

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2005

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 1-11316

**OMEGA HEALTHCARE  
INVESTORS, INC.**

(Exact name of Registrant as specified in its charter)

Maryland 38-3041398  
(State of Incorporation) (I.R.S. Employer Identification No.)

9690 Deereco Road, Suite 100, Timonium, MD 21093  
(Address of principal executive offices)

(410) 427-1700  
(Telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to the filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of October 28, 2005.

Common Stock, \$.10 par value	51,394,527
(Class) (Number of shares)	

OMEGA HEALTHCARE INVESTORS, INC.  
FORM 10-Q  
September 30, 2005

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**PART 1 - FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**OMEGA HEALTHCARE INVESTORS, INC.  
CONSOLIDATED BALANCE SHEETS  
(in thousands)**

	<u>September 30,</u> <u>2005</u>	<u>December 31,</u> <u>2004</u>
	<u>(Unaudited)</u>	
<b>ASSETS</b>		
Real estate properties		
Land and buildings at cost	\$ 869,382	\$ 808,574
Less accumulated depreciation	<u>(151,410)</u>	<u>(153,379)</u>
Real estate properties - net	717,972	655,195
Mortgage notes receivable - net	<u>43,506</u>	<u>118,058</u>
	761,478	773,253
Other investments - net	<u>25,270</u>	<u>29,699</u>
	786,748	802,952
Assets held for sale - net	<u>23,624</u>	<u>—</u>
Total investments	810,372	802,952
Cash and cash equivalents	768	12,083
Accounts receivable - net	4,778	5,582
Other assets	12,992	12,733
Operating assets for owned properties	<u>—</u>	<u>213</u>
Total assets	<u>\$ 828,910</u>	<u>\$ 833,563</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Revolving line of credit	\$ 80,700	\$ 15,000
Unsecured borrowings	360,000	360,000
Premium on unsecured borrowings	1,219	1,338
Other long-term borrowings	2,800	3,170
Accrued expenses and other liabilities	22,294	21,067
Operating liabilities for owned properties	<u>374</u>	<u>508</u>
Total liabilities	<u>467,387</u>	<u>401,083</u>
Stockholders' equity:		
Preferred stock	118,488	168,488
Common stock and additional paid-in-capital	601,336	597,780
Cumulative net earnings	207,694	191,013
Cumulative dividends paid	(522,206)	(480,292)
Cumulative dividends - redemption	(43,067)	(41,054)
Unamortized restricted stock awards	(1,452)	(2,231)
Accumulated other comprehensive income (loss)	<u>730</u>	<u>(1,224)</u>
Total stockholders' equity	<u>361,523</u>	<u>432,480</u>
Total liabilities and stockholders' equity	<u>\$ 828,910</u>	<u>\$ 833,563</u>

**Note** - The balance sheet at December 31, 2004 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

See notes to consolidated financial statements.

**OMEGA HEALTHCARE INVESTORS, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**Unaudited**  
**(in thousands, except per share amounts)**

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2005	2004	2005	2004
<b>Revenues</b>				
Rental income	\$ 23,962	\$ 17,201	\$ 67,862	\$ 49,742
Mortgage interest income	1,221	3,224	4,417	9,926
Other investment income - net	670	597	1,778	1,757
Miscellaneous	<u>141</u>	<u>202</u>	<u>4,453</u>	<u>623</u>
Total operating revenues	25,994	21,224	78,510	62,048
<b>Expenses</b>				
Depreciation and amortization	6,230	4,858	18,052	14,393
General and administrative	2,235	2,226	6,470	6,012
Provisions for impairment on real estate properties	5,454	-	9,154	-
Provisions for uncollectible mortgages, notes and accounts receivable	-	-	83	-
Leasehold expiration expense	<u>-</u>	<u>-</u>	<u>750</u>	<u>-</u>
Total operating expenses	<u>13,919</u>	<u>7,084</u>	<u>34,509</u>	<u>20,405</u>
<b>Income before other income and expense</b>	<b>12,075</b>	<b>14,140</b>	<b>44,001</b>	<b>41,643</b>
<b>Other income (expense):</b>				
Interest and other investment income	25	7	90	103
Interest	(7,709)	(5,873)	(21,431)	(16,319)
Interest - amortization of deferred financing costs	(539)	(479)	(1,570)	(1,359)
Interest - refinancing costs	-	-	-	(19,106)
Provisions for impairment on equity securities	-	-	(3,360)	-
Owned and operated professional liability claims	-	-	-	(3,000)
Adjustment of derivatives to fair value	<u>-</u>	<u>-</u>	<u>-</u>	<u>256</u>
Total other expense	(8,223)	(6,345)	(26,271)	(39,425)
<b>Income from continuing operations</b>	<b>3,852</b>	<b>7,795</b>	<b>17,730</b>	<b>2,218</b>
Gain (loss) from discontinued operations	<u>1,267</u>	<u>847</u>	<u>(1,049)</u>	<u>2,063</u>
<b>Net income</b>	<b>5,119</b>	<b>8,642</b>	<b>16,681</b>	<b>4,281</b>
Preferred stock dividends	(2,481)	(3,559)	(8,904)	(12,248)
Preferred stock conversion and redemption charges	<u>-</u>	<u>-</u>	<u>(2,013)</u>	<u>(41,054)</u>
<b>Net income (loss) available to common</b>	<b><u>\$ 2,638</u></b>	<b><u>\$ 5,083</u></b>	<b><u>\$ 5,764</u></b>	<b><u>\$ (49,021)</u></b>
<b>Income (loss) per common share:</b>				
<b>Basic:</b>				
Income (loss) from continuing operations	<u>\$ 0.03</u>	<u>\$ 0.09</u>	<u>\$ 0.13</u>	<u>\$ (1.14)</u>
Net income (loss)	<u>\$ 0.05</u>	<u>\$ 0.11</u>	<u>\$ 0.11</u>	<u>\$ (1.09)</u>
<b>Diluted:</b>				
Income (loss) from continuing operations	<u>\$ 0.03</u>	<u>\$ 0.09</u>	<u>\$ 0.13</u>	<u>\$ (1.14)</u>
Net income (loss)	<u>\$ 0.05</u>	<u>\$ 0.11</u>	<u>\$ 0.11</u>	<u>\$ (1.09)</u>
Dividends declared and paid per common share	<u>\$ 0.22</u>	<u>\$ 0.18</u>	<u>\$ 0.63</u>	<u>\$ 0.53</u>
Weighted-average shares outstanding, basic	<u>51,187</u>	<u>46,552</u>	<u>51,050</u>	<u>44,798</u>
Weighted-average shares outstanding, diluted	<u>51,479</u>	<u>47,134</u>	<u>51,386</u>	<u>44,798</u>
<b>Components of other comprehensive income:</b>				
Net income	\$ 5,119	\$ 8,642	\$ 16,681	\$ 4,281

Unrealized gain (loss) on investments and hedging contracts	<u>730</u>	<u>(708)</u>	<u>730</u>	<u>2,015</u>
Total comprehensive income	<u>\$ 5,849</u>	<u>\$ 7,934</u>	<u>\$ 17,411</u>	<u>\$ 6,296</u>

**OMEGA HEALTHCARE INVESTORS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**Unaudited (in thousands)**

	<b>Nine Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>
<b>Operating activities</b>		
Net income	\$ 16,681	\$ 4,281
Adjustment to reconcile net income to cash provided by operating activities:		
Depreciation and amortization (including amounts in discontinued operations)	19,068	16,002
Provision for impairment on real estate properties	9,154	—
Provision for uncollectible mortgages, notes and accounts receivable	83	—
Provision for impairment on equity securities	3,360	—
Refinancing costs	—	19,106
Amortization of deferred financing costs	1,570	1,359
Loss on assets sold - net	3,492	440
Restricted stock amortization expense	856	279
Adjustment of derivatives to fair value	—	(256)
Other	(1,532)	(38)
Net change in accounts receivable	803	(2,327)
Net change in other assets	2,087	306
Net change in operating assets and liabilities	(438)	(3,532)
Net cash provided by operating activities	55,184	35,620
<b>Cash flows from investing activities</b>		
Acquisition of real estate	(120,696)	(34,114)
Proceeds from sale of real estate investments	25,937	135
Proceeds from sale of stock	—	480
Capital improvements and funding of other investments	(2,749)	(3,542)
Proceeds from other investments - net	1,759	4,158
Investments in other investments - net	(6,167)	(3,165)
Collection of mortgage principal	60,869	6,128
Net cash used in investing activities	(41,047)	(29,920)
<b>Cash flows from financing activities</b>		
Proceeds from credit facility borrowings	180,200	61,700
Payment on credit facility borrowings	(114,500)	(201,774)
Prepayment of re-financing penalty	—	(6,378)
Proceeds from long-term borrowings	—	200,000
Payments of long-term borrowings	(370)	(350)
Proceeds from sale of interest rate cap	—	3,460
Receipts from dividend reinvestment plan and directors fees	2,490	201
Receipts from exercised options	324	3,322
Payments of exercised options	(1,308)	(1,767)
Dividends paid	(41,914)	(32,019)
Redemption of preferred stock	(50,000)	(57,500)
Proceeds from preferred stock offering	—	12,644
Proceeds from common stock offering	—	23,370
Deferred financing costs paid	(333)	(10,400)
Cost of raising capital	(41)	—
Net cash used in financing activities	(25,452)	(5,491)
(Decrease) increase in cash and cash equivalents	(11,315)	209
Cash and cash equivalents at beginning of period	12,083	3,094
Cash and cash equivalents at end of period	\$ 768	\$ 3,303
Interest paid during the period	\$ 18,949	\$ 11,506

**OMEGA HEALTHCARE INVESTORS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
Unaudited  
September 30, 2005

**NOTE 1 - BASIS OF PRESENTATION**

The accompanying unaudited consolidated financial statements for Omega Healthcare Investors, Inc. ("Omega" or the "Company") have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Certain reclassifications have been made to the 2004 financial statements for consistency with the presentation adopted for 2005. Such reclassifications have no effect on previously reported earnings or equity.

In December 2004, the Financial Accounting Standards Board issued FAS No. 123 (revised 2004), *Share-Based Payment* ("FAS No. 123R"), which is a revision of FAS No. 123, *Accounting for Stock-Based Compensation*. FAS No. 123R supersedes Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FAS No. 95, *Statement of Cash Flows*. Registrants were initially required to adopt FAS No. 123R as of the beginning of the first interim or annual period that begins after June 15, 2005. On April 14, 2005, the Securities and Exchange Commission adopted a new rule that allows companies to implement FAS No. 123R at the beginning of their next fiscal year that begins after June 15, 2005. We will adopt FAS No. 123R at the beginning of our 2006 fiscal year. We are currently evaluating the impact of adoption of this pronouncement.

Operating results for the three- and nine-month periods ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. For further information, refer to the financial statements and footnotes included in our annual report on Form 10-K for the year ended December 31, 2004.

Our consolidated financial statements include the accounts of Omega and all direct and indirect wholly owned subsidiaries. All inter-company accounts and transactions have been eliminated in consolidation. We have one reportable segment consisting of investments in real estate. Our business is to provide financing and capital to the long-term healthcare industry with a particular focus on skilled nursing facilities located in the United States. Our core portfolio consists of long-term lease and mortgage agreements. All of our leases are "triple-net" leases, which require the tenants to pay all property-related expenses. Our mortgage revenue derives from fixed-rate mortgage loans, which are secured by first mortgage liens on the underlying real estate and personal property of the mortgagor. Substantially all depreciation expenses reflected in the consolidated statements of operations relate to the ownership of our investment in real estate.

