

LTC PROPERTIES INC
Form 10-K
February 22, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2006

OR

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

Commission file number: 1-11314

LTC PROPERTIES, INC.

(Exact name of Registrant as specified in its charter)

MARYLAND
(State or other jurisdiction of incorporation or organization)

71-0720518
(I.R.S. Employer Identification No.)

31365 Oak Crest Drive Suite 200

Westlake Village, California 91361

(Address of principal executive offices)

Registrant's telephone number, including area code: (805) 981-8655

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class

Common stock, \$.01 Par Value

8.50% Series E Cumulative Convertible Preferred Stock, \$.01 Par Value

8.00% Series F Cumulative Preferred Stock, \$.01 Par Value

Name of Each Exchange on Which Registered

New York Stock

Exchange

New York Stock

Exchange

New York Stock

Exchange

Securities registered pursuant to Section 12(g) of the Act: NONE

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Indicate by checkmark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act Yes No

Indicate by checkmark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer Accelerated filer Non-accelerated filer

Indicated by check mark whether the Registrant is a shell company Yes No

The aggregate market value of voting and non-voting stock held by non-affiliates of the Registrant was approximately \$492,423,470 as of June 30, 2006 (the last business day of the Registrant's most recently completed second fiscal quarter).

The number of shares of common stock outstanding as of February 15, 2007 was 23,589,162.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement for the Registrant's 2007 Annual Meeting of Stockholders have been incorporated into Part III of this Report.

STATEMENT REGARDING FORWARD LOOKING DISCLOSURE

Certain information contained in this annual report includes statements that are not purely historical and are forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding our expectations, beliefs, intentions or strategies regarding the future. All statements other than historical facts contained in this annual report are forward looking statements. These forward looking statements involve a number of risks and uncertainties. All forward looking statements included in this annual report are based on information available to us on the date hereof, and we assume no obligation to update such forward looking statements. Although we believe that the assumptions and expectations reflected in such forward looking statements are reasonable, no assurance can be given that such expectations will prove to have been correct. The actual results achieved by us may differ materially from any forward looking statements due to the risks and uncertainties of such statements.

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

Item 1. BUSINESS

General

LTC Properties, Inc., a health care real estate investment trust (or REIT), was incorporated on May 12, 1992 in the State of Maryland and commenced operations on August 25, 1992. We invest primarily in long-term care and other health care related properties through mortgage loans, property lease transactions and other investments. Our primary objectives are to sustain and enhance stockholder equity value and provide current income for distribution to stockholders through real estate investments in long-term care properties and other health care related properties managed by experienced operators. To meet these objectives, we attempt to invest in properties that provide opportunity for additional value and current returns to our stockholders and diversify our investment portfolio by geographic location, operator and form of investment.

In accordance with plain English guidelines provided by the Securities and Exchange Commission, whenever we refer to our company or to us, or use the terms we or our, we are referring to LTC Properties, Inc. and/or our subsidiaries.

We were organized to qualify, and intend to continue to qualify, as a REIT. So long as we qualify, with limited exceptions, we may deduct distributions, both preferred dividends and common dividends, to our stockholders from our taxable income. We have made distributions, and intend to continue to make distributions to our stockholders, in order to eliminate any federal tax liability.

Owned Properties. As of December 31, 2006, our investment in owned properties consisted of 63 skilled nursing properties with a total of 7,304 beds, 84 assisted living properties with a total of 3,744 units and one school in 23 states, representing a gross investment of approximately \$488.3 million. Here and throughout this Form 10-K wherever we provide details of our properties bed/unit count the number of beds/units applies to skilled nursing properties and assisted living residences only. This number is based upon unit/bed counts shown on operating licenses provided to us by lessees/borrowers or units/beds as stipulated by lease/mortgage documents. We have found during the years that these numbers often differ, usually not materially, from units/beds in operation at any point in time. The differences are caused by such things as operators converting a patient/resident room for alternative uses, such as offices or storage, or converting a multi-patient room/unit into a single patient room/unit. We monitor our properties on a routine basis through site visits and reviews of current licenses. In an instance where such change would cause a de-licensing of beds or in our opinion impact the value of the property, we would take action

against the lessee/borrower to preserve the value of the property/collateral. See *Item 8. FINANCIAL STATEMENTS Note 6. Real Estate Investments* for further description.

The following operators accounted for more than 10% of our 2006 rental revenue:

Lessee	Percent of Rental Revenue
Extencicare REIT and ALC	19.6 %
Alterra Healthcare Corporation	19.0 %
Preferred Care, Inc.	13.4 %

Mortgage Loans. As part of our strategy of making long-term investments in properties used in the provision of long-term health care services, we provide mortgage financing on such properties based on our established investment underwriting criteria. See *Investment and Other Policies* in this section for further discussion. We have also provided construction loans that by their terms converted into purchase/lease transactions or permanent financing mortgage loans upon completion of construction. See *Item 8. FINANCIAL STATEMENTS Note 6. Real Estate Investments* for further description.

