompanying notes.

Consolidated
STATEMENTS OF CASH FLOWS

(Dollars in thousands)	Year Ended December 31,		
	2004 (Restated)	2003 (Restated)	2002 (Restated)
OPERATING ACTIVITIES			
Net income	\$ 55,533	\$ 60,402	\$ 62,383
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation and amortization	57,420	43,235	43,426
Deferred compensation amortization	3,554	3,466	3,511
Increase (decrease) in other liabilities	5,410	1,268	(2,739)
Increase in other assets	(2,070)	(10,496)	(6,237)
Accelerated vesting of deferred compensation	—	—	8,674
Increase in accounts payable and accrued liabilities	6,203	1,082	1,855
Increase in straight-line rent	(1,022)	(1,463)	(1,475)
Net (gain) loss on sales of real estate and impairments	1,210	1,109	(3,388)
Net cash provided by operating activities	126,238	98,603	106,010
INVESTING ACTIVITIES			
Acquisition and development of real estate properties	(355,470)	(78,346)	(38,371)
Funding of mortgages and notes receivable	(3,465)	(33,216)	(6,802)
Proceeds from sales of real estate	10,189	19,714	81,267
Proceeds from mortgage and notes payments/sales	48,636	21,969	23,094
Net cash provided by (used in) investing activities	(300,110)	(69,879)	59,188
FINANCING ACTIVITIES			
Borrowings on notes and bonds payable	565,494	311,000	218,500
Repayments on notes and bonds payable	(436,689)	(261,092)	(207,193)
Dividends paid	(115,700)	(104,291)	(105,894)
Debt issuance costs	(2,566)	(2,436)	—
Preferred stock redemption	—	—	(75,000)
Termination of interest rate swaps	—	18,411	—
Common stock redemption	—	(10,902)	—
Proceeds from issuance of common stock	161,099	25,101	1,861
Net cash provided by (used in) financing activities	171,638	(24,209)	(167,726)
Increase (decrease) in cash and cash equivalents	(2,234)	4,515	(2,528)
Cash and cash equivalents, beginning of year	4,917	402	2,930
Cash and cash equivalents, end of year	<u>\$ 2,683</u>	<u>\$ 4,917</u>	<u>\$ 402</u>

See accompanying notes.