**NOTE 2 - PROPERTIES**

In the ordinary course of our business activities, we periodically evaluate investment opportunities and extend credit to customers. We also regularly engage in lease and loan extensions and modifications. Additionally, we actively monitor and manage our investment portfolio with the objectives of improving credit quality and increasing returns. In connection with portfolio management, we may engage in various collection and foreclosure activities.

If we acquire real estate pursuant to a foreclosure, lease termination or bankruptcy proceeding and do not immediately re-lease or sell the properties to new operators, the assets will be included on the balance sheet as "foreclosed real estate properties," and the value of such assets is reported at the lower of cost or estimated fair value.

The table below summarizes our number of properties and investment by category for the nine months ended September 30, 2005:

Facility Count	Leased Property	Mortgage Notes Receivable	Facilities Held for Sale	Total Healthcare Facilities
Balance at December 31, 2004	175	46	-	221
Properties sold/mortgages paid	(7)	(12)	-	(19)
Properties acquired	14	-	-	14
Properties transferred to assets held for sale	(7)	-	7	-
Properties transferred to purchase/leaseback	6	(6)	-	-
Balance at September 30, 2005	181	28	7	216

  

Investment (\$000's)				
Balance at December 31, 2004	\$ 808,574	\$ 118,058	\$ -	\$ 926,632
Properties sold/mortgages paid	(38,975)	(59,657)	-	(98,632)
Properties acquired	124,655	-	-	124,655
Properties transferred to assets held for sale	(29,704)	-	23,624	(6,080)
Properties transferred to purchase/leaseback	13,776	(13,776)	-	-
Impairment on properties	(9,154)	-	-	(9,154)
Capital expenditures and other	210	(1,119)	-	(909)
Balance at September 30, 2005	\$ 869,382	\$ 43,506	\$ 23,624	\$ 936,512

#### Leased Property

Our leased real estate properties, represented by 179 long-term care facilities and two rehabilitation hospitals at September 30, 2005, are leased under provisions of single leases and master leases with initial terms typically ranging from 5 to 15 years, plus renewal options. Substantially all of the leases and master leases provide for minimum annual rentals that are subject to annual increases based upon increases in the Consumer Price Index or increases in revenues of the underlying properties, with certain maximum limits. Under the terms of the leases, the lessee is responsible for all maintenance, repairs, taxes and insurance on the leased properties.

Set forth below is a summary of the lease and acquisition transactions that occurred in the first nine months of 2005.

##### *CommuniCare Health Services, Inc.*

- On June 28, 2005, we purchased five skilled nursing facilities ("SNFs") located in Ohio (3) and Pennsylvania (2), totaling 911 beds. The investment, excluding working capital, totaled approximately \$50 million. The SNFs were purchased from an unrelated third party and are now operated by subsidiaries of CommuniCare Health Services, Inc. ("CommuniCare"), a current lessee, with the five facilities being consolidated into a n existing master lease. The term of the master lease was extended to ten years ending June 30, 2015, with two nine year renewal options.

##### *Senior Management Services, Inc.*

- Effective June 1, 2005, we purchased two SNFs for a total investment of approximately \$9.5 million. Both facilities, totaling 440 beds, are located in Texas. The facilities were consolidated into a master lease with an existing operator, Senior Management Services, Inc. The term of the existing master lease was extended to ten years and runs through May 31, 2015, followed by two renewal options of ten years each.



### *Essex Healthcare Corporation*

- On January 13, 2005, we closed on approximately \$58 million of net new investments as a result of the exercise by American Health Care Centers ("American") of a put agreement with us for the purchase of 13 SNFs. The gross purchase price of approximately \$79 million was satisfied in part by a purchase option of approximately \$7 million and approximately \$14 million in mortgage loans we had outstanding with American and its affiliates.
- The 13 properties, all located in Ohio, continue to be leased by Essex Healthcare Corporation ("Essex"). The master lease and related agreements have remaining terms of approximately six years.

### *Claremont Health Care Holdings, Inc.*

- Effective January 1, 2005, we re-leased one SNF formerly leased to Claremont Health Care Holdings, Inc., located in New Hampshire and representing 68 beds to an existing operator. This facility was added to an existing master lease, which expires on December 31, 2013, followed by two 10-year renewal options.

### *Other*

- During the three months ended September 30, 2005, a \$5.5 million provision for impairment charge was recorded to reduce the carrying value on three facilities to their estimated fair value.
- During the three months ended March 31, 2005, a \$3.7 million provision for impairment charge was recorded to reduce the carrying value on two facilities, which were subsequently closed, to their estimated fair value.

### **Assets Held for Sale**

- On July 29, 2005, we received notice from AHC Properties, Inc. ("Alterra") of their intent to exercise their option to purchase six assisted living facilities ("ALFs") for approximately \$20.4 million. The ALFs are currently leased to Alterra in a master lease with annual revenue of approximately \$1.7 million. The closing of this transaction is scheduled for the fourth quarter of 2005, subject to closing conditions typical in real estate transactions. At September 30, 2005, the net book value of these facilities was approximately \$15.4 million.
- On June 23, 2005, a \$1.0 million deposit related to an agreement to sell a SNF in Florida was received into escrow on our behalf. On July 26, 2005, an additional \$0.5 million deposit was received into escrow. The purchase price of the facility is \$14.5 million and the closing is scheduled for the fourth quarter of 2005. The due diligence period has expired, and the deposits are not refundable unless we breach our obligations under the purchase agreement. At September 30, 2005, the net book value of this facility was approximately \$8.2 million.

### **Assets Sold**

- On August 1, 2005, we sold 50.4 acres of undeveloped land, located in Ohio, for net cash proceeds of approximately \$1 million. The sale resulted in an accounting gain of approximately \$0.7 million.
- On June 30, 2005, we sold four SNFs to subsidiaries of Alden Management Services, Inc., who previously leased the facilities from us. All four facilities are located in Illinois. The sales price totaled approximately \$17 million. We received net cash proceeds of approximately \$12 million plus a secured promissory note of approximately \$5.4 million. The sale resulted in a non-cash accounting loss of approximately \$4.2 million.

- During the three months ended March 31, 2005, we sold three facilities, located in Florida and California, for their approximate net book value, realizing cash proceeds of approximately \$6 million, net of closing costs and other expenses.

## Acquisitions

The table below summarizes the acquisitions completed during the nine months ended September 30, 2005. The purchase price includes estimated transaction costs.

<u>100% Interest Acquired</u>	<u>Acquisition Date</u>	<u>Purchase Price (\$000's)</u>
Thirteen facilities in OH	January 13, 2005	\$79,300
Two facilities in TX	June 1, 2005	\$ 9,500
Five facilities in PA and OH	June 28, 2005	\$49,600

The acquired properties are included in our results of operations from the respective date of acquisition. The following unaudited pro forma results of operations reflect these transactions as if each had occurred on January 1 of the year presented. In our opinion, all significant adjustments necessary to reflect the effects of the acquisitions have been made.

	<b>Pro Forma</b>			
	<b>(in thousands, except per share amounts)</b>			
	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Revenues	\$ 25,994	\$ 24,864	\$ 81,775	\$ 72,967
Net income	\$ 5,119	\$ 9,703	\$ 17,183	\$ 7,465
Earnings (loss) per share - Basic	0.05	\$ 0.13	\$ 0.12	\$ (1.02)
Earnings (loss) per share - Diluted	\$ 0.05	\$ 0.13	\$ 0.12	\$ (1.02)

## Mortgage Notes Receivable

Mortgage notes receivable relate to 28 long-term care facilities. The mortgage notes are secured by first mortgage liens on the borrowers' underlying real estate and personal property. The mortgage notes receivable relate to facilities located in six states, operated by seven independent healthcare operating companies. We monitor compliance with mortgages and when necessary have initiated collection, foreclosure and other proceedings with respect to certain outstanding loans. As of September 30, 2005, we had no foreclosed property and none of our mortgages were in foreclosure proceedings.

Mortgage interest income is recognized as earned over the terms of the related mortgage notes. Reserves are taken against earned revenues from mortgage interest when collection of amounts due becomes questionable or when negotiations for restructurings of troubled operators lead to lower expectations regarding ultimate collection. When collection is uncertain, mortgage interest income on impaired mortgage loans is recognized as received after taking into account application of security deposits.

On February 1, 2005, Mariner Health Care, Inc. ("Mariner") exercised its right to prepay in full the \$59.7 million aggregate principal amount owed to us under a promissory note secured by a mortgage with an interest rate of 11.57%, together with the required prepayment premium of 3% of the outstanding principal balance and all accrued and unpaid interest. In addition, pursuant to certain provisions contained in the promissory note, Mariner paid us an amendment fee owed for the period ending on February 1, 2005.

A provision for loss on notes receivable of \$0.1 million was recorded during the three-months ended June 30, 2005.

### **NOTE 3 - INVESTMENTS IN EQUITY SECURITIES**

In accordance with Statement of Financial Accounting Standards No. 115 ("FAS 115"), "Accounting for Certain Investments in Debt and Equity Securities," our marketable security classified as available-for-sale is stated at fair value with unrealized gains and losses recorded in accumulated other comprehensive income. Realized gains and losses and declines in value judged to be other-than-temporary on securities held as available-for-sale are included in the other expense in the accompanying consolidated financial statements. The cost of securities sold is based on the specific identification method. Interest and dividends on securities available-for-sale are included in investment income. If events or circumstances indicate that the fair value of an investment has declined below its carrying value and we consider the decline to be "other than temporary," the investment is written down to fair value and an impairment loss is recognized.

At September 30, 2005, we had one marketable security which is included in Other Investments - Net. In accordance with FAS 115, during the quarter ended June 30, 2005, we recorded a \$3.4 million provision for impairment to write-down our 760,000 share investment in Sun Healthcare Group, Inc. ("Sun") common stock to fair market value at the date the provision was recorded.

### **NOTE 4 - CONCENTRATION OF RISK**

As of September 30, 2005, our portfolio of domestic investments consisted of 216 healthcare facilities, located in 28 states and operated by 38 third-party operators. Our gross investment in these facilities, net of impairments and before reserve for uncollectible loans, totaled approximately \$937 million at September 30, 2005, with approximately 98% of our real estate investments related to long-term care facilities. This portfolio is made up of 179 long-term healthcare facilities, two rehabilitation hospitals owned and leased to third parties, fixed rate mortgages on 28 long-term healthcare facilities and seven facilities held for sale. At September 30, 2005, we also held miscellaneous investments of approximately \$25 million, consisting primarily of secured loans to third-party operators of our facilities.

At September 30, 2005, approximately 27% of our real estate investments were operated by two public companies: Sun (16%) and Advocat, Inc. ("Advocat") (11%). Our largest private company operators (by investment) were Guardian LTC Management, Inc. (9%), Essex (8%), CommuniCare (8%), Haven Healthcare (6%) and Seacrest Healthcare (6%). No other operator represents more than 5% of our investments. The three states in which we had our highest concentration of investments were Ohio (17%), Florida (13%) and Pennsylvania (11%) at September 30, 2005.

For the three-month period ended September 30, 2005, our revenues from operations totaled \$26.0 million, of which approximately \$5.5 million were derived from Sun (21%) and \$3.1 million from Advocat (12%). For the nine-month period ended September 30, 2005, our revenues from operations totaled \$78.5 million, of which approximately \$16.4 million were from Sun (21%) and \$9.2 million from Advocat (12%). No other operator generated more than 10% of our revenues from operations for the three- and nine-month periods ended September 30, 2005.