See *Item 8. FINANCIAL STATEMENTS Note 10. Debt Obligations* for a description of our Senior Mortgage Participation Payable, which was secured by certain of our mortgage loans receivable.

REMIC Certificates. In the past, we have completed securitizations by transferring mortgage loans to newly created Real Estate Mortgage Investment Conduits (or REMIC) that, in turn, issued mortgage pass-through certificates aggregating approximately the same amount. A portion of the REMIC Certificates were then sold to third parties and a portion of the REMIC Certificates were retained by us. The REMIC Certificates we retained were subordinated in right of payment to the REMIC Certificates sold to third parties and a portion of the REMIC Certificates we retained were interest-only certificates which had no principal amount and entitled us to receive cash flows designated as interest. Between 1993 and 1998 we completed four REMIC pools. The 1993, 1994, 1996 and 1998 REMIC pools have all been fully retired. During 2005, a loan was paid off in the 1998 REMIC pool which caused the last third party REMIC Certificate holders entitled to any principal payments to be paid off in full. Under Emerging Issues Task Force No. 02-9 (EITF 02-9) *Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold* , a Special Purpose Entity (SPE) may become non-qualified or tainted which generally results in the repurchase by the transferor of all the assets sold to and still held by the SPE. Since we are now the sole REMIC Certificate holder entitled to principal from the underlying loan pool, we bear all the risks and are entitled to all the rewards from the underlying loan pool. As required by EITF 02-9, the repurchase for the transferred assets was accounted for at fair value. At December 31, 2006, we did not have any investment in REMIC Certificates on our balance sheet. See *Item 8. FINANCIAL STATEMENTS Note 6. Real Estate Investments and Note 7. Asset Securitizations* for further description of our historical investments in REMIC Certificates.

We maintain a long-term investment interest in mortgages we originate either through the direct retention of the mortgages or historically through the retention of REMIC Certificates originated in our securitizations. We are a REIT and, as such, make our investments with the intent to hold them for long-term purposes. However, in the past we have securitized a portion of our mortgage loan portfolio when a securitization provided us with the best available form of capital to fund additional long-term investments. In addition, we believe that the REMIC Certificates we retained in the past from our securitizations provided our stockholders with a more diverse real estate investment while maintaining the returns that provided value to our stockholders.

Investment and Other Policies

Objectives and Policies. Our investment policy is to invest primarily in income-producing long-term care properties. Also see *Government Regulation* below. Primarily, as a result of obligations we had under our Secured Revolving Credit, we made few investments in years 2000 through 2003. Over the past three years (2004 through 2006), we invested approximately \$57.6 million in mortgage loans and we acquired skilled nursing and assisted living properties for approximately \$49.7 million. At this time, we anticipate completing some level of new investments in 2007; however, given the highly competitive environment for health care real estate acquisitions and mortgages, we can give no assurances that we will complete a significant level of new investments in 2007.

We believe that this competitive market has created an environment of very highly priced properties and low yielding mortgages. Because our historical strategy has been to invest in low cost per bed properties, we believe there is an opportunity for us to invest additional funds in our owned properties where the lessees have high occupancies and expansion ability. This market is captive to us since we own the properties. We are actively reviewing all of our owned properties and discussing additional investments with such likely lessees. We would make these investments at rates that would approximate our historical lease rates.

Historically our investments have consisted of:

- mortgage loans secured by long-term care properties;
- fee ownership of long-term care properties which are leased to providers; or
- participation in such investments indirectly through investments in real estate partnerships or other entities that themselves make direct investments in such loans or properties.

In evaluating potential investments, we consider factors such as:

- type of property;
- the location;
- construction quality, condition and design of the property;
- the property's current and anticipated cash flow and its adequacy to meet operational needs and lease obligations or debt service obligations;
- the experience, reputation and solvency of the licensee providing services;
- the payor mix of private, Medicare and Medicaid patients;
- the growth, tax and regulatory environments of the communities in which the properties are located;
- the occupancy and demand for similar properties in the area surrounding the property; and
- the Medicaid reimbursement policies and plans of the state in which the property is located.

For investments in long-term care properties we favor low cost per bed opportunities, whether in fee simple properties or in mortgages. In addition, with respect to skilled nursing properties, we attempt to invest in properties that do not have to rely on a high percentage of private-pay patients. We seek to invest in properties that are located in suburban and rural areas of states. Prior to every investment, we conduct a property site review to assess the general physical condition of the property and the potential of additional sub-acute services. In addition, we review the environmental reports, state survey and financial statements of the property before the investment is made. We prefer to invest in a property that

has a significant

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market presence in its community and where state certificate of need and/or licensing procedures limit the entry of competing properties.