## NOTE 5 - DIVIDENDS

In order to qualify as a REIT, we are required to distribute dividends (other than capital gain dividends) to our stockholders in an amount at least equal to (A) the sum of (i) 90% of our "REIT taxable income" (computed without regard to the dividends paid deduction and our net capital gain), and (ii) 90% of the net income (after tax), if any, from foreclosure property, minus (B) the sum of certain items of non-cash income. In addition, if we dispose of any built-in gain asset during a recognition period, we will be required to distribute at least 90% of the built-in gain (after tax), if any, recognized on the disposition of such asset. Such distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before we timely file our tax return for such year and paid on or before the first regular dividend payment after such declaration. In addition, such distributions are required to be made pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that such class is entitled to such a preference. To the extent that we do not distribute all of our net capital gain or do distribute at least 90%, but less than 100% of our "REIT taxable income," as adjusted, we will be subject to tax thereon at regular ordinary and capital gain corporate tax rates. In addition, our \$200 million revolving senior secured credit facility ("Credit Facility") has certain financial covenants that limit the distribution of dividends paid during a fiscal quarter to no more than 95% of our immediately prior fiscal quarter's FFO as defined in the loan agreement governing the Credit Facility (the "Loan Agreement"), unless a greater distribution is required to maintain REIT status. The Loan Agreement defines FFO as net income (or loss), plus depreciation and amortization and shall be adjusted for charges related to: (i) restructuring our debt; (ii) redemption of preferred stock; (iii) litigation charges up to \$5.0 million; (iv) non-cash charges for accounts and notes receivable up to \$5.0 million; (v) non-cash compensation related expenses; and (vi) non-cash impairment charges.

### *Common Dividends*

On October 18, 2005, the Board of Directors declared a common stock dividend of \$0.22 per share to be paid November 15, 2005 to common stockholders of record on October 31, 2005.

On July 19, 2005, the Board of Directors declared a common stock dividend of \$0.22 per share, an increase of \$0.01 per common share compared to the prior quarter. This common stock dividend was paid August 15, 2005 to common stockholders of record on July 29, 2005.

On April 19, 2005, the Board of Directors declared a common stock dividend of \$0.21 per share, an increase of \$0.01 per common share compared to the prior quarter. The common stock dividend was paid May 16, 2005 to common stockholders of record on May 2, 2005.

On January 18, 2005, the Board of Directors declared a common stock dividend of \$0.20 per share, an increase of \$0.01 per common share compared to the prior quarter. The common stock dividend was paid February 15, 2005 to common stockholders of record on January 31, 2005.

### *Series D Preferred Dividends*

On October 18, 2005, the Board of Directors declared the regular quarterly dividends for its 8.375% Series D Cumulative Redeemable Preferred Stock ("Series D Preferred Stock") to stockholders of record on October 31, 2005. The stockholders of record of the Series D Preferred Stock on October 31, 2005 will be paid dividends in the amount of \$0.52344 per preferred share on November 15, 2005. The liquidation preference for our Series D Preferred Stock is \$25.00 per share. Regular quarterly preferred dividends for the Series D Preferred Stock represent dividends for the period August 1, 2005 through October 31, 2005.

On July 19, 2005, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share for its Series D Preferred Stock, that were paid August 15, 2005 to preferred stockholders of record on July 29, 2005.

On March 15, 2005, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share for its Series D Preferred Stock, that were paid May 16, 2005 to preferred stockholders of record on May 2, 2005.

On January 18, 2005, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share for its Series D Preferred Stock, that were paid February 15, 2005 to preferred stockholders of record on January 31, 2005.

#### *Series B Preferred Stock Redemption and Quarterly Dividends*

On March 15, 2005, the Board of Directors also authorized the redemption of all shares outstanding of our 8.625% Series B Preferred Stock ("Series B Preferred Stock") (NYSE:OHI PrB; CUSIP: 681936208). We redeemed all of the outstanding shares on May 2, 2005 for \$25.00 per share, plus \$0.55104 per share in accrued and unpaid dividends through the redemption date, for an aggregate redemption price of \$25.55104 per share. Dividends on the shares of Series B Preferred Stock ceased to accrue from and after the redemption date, after which the Series B Preferred Stock was no longer outstanding and holders of the Series B Preferred Stock have only the right to receive the redemption price. During the quarter ended June 30, 2005, our Board of Directors formally reclassified the shares previously designated as Series B Preferred Stock as authorized but unissued shares of preferred stock without designation as to series pursuant to authority granted to the Board of Directors in our Articles of Incorporation.

The notice of redemption and related materials were mailed to the holders of the Series B Preferred Stock on or about April 1, 2005. EquiServe Trust Company acted as our redemption and paying agent. On or before the redemption date, we deposited with EquiServe the aggregate redemption price to be held in trust for the benefit of the holders of the Series B Preferred Stock. Holders of the Series B Preferred Stock who held shares through the Depository Trust Company had their shares of the Series B Preferred Stock redeemed in accordance with the Depository Trust Company's procedures.

In connection with the redemption of the Series B Preferred Stock, for the three-month period ended June 30, 2005, we recorded a non-cash, non-recurring reduction in net income attributable to common shareholders of approximately \$2.0 million. This reduction was taken in accordance with the Securities and Exchange Commission's Interpretation of FASB-EITF Topic D-42 ("The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock"), issued on July 31, 2003. Under this interpretation, all costs associated with the original issuance of the Series B Preferred Stock were recorded as a reduction of net income attributable to common stockholders.

On January 18, 2005, the Board of Directors declared regular quarterly dividends of approximately \$0.53906 per preferred share for its Series B Preferred Stock, that were paid February 15, 2005 to preferred stockholders of record on January 31, 2005.

#### **NOTE 6 - TAXES**

As a qualified REIT, we will not be subject to Federal income taxes on our income, and no provisions for Federal income taxes have been made. We are permitted to own up to 100% of a "taxable REIT subsidiary" ("TRS"). Currently we have two TRSs that are taxable as corporations and that pay federal, state and local income tax on their net income at the applicable corporate rates.

## NOTE 7 - STOCK-BASED COMPENSATION

### Stock Options

We account for stock options using the intrinsic value method as defined by APB Opinion No. 25, *Accounting for Stock Issued to Employees*. Under the terms of our 2000 Stock Incentive Plan (the "2000 Plan"), we reserved 3,500,000 shares of common stock. The exercise price per share of an option under the 2000 Plan cannot be reduced after the date of grant, nor can an option be cancelled in exchange for an option with a lower exercise price per share. The 2000 Plan provides for non-employee directors to receive options that vest over three years while other grants vest over the period required in the agreement applicable to the individual recipient. Directors, officers, employees and consultants are eligible to participate in the 2000 Plan. At September 30, 2005, there were outstanding options for 261,065 shares of common stock granted to 16 eligible participants under the 2000 Plan. Additionally, 355,655 shares of restricted stock have been granted under the provisions of the 2000 Plan, and as of September 30, 2005, there were no shares of unvested restricted stock outstanding under the 2000 Plan.

At September 30, 2005, under the 2000 Plan, there were options for 136,600 shares of common stock currently exercisable with a weighted-average exercise price of \$6.99, with exercise prices ranging from \$2.32 to \$37.20. There were 559,960 shares available for future grants as of September 30, 2005. A breakdown of the options outstanding under the 2000 Plan as of September 30, 2005, by price range, is presented below:

Option Price Range	Number	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)	Number Exercisable	Weighted Average Price on Options Exercisable
\$2.32-\$3.00	141,836	\$ 2.88	5.89	38,522	\$ 2.77
\$3.01-\$3.81	75,981	\$ 3.24	6.15	59,832	\$ 3.24
\$6.02-\$9.33	24,247	\$ 6.71	6.58	19,245	\$ 6.32
\$20.25-\$37.20	19,001	\$ 28.03	1.73	19,001	\$ 28.03

On April 20, 2004, our Board of Directors approved the 2004 Stock Incentive Plan (the "2004 Plan"), which was subsequently approved by our stockholders at our annual meeting held on June 3, 2004. Under the terms of the 2004 Plan, we reserved 3,000,000 shares of common stock. The exercise price per share of an option under the 2004 Plan cannot be less than fair market value (as defined in the 2004 Plan) on the date of grant. The exercise price per share of an option under the 2004 Plan cannot be reduced after the date of grant, nor can an option be cancelled in exchange for an option with a lower exercise price per share. Directors, officers, employees and consultants are eligible to participate in the 2004 Plan. As of September 30, 2005, a total of 335,465 shares of restricted stock and 317,500 restricted stock units have been granted under the 2004 Plan, and as of September 30, 2005, there were no outstanding options to purchase shares of common stock under the 2004 Plan.

At September 30, 2005, the only options outstanding to purchase shares of common stock were options issued under our 2000 Plan for 261,065 shares of common stock. For the quarter ended September 30, 2005, no options were granted under any of our stock incentive plans. The following is a summary of option activity under the 2000 Plan:

<u>Stock Options</u>	<u>Number of Shares</u>	<u>Exercise Price</u>	<u>Weighted-Average Price</u>
Outstanding at December 31, 2004	570,183	\$ 2.320-37.205	\$ 3.891
Granted during 1 <sup>st</sup> quarter 2005			
Exercised	(74,970)	2.320-9.330	2.805
Cancelled	-	---	-
Outstanding at March 31, 2005	495,213	\$ 2.320-37.205	\$ 4.056
Granted during 2 <sup>nd</sup> quarter 2005			
Exercised	(109,234)	2.320-9.330	2.735
Cancelled	(5,833)	3.410-3.410	3.410
Outstanding at June 30, 2005	380,146	\$ 2.320-37.205	\$ 4.446
Granted during 3 <sup>rd</sup> quarter 2005			
Exercised	(119,081)	2.320-6.020	2.861
Cancelled	-	---	-
Outstanding at September 30, 2005	261,065	\$ 2.320-37.205	\$ 5.168

Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*, which was effective January 1, 2003, requires certain disclosures related to our stock-based compensation arrangements.

The following table presents the effect on net income and earnings per share if we had applied the fair value recognition provisions of FAS No. 123, *Accounting for Stock-Based Compensation*, to our stock-based compensation.

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>September 30,</u>		<u>September 30,</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
	<u>(in thousands, except per share amounts)</u>		<u>(in thousands, except per share amounts)</u>	
Net income (loss) to common stockholders	\$ 2,638	\$ 5,083	\$ 5,764	\$ (49,021)
Add: Stock-based compensation expense included in net income (loss) to common stockholders	285	279	856	279
	2,923	5,362	6,620	(48,742)
Less: Stock-based compensation expense determined under the fair value based method for all awards	323	282	1,013	294
Pro forma net income (loss) to common stockholders	<u>\$ 2,600</u>	<u>\$ 5,080</u>	<u>\$ 5,607</u>	<u>\$ (49,036)</u>
Earnings (loss) per share:				
Basic, as reported	<u>\$ 0.05</u>	<u>\$ 0.11</u>	<u>\$ 0.11</u>	<u>\$ (1.09)</u>
Basic, pro forma	<u>\$ 0.05</u>	<u>\$ 0.11</u>	<u>\$ 0.11</u>	<u>\$ (1.09)</u>
Diluted, as reported	<u>\$ 0.05</u>	<u>\$ 0.11</u>	<u>\$ 0.11</u>	<u>\$ (1.09)</u>
Diluted, pro forma	<u>\$ 0.05</u>	<u>\$ 0.11</u>	<u>\$ 0.11</u>	<u>\$ (1.09)</u>

No stock options were issued during 2005, for options issued for 2004 and prior years fair value was calculated on the grant dates using the Black-Scholes options-pricing model with the following assumptions.

**Significant Weighted-Average Assumptions:**

Risk-free Interest Rate at time of Grant	2.50%
Expected Stock Price Volatility	3.00%
Expected Option Life in Years <sup>(a)</sup>	4
Expected Dividend Payout	5.00%

(a) Expected life is based on contractual expiration dates

## **Restricted Stock**

On September 10, 2004, we entered into restricted stock agreements with four executive officers under the 2004 Plan. A total of 317,500 shares of restricted stock were granted, which equated to approximately \$3.3 million of deferred compensation. The shares vest thirty-three and one-third percent (33 1/3%) on each of January 1, 2005, January 1, 2006 and January 1, 2007 so long as the executive officer remains employed on the vesting date, with vesting accelerating upon a qualifying termination of employment or upon the occurrence of a change of control (as defined in the Restricted Stock Agreements).

For the three-month period ended September 30, 2005, we issued 383 shares of restricted common stock to each non-employee director under the 2004 Plan for a total of 1,915 shares. These shares represent a payment of the portion of the directors' annual retainer that is payable in shares of our common stock.

## **Performance Restricted Stock Units**

On September 10, 2004, we entered into performance restricted stock unit agreements with our four executive officers under the 2004 Plan. A total of 317,500 restricted stock units were issued under the 2004 Plan and will fully vest into shares of common stock when our company attains \$0.30 per share of adjusted funds from operations (as defined in the Restricted Stock Unit Agreements) for two (2) consecutive quarters, with vesting accelerating upon a qualifying termination of employment or upon the occurrence of a change of control (as defined in the Restricted Stock Unit Agreements). The issuance of restricted stock units has no impact on our calculation of diluted earnings per common share at this time; however, under our current method of accounting for stock-based compensation, the expense related to the restricted stock units will be recognized when it becomes probable that the vesting requirements will be met.

## **NOTE 8 - FINANCING ACTIVITIES AND BORROWING ARRANGEMENTS**

### **Bank Credit Agreements**

At September 30, 2005, \$80.7 million was outstanding under our Credit Facility and \$3.9 million was utilized for the issuance of letters of credit, leaving availability of \$115.4 million. On April 26, 2005, we amended our Credit Facility to reduce both LIBOR and Base Rate interest spreads (as defined in the Credit Facility) by 50 basis points for borrowings outstanding. The \$80.7 million of outstanding borrowings had a blended interest rate of 6.31% at September 30, 2005.

Our long-term borrowings require us to meet certain property level financial covenants and corporate financial covenants, including prescribed leverage, fixed charge coverage, minimum net worth, limitations on additional indebtedness and limitations on dividend payouts. As of September 30, 2005, we were in compliance with all property level and corporate financial covenants.

At December 31, 2004, we had \$15.0 million of outstanding borrowings with a blended interest rate of 5.41%.

### **\$60 Million 7% Senior Unsecured Notes Offering**

On October 29, 2004, we completed a privately placed offering of an additional \$60 million aggregate principal amount of 7% senior notes due 2014 (the "Additional Notes") at an issue price of 102.25% of the principal amount of the Additional Notes (equal to a per annum yield to maturity of approximately 6.67%), resulting in gross proceeds of approximately \$61 million. The terms of the Additional Notes offered were substantially identical to our existing \$200 million aggregate principal amount of 7% senior notes due 2014 issued in March 2004 (the "Existing Notes"), which were subsequently exchanged for registered senior notes in September 2004. The Additional Notes were issued through a private placement to qualified institutional buyers under Rule 144A under the Securities Act of 1933 (the "Securities Act") and in offshore transactions pursuant to Regulation S under the Securities Act.



On December 21, 2004, we filed a registration statement on Form S-4 under the Securities Act with the SEC offering to exchange (the "Additional Notes Exchange Offer") up to \$60 million aggregate principal amount of our registered 7% Senior Notes due 2014 (the "Additional Exchange Notes"), for all of our outstanding unregistered Additional Notes. On March 18, 2005, upon the expiration of the Additional Notes Exchange Offer, \$60 million aggregate principal amount of Additional Exchange Notes were exchanged for the unregistered Additional Notes. As a result of the Additional Exchange Offer, no Additional Notes remain outstanding. The terms of the Additional Exchange Notes are identical to the terms of the Additional Notes, except that the Additional Exchange Notes are registered under the Securities Act and therefore freely tradable (subject to certain conditions) along with our previously registered Existing Notes as a single class. The Additional Exchange Notes represent our unsecured senior obligations and have been guaranteed by all of our subsidiaries with unconditional guarantees of payment that rank equally with existing and future senior unsecured debt of such subsidiaries and senior to existing and future subordinated debt of such subsidiaries.

Our \$260 million 7% senior notes due 2014 ("Senior Notes") are guaranteed jointly and severally, fully and unconditionally by all of our wholly-owned subsidiaries. We are the issuer and non-guarantor of the Senior Notes and, aside from the assets or operations of our subsidiaries, we do not have any significant assets or operations. Pursuant to the terms of the indenture governing the Senior Notes, we will not and will not permit any of our subsidiary guarantors to cause or otherwise effect any consensual encumbrance or restriction with respect to the payment of any dividend or the making of any distributions on any capital stock, to pay indebtedness owed to us or any subsidiary guarantor, to make loans or advances to us or any of our subsidiary guarantors, or transfer its property or assets to us or any of our subsidiary guarantors other than in certain limited exceptions.

#### **NOTE 9 - LITIGATION**

We are subject to various legal proceedings, claims and other actions arising out of the normal course of business. While any legal proceeding or claim has an element of uncertainty, management believes that the outcome of each lawsuit, claim or legal proceeding that is pending or threatened, or all of them combined, will not have a material adverse effect on our consolidated financial position or results of operations.

We and several of our wholly-owned subsidiaries have been named as defendants in professional liability claims related to our former owned and operated facilities. Other third-party managers responsible for the day-to-day operations of these facilities have also been named as defendants in these claims. In these suits, patients of certain previously owned and operated facilities have alleged significant damages, including punitive damages against the defendants. The majority of these lawsuits representing the most significant amount of exposure were settled in 2004. There currently is one lawsuit pending that is in the discovery stage, and we are unable to predict the likely outcome of this lawsuit at this time.

#### **NOTE 10 - DISCONTINUED OPERATIONS**

SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires the presentation of the net operating results of facilities sold during 2005 or currently classified as held-for-sale as income from discontinued operations for all periods presented. We incurred a net gain from discontinued operations of approximately \$1.3 million and a net loss of \$1.0 million for the three- and nine-month periods ended September 30, 2005, respectively, in the accompanying consolidated statements of operations.

The following table summarizes the results of operations of facilities sold or held-for-sale during the three- and nine- month periods ended September 30, 2005 and 2004, respectively.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2005	2004	2005	2004
	(in thousands)		(in thousands)	
<b>Revenues</b>				
Rental income	\$ 602	\$ 1,371	\$ 3,434	\$ 4,122
Other income	—	12	24	41
Subtotal revenues	602	1,383	3,458	4,163
<b>Expenses</b>				
Depreciation and amortization	45	536	1,015	1,612
Subtotal expenses	45	536	1,015	1,612
Income before gain (loss) on sale of assets	557	847	2,443	2,551
Gain (loss) on assets sold - net	710	—	(3,492)	(488)
<b>Gain (loss) from discontinued operations</b>	<u>\$ 1,267</u>	<u>\$ 847</u>	<u>\$ (1,049)</u>	<u>\$ 2,063</u>

#### NOTE 11 - EARNINGS PER SHARE

The computation of basic earnings per common share ("EPS") is computed by dividing net income available to common stockholders by the weighted-average number of shares of common stock outstanding during the relevant period. Diluted EPS reflects the potential dilution that could occur from shares issuable through stock-based compensation, including stock options and restricted stock rewards.

For the three- and nine-month periods ended September 30, 2005, the dilutive effect from stock options was immaterial. For the three-month period ended September 30, 2004, there was an immaterial dilutive effect from stock options. For the nine-month period ended September 30, 2004, there was no dilutive effect from stock options.

#### NOTE 12 - SUBSEQUENT EVENTS

##### Dividends

On October 18, 2005, the Board of Directors declared a common stock dividend of \$0.22 per share to be paid November 15, 2005 to common stockholders of record on October 31, 2005. Also on October 18, 2005, the Board of Directors declared the regular quarterly dividends for its 8.375% Series D Preferred Stock to stockholders of record on October 31, 2005. The stockholders of record of the Series D Preferred Stock on October 31, 2005 will be paid dividends in the amount of \$0.52344 per preferred share on November 15, 2005.

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

### Forward-looking Statements, Reimbursement Issues and Other Factors Affecting Future Results

*The following discussion should be read in conjunction with the financial statements and notes thereto appearing elsewhere in this document. This document contains forward-looking statements within the meaning of the federal securities laws, including statements regarding potential financings and potential future changes in reimbursement. These statements relate to our expectations, beliefs, intentions, plans, objectives, goals, strategies, future events, performance and underlying assumptions and other statements other than statements of historical facts. In some cases, you can identify forward-looking statements by the use of forward-looking terminology including, but not limited to, terms such as "may," "will," "anticipates," "expects," "believes," "intends," "should" or comparable terms or the negative thereof. These statements are based on information available on the date of this filing and only speak as to the date hereof and no obligation to update such forward-looking statements should be assumed. Our actual results may differ materially from those reflected in the forward-looking statements contained herein as a result of a variety of factors, including, among other things:*

- (i) those items discussed under "Risk Factors" in Item 1 to our annual report on Form 10-K for the year ended December 31, 2004;
- (ii) uncertainties relating to the business operations of the operators of our assets, including those relating to reimbursement by third-party payors, regulatory matters and occupancy levels;
- (iii) the ability of any operators in bankruptcy to reject unexpired lease obligations, modify the terms of our mortgages and impede our ability to collect unpaid rent or interest during the process of a bankruptcy proceeding and retain security deposits for the debtors' obligations;
- (iv) our ability to sell closed assets on a timely basis and on terms that allow us to realize the carrying value of these assets;
- (v) our ability to negotiate appropriate modifications to the terms of our credit facility;
- (vi) our ability to manage, re-lease or sell any owned and operated facilities;
- (vii) the availability and cost of capital;
- (viii) competition in the financing of healthcare facilities;
- (ix) regulatory and other changes in the healthcare sector;
- (x) the effect of economic and market conditions generally and, particularly, in the healthcare industry;
- (xi) changes in interest rates;
- (xii) the amount and yield of any additional investments;
- (xiii) changes in tax laws and regulations affecting real estate investment trusts; and
- (xiv) changes in the ratings of our debt and preferred securities.

### Overview

At September 30, 2005, our portfolio of domestic investments consisted of 216 healthcare facilities, located in 28 states and operated by 38 third-party operators. Our gross investment in these facilities, net of impairments and before reserve for uncollectible loans, totaled approximately \$937 million at September 30, 2005, with approximately 98% of our real estate investments related to long-term care facilities. This portfolio is made up of 179 long-term healthcare facilities, two rehabilitation hospitals owned and leased to third parties, fixed rate mortgages on 28 long-term healthcare facilities and seven long-term healthcare facilities that are currently held for sale. At September 30, 2005, we also held miscellaneous investments of approximately \$25 million, consisting primarily of secured loans to third-party operators of our facilities.