We believe that assisted living facilities are an important sector in the long-term care market and our investments include direct ownership of assisted living properties. For assisted living investments we have attempted to diversify our portfolio both geographically and across product levels. Thus, we believe that although the majority of our investments are in affordably priced units, our portfolio also includes upscale units in appropriate markets with certain operators.

Borrowing Policies. We may incur additional indebtedness when, in the opinion of our Board of Directors, it is advisable. We may incur such indebtedness to make investments in additional long-term care properties or to meet the distribution requirements imposed upon REITs under the Internal Revenue Code of 1986, as amended. For other short-term purposes, we may, from time to time, negotiate lines of credit, or arrange for other short-term borrowings from banks or otherwise. We may also arrange for long-term borrowings through public offerings or from institutional investors.

In addition, we may incur mortgage indebtedness on real estate which we have acquired through purchase, foreclosure or otherwise. We may also obtain mortgage financing for unleveraged or underleveraged properties in which we have invested or may refinance properties acquired on a leveraged basis. There is no limitation on the number or amount of mortgages that may be placed on any one property, and we have no policy with respect to limitations on borrowing, whether secured or unsecured.

Prohibited Investments and Activities. Our policies, which are subject to change by our Board of Directors without stockholder approval, impose certain prohibitions and restrictions on our investment practices or activities including prohibitions against:

- investing in any junior mortgage loan unless by appraisal or other method, the Directors determine that
 - (a) the capital invested in any such loan is adequately secured on the basis of the equity of the borrower in the property underlying such investment and the ability of the borrower to repay the mortgage loan; or
 - (b) such loan is a financing device we enter into to establish the priority of our capital investment over the capital invested by others investing with us in a real estate project;
- investing in commodities or commodity futures contracts (other than interest rate futures, when used solely for hedging purposes);
- investing more than 1% of our total assets in contracts for sale of real estate unless such contracts are recordable in the chain of title;
- holding equity investments in unimproved, non-income producing real property, except such properties as are currently undergoing development or are presently intended to be developed within one year, together with mortgage loans on such property (other than first mortgage development loans), aggregating to more than 10% of our assets.

Competition

In the health care industry, we compete for real property investments with health care providers, other health care related REITs, real estate partnerships, banks, private equity funds, venture capital funds and other investors. Many of our competitors are significantly larger and have greater financial resources and lower cost of capital than we have available to us. Our ability to compete successfully for real property investments will be determined by numerous factors, including our ability to identify suitable acquisition

targets, our ability to negotiate acceptable terms for any such acquisition and the availability and our cost of capital.

The lessees and borrowers of our properties compete on a local, regional and, in some instances, national basis with other health care providers. The ability of the lessee or borrower to compete successfully for patients or residents at our properties depends upon several factors, including the levels of care and services provided by the lessees or borrowers, the reputation of the providers, physician referral patterns, physical appearances of the properties, family preferences, financial condition of the operator and other competitive systems of health care delivery within the community, population and demographics.

Government Regulation

The health care industry is heavily regulated by the government. Our borrowers and lessees who operate health care facilities are subject to extensive regulation by federal, state and local governments. These laws and regulations are subject to frequent and substantial changes resulting from legislation, adoption of rules and regulations, and administrative and judicial interpretations of existing law. These changes may have a dramatic effect on the definition of permissible or impermissible activities, the relative costs associated with doing business and the amount of reimbursement by both government and other third-party payors. These changes may be applied retroactively. The ultimate timing or effect of these changes cannot be predicted. The failure of any borrower of funds from us or lessee of any of our properties to comply with such laws, requirements and regulations could result in sanctions or remedies such as denials of payment for new Medicare and Medicaid admissions, civil monetary penalties, state oversight and loss of Medicare and Medicaid participation or licensure. Such action could affect our borrower's or lessee's ability to operate its facility or facilities and could adversely affect such borrower's or lessee's ability to make debt or lease payments to us.

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

The ability of our borrowers and lessees to generate revenue and profit determines the underlying value of that property to us. Revenues of our borrowers and lessees are generally derived from payments for patient care. Sources of such payments for skilled nursing facilities include the federal Medicare program, state Medicaid programs, private insurance carriers, health care service plans, health maintenance organizations, preferred provider arrangements, and self-insured employers, as well as the patients themselves.