## Medicare Reimbursement

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

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

Legislation adopted in 1999 and 2000 provided for a few temporary increases to Medicare payment rates, but a number of these temporary increases have since expired or will expire in the near future. Specifically, in 1999 the Balanced Budget Refinement Act ("Balanced Budget Refinement Act") included a 4% across-the-board increase of the adjusted federal per diem payment rate for all patient acuity categories (known as "Resource Utilization Groups" or "RUGs") that was in effect from April 2000 through September 30, 2002. In 2000, the Benefits Improvement and Protection Act ("Benefits Improvement and Protection Act") included a 16.7% increase in the nursing component of the case-mix adjusted federal periodic payment rate, which was implemented in April 2000 and also expired October 1, 2002. The October 1, 2002 expiration of these temporary increases has had an adverse impact on the revenues of the operators of SNFs and has negatively impacted some operators' ability to satisfy their monthly lease or debt payments to us.

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

On August 4, 2005, CMS published a final rule, effective October 1, 2005, establishing Medicare payments for SNFs under the prospective payment system for federal fiscal year 2006 (October 1, 2005 to September 30, 2006). Consistent with the proposed version of this rule published in May, the final rule modifies the RUG case-mix classification system and adds nine new categories to the system, expanding the number of RUGs from 44 to 53. The implementation of the RUG refinements will trigger the expiration of the temporary payment increases of 20% and 6.7% established by the Balanced Budget Refinement Act and the Benefits Improvement and Protection Act, respectively. Additionally, CMS announced updates to reimbursement rates in the final rule reflecting an increase in the full market-basket of 3.1%.

In the August 4, 2005 notice, CMS estimates that the increases in Medicare reimbursements to SNFs arising from the refinements to the prospective payment system and the market basket update under the final rule will offset the reductions stemming from the elimination of the temporary increases during fiscal year 2006 (October 1, 2005 through September 30, 2006). CMS estimates that there will be an overall increase in Medicare payments to SNFs totaling \$20 million in fiscal year 2006 compared to 2005.

Nonetheless, we cannot accurately predict what effect, if any, these changes will have on our lessees and mortgagors in 2006 and beyond. However, these changes to the Medicare prospective payment system for SNFs, including the elimination of temporary increases, could adversely impact the revenues of the operators of nursing facilities and could negatively impact the ability of some of our lessees and mortgagors to satisfy their monthly lease or debt payments to us.

A 128% temporary increase in the per diem amount paid to SNFs for residents who have AIDS took effect on October 1, 2004. This temporary payment increase arises from the Medicare Prescription Drug Improvement and Modernization Act of 2003 ("Medicare Modernization Act"). The August 2005 notice announcing the final rule for the SNF prospective payment system for fiscal year 2006 clarifies that the increase will remain in effect for fiscal year 2006, although CMS also notes that the AIDS add-on was not intended to be a permanent.

The Medicare Modernization Act also temporarily reinstated a moratorium on the application of a reimbursement cap on outpatient rehabilitative services. The therapy cap limits reimbursement for physical therapy and speech-language pathology services provided on an outpatient basis. Congress first enacted a moratorium on the implementation of a reimbursement cap from January 1, 2000 until January 1, 2003. CMS enforced the reimbursement cap from September 1, 2003 through December 7, 2003, at which point Congress reinstated the moratorium under the Medicare Modernization Act. The moratorium remains in place through December 31, 2005, and its future beyond that date is unclear at this point. If Congress does not act to delay or remove the cap during the interim, a cap of \$1,750 per year is scheduled to be reinstated on outpatient rehabilitative services beginning on January 1, 2006.

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

CMS released a proposed rule in February 2003 that, if implemented, would limit Medicare reimbursement to certain providers, including SNFs, for bad debt arising from unpaid beneficiary deductibles and coinsurance amounts. In the proposed rule, CMS indicated that reimbursement rates would be reduced by 10% each year for three years until reimbursement rates to SNFs for bad debt equal 70% of reimbursement rates during federal fiscal year 2003. CMS has not issued a final rule on this issue, and we cannot predict whether CMS will implement these proposed policies or when the final rule may be issued. However, extensive cuts in Medicare payments for bad debt could have a material adverse effect on our operators' financial condition and operations, which could adversely affect their ability to meet their payment obligations to us.

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

## Medicaid and Other Third-Party Reimbursement

Each state has its own Medicaid program that is funded jointly by the state and federal government. Federal law governs how each state manages its Medicaid program, but there is wide latitude for states to customize Medicaid programs to fit the needs and resources of their citizens. Rising Medicaid costs and decreasing state revenues caused by recent economic conditions have prompted an increasing number of states to cut or consider reductions in Medicaid funding as a means of balancing their respective state budgets. Existing and future initiatives affecting Medicaid reimbursement may reduce utilization of (and reimbursement for) services offered by the operators of our properties. In recent years, many states announced actual or potential budget shortfalls, and many budget forecasts for 2006 could be similar. As a result of these budget shortfalls, many states have announced that they are implementing or considering implementing “freezes” or cuts in Medicaid reimbursement rates, including rates paid to SNF providers, or reductions in Medicaid enrollee benefits, including long-term care benefits. We cannot predict the extent to which Medicaid rate freezes or cuts or benefit reductions ultimately will be adopted, the number of states that will adopt them or the impact of such adoption on our operators. However, extensive Medicaid rate cuts or freezes or benefit reductions could have a material adverse effect on our operators’ liquidity, financial condition and results of operations, which could adversely affect their ability to make lease or mortgage payments to us.

On April 28, 2005, both houses of Congress adopted a \$2.6 trillion FY 2006 budget resolution conference report that calls for \$34.7 billion in savings from mandatory programs over five years, including \$10 billion in savings from Medicaid. This budget resolution is nonbinding, but it acts as a guideline for Congress for the final budget. Although the exact amount of the Medicaid cuts are not finalized, the proposed reductions are significant and would likely have an adverse impact on state Medicaid programs and providers generally. As part of the effort to satisfy the budget reconciliation instructions included in the budget resolution, Congress is considering various options to achieve the \$10 billion in savings, although the content and likelihood of enactment of legislation remains uncertain.

The U.S. Department of Health and Human Services established the Medicaid Advisory Commission in May 2005 to provide recommendations by September 1, 2005 on options for achieving the \$10 billion in savings from the Medicaid program as set forth in Congress’ budget resolution reconciliation instructions. The Commission fulfilled this mandate by issuing recommendations for achieving \$11 billion in Medicaid savings over the next five years. These recommendations focus on (1) reforming the prescription drug reimbursement formula under Medicaid; (2) extending the Medicaid drug rebate program to Medicaid managed care; (3) changing the start date of the penalty period for persons transferring assets for Medicare eligibility; (4) increasing the “look-back” period for transfer of resources; (5) implementing tiered co-payments for prescription drugs under Medicaid; and (6) reforming the Medicaid Managed Care Organization provider tax requirement. The Medicaid Advisory Commission also is tasked with providing recommendations by December 31, 2006 on ensuring the long-term sustainability of the Medicaid program.

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

CMS also continues to scrutinize state funding mechanisms, including use of intergovernmental transfers, as part of a continued effort to control Medicaid program spending.

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

## **Fraud and Abuse Laws and Regulations**

There are various extremely complex and largely uninterpreted federal and state laws governing a wide array of referrals, relationships and arrangements and prohibiting fraud by healthcare providers, including criminal provisions that prohibit filing false claims or making false statements to receive payment or certification under Medicare and Medicaid, or failing to refund overpayments or improper payments. Governments are devoting increasing attention and resources to anti-fraud initiatives against healthcare providers. Penalties for healthcare fraud have been increased and expanded over recent years, including broader provisions for the exclusion of providers from the Medicare and Medicaid programs, and the Office of the Inspector General for the U.S. Department of Health and Human Services ("OIG"), in cooperation with other federal and state agencies, continues to focus on the activities of SNFs in certain states in which we have properties. In addition, the federal False Claims Act allows a private individual with knowledge of fraud to bring a claim on behalf of the federal government and earn a percentage of the federal government's recovery. Because of these incentives, these so-called "whistleblower" suits have become more frequent. The violation of any of these laws or regulations by an operator may result in the imposition of fines or other penalties that could jeopardize that operator's ability to make lease or mortgage payments to us or to continue operating its facility.

## **Legislative and Regulatory Developments**

Each year, legislative and regulatory proposals are introduced or proposed in Congress, state legislatures as well as by federal and state agencies, which, if implemented, could result in major changes in the healthcare system, either nationally or at the state level. In addition, regulatory proposals and rules are released on an ongoing basis that may have major impacts on the healthcare system generally and the industries in which our operators do business. Legislative and regulatory developments can be expected to occur on an ongoing basis at the local, state and federal levels that have direct or indirect impacts on the policies governing the reimbursement levels paid to our facilities by public and private third-party payors, the costs of doing business and the threshold requirements that must be met for facilities to continue operation or to expand. The Medicare Modernization Act, which is one example of such legislation, was enacted in December 2003. The significant expansion of other benefits for Medicare beneficiaries under this Act, such as the prescription drug benefit, could result in financial pressures on the Medicare program that might result in future legislative and regulatory changes with impacts on our operators. Although the creation of a prescription drug benefit for Medicare beneficiaries was expected to generate fiscal relief for state Medicaid programs, the structure of the benefit and costs associated with its implementation and administration through the states may mitigate the relief for states that was anticipated. CMS also launched the Nursing Home Quality Initiative program in 2002, which requires nursing homes participating in Medicare to provide consumers with comparative information about the quality of care at the facility. In the event any of our operators do not maintain the same or superior levels of quality care as their competitors, patients could choose alternate facilities, which could adversely impact our operators' revenues. In addition, the reporting of such information could lead in the future to reimbursement policies that reward or penalize facilities on the basis of the reported quality of care parameters. Other proposals under consideration include efforts by individual states to control costs by decreasing state Medicaid reimbursements in the current or future fiscal years and federal legislation addressing various issues, such as protecting consumers in managed care plans, improving quality of care and reducing medical errors throughout the health care industry. We cannot accurately predict whether any proposals will be adopted or, if adopted, what effect, if any, these proposals would have on operators and, thus, our business.

## **Potential Risks from Bankruptcies**

Our lease arrangements with operators who operate more than one of our facilities are generally made pursuant to a single master lease ("Master Lease") covering all of that operator's facilities. The Bankruptcy Reform Act of 1978, as amended and supplemented ("Bankruptcy Code"), provides that a trustee or a debtor-in-possession in a case under the Bankruptcy Code has the power and the option to assume, assume and assign to a third party, or reject the unexpired lease of a debtor-lessee. In the event that the unexpired lease is assumed on behalf of the debtor-lessee, obligations under the lease generally would be entitled to a priority over other unsecured pre-bankruptcy claims. However, the debtor-lessee may not have to cure historical non-monetary defaults under the lease to the extent that they have not resulted in an actual pecuniary loss, but the debtor-lessee must cure non-monetary defaults under the lease from the time of assumption going forward. If a lease is rejected, assuming that the lessor does not have a perfected security interest in collateral to secure the lease rejection damages, the lessor has a general unsecured claim limited to any unpaid rent already due plus an amount equal to the rent reserved under the lease, without acceleration, for the greater of one year or 15% of the remaining term of such lease, not to exceed three years. A debtor-lessee must generally pay all rent payments coming due under the lease after the bankruptcy filing but before the rejection of the lease. The Bankruptcy Code provides that the debtor-lessee must make the decision regarding assumption/assumption and assignment/rejection within a certain period of time. However, the bankruptcy court in certain instances may extend this time period.

Generally, with respect to our mortgage loans, the imposition of an automatic stay under the Bankruptcy Code precludes us from exercising foreclosure or other remedies against the debtor without first obtaining stay relief from the bankruptcy court. Pre-petition creditors generally do not have rights to the cash flows from the properties underlying the mortgages. Mortgagees may, however, receive periodic payments from the debtor/mortgagors. Such payments are referred to as adequate protection payments. The timing of adequate protection payments and whether the mortgagees are entitled to such payments at all in bankruptcy depends on negotiating an acceptable settlement with the mortgagor (subject to approval of the bankruptcy court) or on the order of the bankruptcy court in the event a negotiated settlement cannot be achieved. A mortgagee also is treated differently from a landlord in three key respects. First, the mortgage loan is not subject to assumption or rejection because it is not an executory contract or a lease. Second, the mortgagee's loan may be divided into (1) a secured loan for the portion of the mortgage debt that does not exceed the value of the property and (2) a general unsecured loan for the portion of the mortgage debt that exceeds the value of the property. Assuming that there is not enough money to pay all unsecured creditors in full, a secured creditor such as our company is entitled to the recovery of (i) interest and (ii) reasonable fees, costs and charges provided for under the agreement or state statute under which such claim arose only if, and to the extent that, the value of the collateral exceeds the amount owed. If the value of the collateral exceeds the amount of the debt, interest as well as reasonable fees, costs, and charges may not be paid during the bankruptcy case, but will accrue until confirmation of a plan of reorganization/liquidation or such other time as the court orders. If the value of the collateral held by a secured creditor is less than the secured debt (including such creditor's secured debt and the secured debt of any creditor with a more senior security interest in the collateral), interest on the loan for the time period between the filing of the case and confirmation may be disallowed. Finally, while a lease generally would either be rejected or assumed with all of its benefits and burdens intact, the terms of a mortgage, including the rate of interest and the timing of principal payments, may be modified if the debtor is able to effect a "cram down" under the Bankruptcy Code.

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

### **Concentration of Risk**

For the three-month period ended September 30, 2005, our revenues from operations totaled \$26.0 million, of which approximately \$5.5 million were derived from Sun Healthcare Group, Inc. ("Sun") (21%) and \$3.1 million from Advocat, Inc. ("Advocat") (12%). For the nine-month period ended September 30, 2005, our revenues from operations totaled \$78.5 million, of which approximately \$16.4 million were derived from Sun (21%) and \$9.2 million from Advocat (12%). No other operator generated more than 10% of our revenues from operations for the three- and nine-month periods ended September 30, 2005.



As of September 30, 2005, our real estate investments consisted of 216 healthcare facilities, located in 28 states and operated by 38 third-party operators. Our gross investment in these facilities, net of impairments and before reserve for uncollectible loans, totaled approximately \$937 million at September 30, 2005, with approximately 98% of our real estate investments related to long-term care facilities. This portfolio is made up of 179 long-term healthcare facilities, two rehabilitation hospitals owned and leased to third parties, fixed rate mortgages on 28 long-term healthcare facilities and seven facilities held for sale.

At September 30, 2005, approximately 27% of our real estate investments were operated by two public companies: Sun (16%) and Advocat (11%). Our largest private company operators (by investment) were Guardian LTC Management, Inc. (9%), Essex Healthcare Corp. ("Essex") (8%), CommuniCare Health Services, Inc. ("CommuniCare") (8%), Haven Healthcare (6%), and Seacrest Healthcare (6%). No other operator represents more than 5% of our investments. The three states in which we had our highest concentration of investments were Ohio (17%), Florida (13%) and Pennsylvania (11%) at September 30, 2005.

#### **Healthcare Investment Risks**

The possibility that the healthcare facilities will not generate income sufficient to meet operating expenses or will yield returns lower than those available through investments in comparable real estate or other investments are additional risks of investing in healthcare-related real estate. Income from properties and yields from investments in such properties may be affected by many factors, including changes in governmental regulation (such as zoning laws), general or local economic conditions (such as fluctuations in interest rates and employment conditions), local supply and demand for improved real estate, a reduction in rental income as the result of an inability to maintain occupancy levels, natural disasters (such as earthquakes and floods) or other factors.

#### **General Real Estate Risks**

Real estate investments are relatively illiquid and, therefore, tend to limit our ability to vary our portfolio promptly in response to changes in economic or other conditions. Thus, if the operation of any of our properties becomes unprofitable due to competition, age of improvements or other factors such that the lessee or borrower becomes unable to meet its obligations on the lease or mortgage loan, the liquidation value of the property may be substantially less, particularly relative to the amount owed on any related mortgage loan, than would be the case if the property were readily adaptable to other uses.

#### **Critical Accounting Policies and Estimates**

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and a summary of our significant accounting policies is included in Note 2 to our annual report on Form 10-K for the year ended December 31, 2004. Our preparation of the financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of our financial statements, and the reported amounts of revenue and expenses during the reporting period.

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

## **Revenue Recognition**

With the exception of six master leases, rental income and mortgage interest income are recognized as earned over the terms of the related master leases and mortgage notes, respectively. Such income includes periodic increases based on pre-determined formulas (i.e., such as increases in the Consumer Price Index) as defined in the master leases and mortgage loan agreements. Reserves are taken against earned revenues from leases and mortgages when collection becomes questionable or when negotiations for restructurings of troubled operators result in significant uncertainty regarding ultimate collection. The amount of the reserve is estimated based on what management believes will likely be collected. When collection is uncertain, lease revenues are recorded when received, after taking into account application of security deposits. Interest income on impaired mortgage loans is recognized when received after taking into account application of principal repayments and security deposits.

The six master leases not recognized as earned over the term of the lease are recognized on a straight-line basis. We recognize the minimum base rental revenue under the respective master lease on a straight-line basis over the term of the related lease. Accrued straight-line rents represent the rental revenue recognized in excess of rents due under the lease agreements at the balance sheet date.

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

## **Depreciation and Asset Impairment**

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

If we decide to sell rental properties or land holdings, we evaluate the recoverability of the carrying amounts of the assets. If the evaluation indicates that the carrying value is not recoverable from estimated net sales proceeds, the property is written down to estimated fair value less costs to sell. Our estimates of cash flows and fair values of the properties are based on current market conditions and consider matters such as rental rates and occupancies for comparable properties, recent sales data for comparable properties, and, where applicable, contracts or the results of negotiations with purchasers or prospective purchasers. Changes in estimated future cash flows due to changes in our plans or view of market and economic conditions could result in recognition of additional impairment losses, which, under applicable accounting guidance, could be substantial.

During the three months ended September 30, 2005, we recognized impairment losses associated with three facilities of approximately \$5.5 million. For the nine months ended September 30, 2005, we recognized impairment losses associated with five facilities of approximately \$9.2 million.

## ***Loan Impairment***

Management, periodically but not less than annually, evaluates our outstanding loans and notes receivable. When management identifies potential loan impairment indicators, such as non-payment under the loan documents, impairment of the underlying collateral, financial difficulty of the operator or other circumstances that may impair full execution of the loan documents, and management believes these indicators are permanent, then the loan is written down to the present value of the expected future cash flows. In cases where expected future cash flows cannot be estimated, the loan is written down to the fair value of the collateral. The fair value of the loan is determined by market research, which includes valuing the property as a nursing home as well as other alternative uses.

## ***Assets Held for Sale and Discontinued Operations***

Pursuant to the provisions of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," the operating results of specified real estate assets that have been sold, or otherwise qualify as held for disposition (as defined by SFAS No. 144), are reflected as discontinued operations in the consolidated statements of operations for all periods presented. At September 30, 2005, we have \$23.6 million of assets that qualify as held for disposition, as defined by SFAS No. 144. See Note 2 - Properties; Assets Held for Sale.

In addition, during the three months ended September 30, 2005, we sold 50.4 acres of undeveloped land, located in Ohio, realizing net cash proceeds of approximately \$1.0 million. The sale resulted in an accounting gain of \$0.7 million, net of closing costs and other expenses. During the three months ended June 30, 2005, we sold four SNFs located in Illinois. The sales price totaled approximately \$17 million. We received net cash proceeds of approximately \$12 million plus a secured promissory note of approximately \$5.4 million. The sale resulted in a non-cash accounting loss of approximately \$4.2 million. During the three months ended March 31, 2005 we sold three facilities in Florida and California for their approximate net book value, realizing cash proceeds of approximately \$6 million, net of closing costs and other expenses. See Note 2 - Properties; Assets Sold and Note 10 - Discontinued Operations.

## **Results of Operations**

The following discussion relates to our consolidated results of operations, financial position and liquidity and capital resources, which should be read in conjunction with our consolidated financial statements and accompanying notes.

### ***Three Months Ended September 30, 2005 and 2004***

#### ***Operating Revenues***

Our operating revenues for the three months ended September 30, 2005 totaled \$26.0 million, an increase of \$4.8 million, over the same period in 2004. The \$4.8 million increase was primarily a result of new investments made throughout 2004 and during the first nine months of 2005, re-leasing and restructuring activities completed throughout 2004, as well as scheduled contractual increases in rents. The increase in operating revenues from new investments was partially offset by a reduction in mortgage interest income.

Detailed changes in operating revenues during the three months ended September 30, 2005 are as follows:

- Rental income for the three months ended September 30, 2005 was \$24.0 million, an increase of \$6.8 million over the same period in 2004. The increase was due to new leases entered into throughout 2004 and during the first nine months of 2005, restructurings and re-leasing activities and scheduled contractual increases in rents.
- Mortgage interest income for the three months ended September 30, 2005 totaled \$1.2 million, a decrease of \$2.0 million over the same period in 2004. The decrease was primarily the result of normal amortization and a \$60 million loan payoff that occurred in the first quarter of 2005.
- Other investment income for the three months ended September 30, 2005 totaled \$0.7 million, an increase of \$0.1 million over the same period in 2004.
- Miscellaneous revenue for the three months ended September 30, 2005 was \$0.1 million, a decrease of \$0.1 million over the same period in 2004.

#### *Operating Expenses*

Operating expenses for the three months ended September 30, 2005 totaled \$13.9 million, an increase of approximately \$6.8 million over the same period in 2004. The increase was primarily due to a \$5.5 million provision for impairment charge recorded in the three months ended September 30, 2005, and \$1.4 million of increased depreciation expense.

Detailed changes in our operating expenses during the three months ended September 30, 2005 are as follows:

- Our depreciation and amortization expense for the three months ended September 30, 2005 was \$6.2 million, compared to \$4.9 million for the same period in 2004. The increase is due to new investments placed throughout 2004 and during the first nine months of 2005.
- We recorded a \$5.5 million provision for impairment charge to reduce the carrying value of three facilities to their estimated fair value.

#### *Other Expense*

For the three months ended September 30, 2005, our total other net expenses were \$8.2 million as compared to \$6.3 million for the same period in 2004. The significant change is as follows:

- Our interest expense, excluding amortization of deferred costs, for the three months ended September 30, 2005 was \$7.7 million, compared to \$5.9 million for the same period in 2004. This increase was primarily due to higher debt on our balance sheet versus the same period in 2004.

#### ***Nine Months Ended September 30, 2005 and 2004***

#### *Operating Revenues*

Our operating revenues for the nine months ended September 30, 2005 totaled \$78.5 million, an increase of \$16.5 million, over the same period in 2004. The \$16.5 million increase was primarily a result of new investments made throughout 2004 and during the first nine months of 2005, contractual interest revenue associated with the payoff of a mortgage note, re-leasing and restructuring activities completed throughout 2004, as well as scheduled contractual increases in rents. The increase in operating revenues from new investments was partially offset by a reduction in mortgage interest income.

Detailed changes in operating revenues during the nine months ended September 30, 2005 are as follows:

- Rental income for the nine months ended September 30, 2005 was \$67.9 million, an increase of \$18.1 million over the same period in 2004. The increase was due to new leases entered into throughout 2004 and during the first nine months of 2005, restructurings and re-leasing activities and scheduled contractual increases in rents.
- Mortgage interest income for the nine months ended September 30, 2005 totaled \$4.4 million, a decrease of \$5.5 million over the same period in 2004. The decrease was primarily the result of normal amortization and a \$60 million loan payoff that occurred in the first quarter of 2005.
- Miscellaneous revenue for the nine months ended September 30, 2005 was \$4.5 million, an increase of \$3.8 million over the same period in 2004. The increase was due to contractual revenue owed to us as a result of a mortgage note prepayment.

#### *Operating Expenses*

Operating expenses for the nine months ended September 30, 2005 totaled \$34.5 million, an increase of approximately \$14.1 million over the same period in 2004. The increase was primarily due to a \$9.2 million non-cash provision for impairment charges recorded in the nine months ended September 30, 2005, a \$0.8 million lease expiration accrual recorded in the three months ended June 30, 2005, and \$3.7 million of increased depreciation expense.

Detailed changes in our operating expenses during the nine months ended September 30, 2005 are as follows:

- Our depreciation and amortization expense for the nine months ended September 30, 2005 was \$18.1 million, compared to \$14.4 million for the same period in 2004. The increase is due to new investments placed throughout 2004 and during the first nine months of 2005.
- Our general and administrative expense, when excluding restricted stock amortization expense, was \$5.6 million, compared to \$5.7 million for the same period in 2004.
- A \$5.5 million provision for impairment charge was recorded to reduce the carrying value on three facilities to their estimated fair value during the three months ended September 30, 2005.
- A \$3.7 million provision for impairment charge was recorded during the three months ended March 31, 2005, to reduce the carrying value on two facilities, which were subsequently closed, to their estimated fair value.
- A \$0.1 million provision for uncollectible notes receivable.
- A \$0.8 million lease expiration accrual relating to disputed capital improvement requirements associated with a lease that expired June 30, 2005.

#### *Other Expense*

For the nine months ended September 30, 2005, our total other net expenses were \$26.3 million as compared to \$39.4 million for the same period in 2004. The significant changes are as follows:

- Our interest expense, excluding amortization of deferred costs, for the nine months ended September 30, 2005 was \$21.4 million, compared to \$16.3 million for the same period in 2004. The increase of \$5.1 million was primarily due to higher average debt balances on our balance sheet versus the same period in 2004.
- During the nine months ended September 30, 2005, we recorded a \$3.4 million provision for impairment on an equity security. In accordance with FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities," we recorded a \$3.4 million provision for impairment to write-down our 760,000 share investment in Sun Healthcare Group, Inc. common stock to its current fair market value.
- For the nine months ended September 30, 2004, we recorded \$3.0 million charge associated with professional liability claims made against our former owned and operated facilities.
- For the nine months ended September 30, 2004, we recorded \$19.1 million of refinancing-related charges associated with refinancing our capital structure. The \$19.1 million consists of a \$6.4 million exit fee paid to our previous bank syndication and a \$6.3 million non-cash deferred financing cost write-off associated with the termination of our then existing \$225 million credit facility and our \$50 million acquisition facility, and a loss of approximately \$6.5 million associated with the sale of an interest rate cap.

**Gain (loss) from Discontinued Operations**

Discontinued operations relate to properties we disposed of in 2005 or are currently held-for-sale and are accounted for as discontinued operations under SFAS No. 144. For the three months ended September 30, 2005, we sold 50.4 acres of undeveloped land, located in Ohio, for approximately \$1.0 million, resulting in an accounting gain of approximately \$0.7 million. For the nine months ended September 30, 2005, we sold assets for approximately \$25 million, resulting in an accounting loss of approximately \$3.5 million. See Note 10 - Discontinued Operations. In accordance with SFAS No. 144, the \$0.7 million net gain is reflected in our consolidated statements of operations as discontinued operations.

**Funds From Operations**

Our funds from operations available to common stockholders ("FFO"), for the three months ended September 30, 2005, was \$8.2 million, a decrease of \$2.3 million as compared to \$10.5 million for the same period in 2004.

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

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

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

The following table presents our FFO results reflecting the impact of asset impairment charges (the SEC's interpretation) for the three and nine months ended September 30, 2005 and 2004:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2005	2004	2005	2004
	(in thousands)		(in thousands)	
<b>Net income (loss) available to common</b>	\$ 2,638	\$ 5,083	\$ 5,764	\$ (49,021)
Add back loss (deduct gain) from real estate dispositions	(710)	—	3,492	488
Sub-total	1,928	5,083	9,256	(48,533)
Elimination of non-cash items included in net income (loss):				
Depreciation and amortization	6,275	5,394	19,068	16,005
<b>Funds from operations available to common stockholders</b>	<u>\$ 8,203</u>	<u>\$ 10,477</u>	<u>\$ 28,324</u>	<u>\$ (32,528)</u>

#### Taxes

As a qualified REIT, we will not be subject to Federal income taxes on our income, and no provisions for Federal income taxes have been made. We are permitted to own up to 100% of a "taxable REIT subsidiary" ("TRS"). Currently, we have two TRSs that are taxable as corporations and that pay federal, state and local income tax on their net income at the applicable corporate rates.

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

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

Below is a brief description, by third-party operator, of our re-leasing, restructuring or new investment transactions that occurred during the nine months ended September 30, 2005.

##### *CommuniCare Health Services, Inc.*

- On June 28, 2005, we purchased five SNFs located in Ohio (3) and Pennsylvania (2), totaling 911 beds. The investment, excluding working capital, totaled approximately \$50 million. The SNFs were purchased from an unrelated third party and are now operated by subsidiaries of CommuniCare, a current lessee, with the five facilities being consolidated into an existing master lease. The term of the master lease was extended to ten years ending June 30, 2015, with two nine year renewal options.

##### *Senior Management Services, Inc.*

- Effective June 1, 2005, we purchased two SNFs for a total investment of approximately \$9.5 million. Both facilities, totaling 440 beds, are located in Texas. The facilities were consolidated into a master lease with an existing operator, Senior Management Services, Inc. The term of the existing master lease was extended to ten years and runs through May 31, 2015, followed by two renewal options of ten years each.

#### *Essex Healthcare Corporation*

- On January 13, 2005, we closed on approximately \$58 million of net new investments as a result of the exercise by American Health Care Centers ("American") of a put agreement with us for the purchase of 13 SNFs. The gross purchase price of approximately \$79 million was satisfied in part by a purchase option of approximately \$7 million and approximately \$14 million in mortgage loans we had outstanding with American and its affiliates.
- The 13 properties, all located in Ohio, continue to be leased by Essex Healthcare Corporation. The master lease and related agreements have remaining terms of approximately six years.

#### *Mariner Health Care, Inc.*

- On February 1, 2005, Mariner Health Care, Inc. ("Mariner") exercised its right to prepay in full the \$59.7 million aggregate principal amount owed to us under a promissory note secured by a mortgage with an interest rate of 11.57%, together with the required prepayment premium of 3% of the outstanding principal balance and all accrued and unpaid interest. In addition, pursuant to certain provisions contained in the promissory note, Mariner paid us an amendment fee owed for the period ending on February 1, 2005.

#### *Claremont Health Care Holdings, Inc.*

- Effective January 1, 2005, we re-leased one SNF formerly leased to Claremont Health Care Holdings, Inc., located in New Hampshire and representing 68 beds to an existing operator. This facility was added to an existing master lease, which expires on December 31, 2013, followed by two 10-year renewal options.

#### *Other*

- During the three months ended September 30, 2005, a \$5.5 million provision for impairment charge was recorded to reduce the carrying value on three facilities to their estimated fair value.
- During the three months ended March 31, 2005, a \$3.7 million provision for impairment charge was recorded to reduce the carrying value on two facilities, which were subsequently closed, to their estimated fair value.

#### *Assets Held for Sale*

- On July 29, 2005, we received notice from AHC Properties, Inc. ("Alterra") of their intent to exercise their option to purchase six assisted living facilities ("ALFs") for approximately \$20.4 million. The ALFs are currently leased to Alterra in a master lease with annual revenue of approximately \$1.7 million. The closing of this transaction is scheduled for the fourth quarter of 2005, subject to closing conditions typical in real estate transactions. At September 30, 2005, the net book value of these facilities was approximately \$15.4 million.
- On June 23, 2005, a \$1.0 million deposit related to an agreement to sell a SNF in Florida was received into escrow on our behalf. On July 26, 2005, an additional \$0.5 million deposit was received into escrow. The purchase price of the facility is \$14.5 million and the closing is scheduled for the fourth quarter of 2005. The due diligence period has expired, and the deposits are not refundable unless we breach our obligations under the purchase agreement. At September 30, 2005, the net book value of this facility was approximately \$8.2 million.





### *Series B Preferred Redemption*

On May 2, 2005, we redeemed all of the 2.0 million outstanding shares of our Series B Preferred Stock at a price of \$25.55104 per share, comprised of the \$25 per share liquidation value and accrued dividend. During 2004, we raised over \$193 million from public offerings of our capital stock, the proceeds of which were used for, among other things, the reduction of amounts owed under our Credit Facility prior to the time such funds were needed to fund the redemption. The redemption of the \$50 million of Series B Preferred Stock, as well as the related accrued dividend, was funded with invested cash on the balance sheet and approximately \$40 million of Credit Facility borrowings, which had been paid down from the proceeds of our 2004 stock offerings. Under FASB-EITF Issue D-42, "The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock," the repurchase of the Series B Preferred Stock resulted in a non-cash charge to net income available to common stockholders of approximately \$2.0 million in the second quarter of 2005.

### *\$60 Million 7% Senior Unsecured Notes Offering*

On October 29, 2004, we completed a privately placed offering of an additional \$60 million aggregate principal amount of 7% senior notes due 2014 (the "Additional Notes") at an issue price of 102.25% of the principal amount of the Additional Notes (equal to a per annum yield to maturity of approximately 6.67%), resulting in gross proceeds of approximately \$61 million. The terms of the Additional Notes offered were substantially identical to our existing \$200 million aggregate principal amount of 7% senior notes due 2014 issued in March 2004 (the "Existing Notes"), which were subsequently exchanged for registered senior notes in September 2004. The Additional Notes were issued through a private placement to qualified institutional buyers under Rule 144A under the Securities Act of 1933 (the "Securities Act") and in offshore transactions pursuant to Regulation S under the Securities Act.

On December 21, 2004, we filed a registration statement on Form S-4 under the Securities Act with the SEC offering to exchange (the "Additional Notes Exchange Offer") up to \$60 million aggregate principal amount of our registered 7% Senior Notes due 2014 (the "Additional Exchange Notes"), for all of our outstanding unregistered Additional Notes. On March 18, 2005, upon the expiration of the Additional Notes Exchange Offer, \$60 million aggregate principal amount of Additional Exchange Notes were exchanged for the unregistered Additional Notes. As a result of the Additional Exchange Offer, no Additional Notes remain outstanding. The terms of the Additional Exchange Notes are identical to the terms of the Additional Notes, except that the Additional Exchange Notes are registered under the Securities Act and therefore freely tradable (subject to certain conditions) along with our previously registered Existing Notes as a single class. The Additional Exchange Notes represent our unsecured senior obligations and have been guaranteed by all of our subsidiaries with unconditional guarantees of payment that rank equally with existing and future senior unsecured debt of such subsidiaries and senior to existing and future subordinated debt of such subsidiaries.

### **Dividends**

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

### *Common Dividends*

On October 18, 2005, the Board of Directors declared a common stock dividend of \$0.22 per share to be paid November 15, 2005 to common stockholders of record on October 31, 2005.

On July 19, 2005, the Board of Directors declared a common stock dividend of \$0.22 per share, an increase of \$0.01 per common share compared to the prior quarter. This common stock dividend was paid August 15, 2005 to common stockholders of record on July 29, 2005.

On April 19, 2005, the Board of Directors declared a common stock dividend of \$0.21 per share, an increase of \$0.01 per common share compared to the prior quarter. The common stock dividend was paid May 16, 2005 to common stockholders of record on May 2, 2005.

On January 18, 2005, the Board of Directors declared a common stock dividend of \$0.20 per share, an increase of \$0.01 per common share compared to the prior quarter. The common stock dividend was paid February 15, 2005 to common stockholders of record on January 31, 2005.

### *Series D Preferred Dividends*

On October 18, 2005, the Board of Directors declared the regular quarterly dividends for its 8.375% Series D Cumulative Redeemable Preferred Stock ("Series D Preferred Stock") to stockholders of record on October 31, 2005. The stockholders of record of the Series D Preferred Stock on October 31, 2005 will be paid dividends in the amount of \$0.52344 per preferred share on November 15, 2005. The liquidation preference for our Series D Preferred Stock is \$25.00 per share. Regular quarterly preferred dividends for the Series D Preferred Stock represent dividends for the period August 1, 2005 through October 31, 2005.

On July 19, 2005, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share for its Series D Preferred Stock, that were paid August 15, 2005 to preferred stockholders of record on July 29, 2005.

On March 15, 2005, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share for its Series D Preferred Stock, that were paid May 16, 2005 to preferred stockholders of record on May 2, 2005.

On January 18, 2005, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share for its Series D Preferred Stock, that were paid February 15, 2005 to preferred stockholders of record on January 31, 2005.

### *Series B Preferred Stock Redemption and Quarterly Dividends*

On March 15, 2005, the Board of Directors also authorized the redemption of all shares outstanding of our 8.625% Series B Preferred Stock ("Series B Preferred Stock") (NYSE:OHI PrB; CUSIP: 681936208). We redeemed all of the outstanding shares on May 2, 2005 for \$25.00 per share, plus \$0.55104 per share in accrued and unpaid dividends through the redemption date, for an aggregate redemption price of \$25.55104 per share. Dividends on the shares of Series B Preferred Stock ceased to accrue from and after the redemption date, after which the Series B Preferred Stock was no longer outstanding and holders of the Series B Preferred Stock have only the right to receive the redemption price. During the quarter ended June 30, 2005, our Board of Directors formally reclassified the shares previously designated as Series B Preferred Stock as authorized but unissued shares of preferred stock without designation as to series pursuant to authority granted to the Board of Directors in our Articles of Incorporation.

The notice of redemption and related materials were mailed to the holders of the Series B Preferred Stock on or about April 1, 2005. EquiServe Trust Company acted as our redemption and paying agent. On or before the redemption date, we deposited with EquiServe the aggregate redemption price to be held in trust for the benefit of the holders of the Series B Preferred Stock. Holders of the Series B Preferred Stock who held shares through the Depository Trust Company had their shares of the Series B Preferred Stock redeemed in accordance with the Depository Trust Company's procedures.

In connection with the redemption of the Series B Preferred Stock, for the three-month period ended June 30, 2005, we recorded a non-cash, non-recurring reduction in net income attributable to common shareholders of approximately \$2.0 million. This reduction was taken in accordance with the Securities and Exchange Commission's Interpretation of FASB-EITF Topic D-42 ("The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock"), issued on July 31, 2003. Under this interpretation, all costs associated with the original issuance of the Series B Preferred Stock were recorded as a reduction of net income attributable to common stockholders.

On January 18, 2005, the Board of Directors declared regular quarterly dividends of approximately \$0.53906 per preferred share for its Series B Preferred Stock, that were paid February 15, 2005 to preferred stockholders of record on January 31, 2005.

### **Liquidity**

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

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

- normal recurring expenses;
- debt service payments;
- preferred stock dividends;
- common stock dividends; and
- growth through acquisitions of additional properties.

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

Cash and cash equivalents totaled \$0.8 million as of September 30, 2005, a decrease of \$11.3 million as compared to the balance at December 31, 2004. The following is a discussion of changes in cash and cash equivalents due to operating, investing and financing activities, which are presented in our Consolidated Statement of Cash Flows.

Operating Activities - Net cash flow from operating activities generated \$55.2 million for the nine months ended September 30, 2005, as compared to \$35.6 million for the same period in 2004. The \$19.6 million increase is due primarily to: (i) incremental revenue associated with acquisitions completed throughout 2004 and the first nine months of 2005; (ii) one-time contractual revenue associated with a mortgage note prepayment; and (iii) normal working capital fluctuations during the period.

Investing Activities - Net cash flow from investing activities was an outflow of \$41.0 million for the nine months ended September 30, 2005, as compared to an outflow of \$29.9 million for the same period in 2004. The change in investing cash flow of \$11.1 million was primarily due to approximately \$87 million of incremental acquisitions made during the nine months ended September 30, 2005 versus the nine months ended September 30, 2004; offset by: (i) approximately \$55 million of incremental mortgage payoffs in 2005 versus 2004; and (ii) net cash of \$25.9 million from asset sales.

Financing Activities - Net cash flow from financing activities was an outflow of \$25.5 million for the nine months ended September 30, 2005 as compared to an outflow of \$5.5 million for the same period in 2004. The change in financing cash flow of \$20.0 million was primarily a result of: (i) repayments on our credit facility and other borrowings; (ii) redemption of our Series B preferred stock of \$50.0 million in 2005 versus a redemption of our Series A preferred stock of \$57.5 million in 2004; and (iii) normal quarterly common and preferred dividend payments. This decrease was partially offset by: (i) issuance of \$118.5 million of preferred equity in the first quarter of 2004; (ii) a public issuance of 2.7 million shares of our common stock at a price of \$9.85 per share in the first quarter of 2004; (iii) a private offering of \$200 million of senior unsecured notes in March 2004; and (iv) the sale of an interest rate cap in March 2004.

### ***Effects of Recently Issued Accounting Standards***

In December 2004, the Financial Accounting Standards Board issued FAS No. 123 (revised 2004), *Share-Based Payment* ("FAS No. 123R"), which is a revision of FAS No. 123, *Accounting for Stock-Based Compensation*. FAS No. 123R supersedes Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends FAS No. 95, *Statement of Cash Flows*. Registrants were initially required to adopt FAS No. 123R as of the beginning of the first interim or annual period that begins after June 15, 2005. On April 14, 2005, subsequent to the end of our 2005 first quarter, the Securities and Exchange Commission adopted a new rule that allows companies to implement FAS No. 123R at the beginning of their next fiscal year, instead of the next reporting period, that begins after June 15, 2005. We will adopt FAS No. 123R at the beginning of our 2006 fiscal year. We are currently evaluating the impact of adoption of this pronouncement.

### **Item 3 - Quantitative and Qualitative Disclosures about Market Risk**

There were no material changes in the Company's market risk during the three months ended September 30, 2005. For additional information, refer to Item 7a as presented in our annual report on Form 10-K for the year ended December 31, 2004.

#### **Item 4 - Controls and Procedures**

##### *Evaluation of Disclosure Controls and Procedures*

Our principal executive officer and principal financial officer are responsible for establishing and maintaining disclosure controls and procedures as defined in the rules promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). We evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2005 and, based on that evaluation, our principal executive officer and principal financial officer have concluded that these controls and procedures were effective as of September 30, 2005.

Disclosure controls and procedures are the controls and other procedures designed to ensure that information that we are required to disclose in our reports under the Exchange Act is recorded, processed, summarized and reported within the time periods required. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information we are required to disclose in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

##### *Changes in Internal Control Over Financial Reporting*

No changes in our internal control over financial reporting were identified as having occurred in the three months ended September 30, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

### Item 1 - Legal Proceedings

See Note 9 - Litigation to the Consolidated Financial Statements in PART I, Item 1 hereto, which is hereby incorporated by reference in response to this item.

### Item 2 - Market for Registrant's Common Equity and Related Stockholder Matters

Our shares of Common Stock are traded on the New York Stock Exchange under the symbol "OHI." During the three months ended September 30, 2005, we purchased 18,912 shares of our common stock from employees to pay the withholding taxes associated with employee exercising of stock options.

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May be Purchased Under these Plans or Programs
July 1, 2005 to July 31, 2005	8,912	\$ 13.92	-	\$ -
August 1, 2005 to August 31, 2005	10,000	14.16	-	-
September 1, 2005 to September 30, 2005	-	-	-	-
Total	18,912	\$ 14.05	-	\$ -

(1) Represents shares purchased from employees to pay the withholding taxes related to the exercise of employee stock options. The shares were not part of a publicly announced repurchase plan or program.

**Item 6 - Exhibits**

Exhibit No.		Description
31.1		Rule 13a-14(a)/15d-14(a) Certification of the Chief Executive Officer.
31.2		Rule 13a-14(a)/15d-14(a) Certification of the Chief Financial Officer.
32.1		Section 1350 Certification of the Chief Executive Officer.
32.2		Section 1350 Certification of the Chief Financial Officer.



**SIGNATURES**

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

OMEGA HEALTHCARE INVESTORS, INC.  
Registrant

Date: October 31, 2005

By: /S/ C. TAYLOR PICKETT  
C. Taylor Pickett  
Chief Executive Officer

Date: October 31, 2005

By: /S/ ROBERT O. STEPHENSON  
Robert O. Stephenson  
Chief Financial Officer



**RULE 13a-14(a)/15d-14(a) CERTIFICATION OF CHIEF EXECUTIVE OFFICER**

I, C. Taylor Pickett, Chief Executive Officer, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Omega Healthcare Investors, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 31, 2005  
/S/ C. TAYLOR PICKETT

C. Taylor Pickett  
Chief Executive Officer

**RULE 13a-14(a)/15d-14(a) CERTIFICATION OF CHIEF FINANCIAL OFFICER**

I, Robert O. Stephenson, Chief Financial Officer, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Omega Healthcare Investors, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 31, 2005

/S/ ROBERT O. STEPHENSON  
Robert O. Stephenson  
Chief Financial Officer

**SECTION 1350 CERTIFICATION  
OF THE CHIEF EXECUTIVE OFFICER**

I, C. Taylor Pickett, Chief Executive Officer of Omega Healthcare Investors, Inc. (the "Company"), hereby certify, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, that:

- (1) the Quarterly Report on Form 10-Q of the Company for the three months ended September 30, 2005 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: October 31, 2005

/S/ C. TAYLOR PICKETT  
C. Taylor Pickett  
Chief Executive Officer

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**SECTION 1350 CERTIFICATION  
OF THE CHIEF FINANCIAL OFFICER**

I, Robert O. Stephenson, Chief Financial Officer of Omega Healthcare Investors, Inc. (the "Company"), hereby certify, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350, that:

- (1) the Quarterly Report on Form 10-Q of the Company for the three months ended September 30, 2005 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: October 31, 2005

/S/ ROBERT O. STEPHENSON

Robert O. Stephenson  
Chief Financial Officer