A significant portion of the revenue of our skilled nursing facility borrowers and lessees is derived from governmentally-funded reimbursement programs, such as Medicare and Medicaid. Because of significant health care costs paid by such government programs, both federal and state governments have adopted and continue to consider various health care reform proposals to control health care costs. There have been fundamental changes in the Medicare program that resulted in reduced levels of payment for a substantial portion of health care services. In many instances, revenues from Medicaid programs are already insufficient to cover the actual costs incurred in providing care to those patients. According to a report issued by the Kaiser Commission on Medicaid and the Uninsured in October 2006, while many states continued to freeze provider rates in fiscal year 2006, more states implemented provider rate increases in fiscal year 2006 or plan to do so in fiscal year 2007. In fiscal year 2006, 46 states froze or cut rates for at least one provider type, but the same number of states also increased rates for at least one

group of providers. Similarly in fiscal year 2007, 47 states intend to increase rates for at least one group of providers and 43 states plan rate freezes or cuts, but no state currently plans to cut Medicaid payments for skilled nursing facilities for fiscal year 2007. Skilled nursing facilities also were the major provider group most likely to see payment increases for fiscal year 2006 and fiscal year 2007, although some skilled nursing facility rate increases are tied to increased provider taxes. Nevertheless, future reduction in state Medicaid payments for skilled nursing facility services could have an adverse effect on the financial condition of our borrowers and lessees which could, in turn, adversely impact the timing or level of their payments to us. Moreover, health care facilities continue to experience pressures from private payors attempting to control health care costs, and reimbursement from private payors has in many cases effectively been reduced to levels approaching those of government payors.

Governmental and public concern regarding health care costs may result in significant reductions in payment to health care facilities, and there can be no assurance that future payment rates for either governmental or private payors will be sufficient to cover cost increases in providing services to patients. Any changes in reimbursement policies which reduce reimbursement to levels that are insufficient to cover the cost of providing patient care could adversely affect revenues of our skilled nursing property borrowers and lessees and to a much lesser extent our assisted living property borrowers and lessees and thereby adversely affect those borrowers and lessees' abilities to make their debt or lease payments to us. Failure of the borrowers or lessees to make their debt or lease payments would have a direct and material adverse impact on us.

On August 4, 2005, the Centers for Medicare & Medicaid Services, commonly known as CMS, published a final rule updating skilled nursing facility prospective payment rates for fiscal year 2006, which began October 1, 2005. This update implemented refinements to the patient classification system and triggered the expiration of a temporary payment add-on for certain high-acuity patients, effective January 1, 2006. The final rule also adopted a 3.1 percent market basket increase for fiscal year 2006. On July 31, 2006, CMS published a notice updating Medicare skilled nursing facility prospective payment system rates for fiscal year 2007, which began October 1, 2006. Under the notice, skilled nursing facilities receive the full 3.1 percent market basket increase to rates, increasing Medicare payments to skilled nursing facilities by approximately \$560.0 million for fiscal year 2007.

On February 5, 2007, the Bush Administration released its fiscal year 2008 budget proposal, which includes legislative and administrative proposals that would reduce Medicare spending by approximately \$5.3 billion in fiscal 2008 and \$75.8 billion over 5 years. Among other things, the budget would provide no update for skilled nursing facilities in 2008 and a -0.65% adjustment to the update annually thereafter. The budget also would move toward site-neutral post-hospital payments to limit inappropriate incentives for five conditions commonly treated in both skilled nursing properties and inpatient rehabilitation facilities. The budget proposal also would eliminate all bad debt reimbursements for unpaid beneficiary cost-sharing over four years. In addition, the budget proposal includes a series of proposals impacting Medicaid, including legislative and administrative changes that would reduce Medicaid payments by almost \$26.0 billion over five years. Many of the proposed policy changes would require Congressional approval to implement. Thus, while the fiscal year 2007 skilled nursing facility rates will not decrease payments to skilled nursing facilities, the loss of revenues associated with potential future changes in skilled nursing facility payment rates could, in the future, have an adverse effect on the financial condition of our borrowers and lessees which could, in turn, adversely impact the timing or level of their payments to us.

The federal physician self-referral law, commonly known as Stark II (or Stark Law), prohibits physicians and certain other types of practitioners from making referrals for certain designated health services paid in whole or in part by Medicare and Medicaid to entities with which the practitioner or a member of the practitioner's immediate family has a financial relationship, unless the financial relationship fits within an applicable exception to the Stark Law. The Stark Law also prohibits the entity receiving the referral from seeking payment under the Medicare and Medicaid programs for services rendered pursuant

to a prohibited referral. If an entity is paid for services rendered pursuant to a prohibited referral, it may incur civil penalties of up to \$15,000 per prohibited claim and may be excluded from participating in the Medicare and Medicaid programs.

Legislative Developments

Each year, legislative proposals are proposed in Congress and in some state legislatures that would affect major changes in the health care system, either nationally or at the state level. Among the proposals under consideration are additional cost controls on the Medicare and Medicaid programs, health care provider cost-containment initiatives, health care coverage expansion for the uninsured, measures to prevent medical errors, limits on damages that could be claimed in physician malpractice lawsuits, and a Patient Bill of Rights to increase the liability of insurance companies as well as the ability of patients to sue in the event of a wrongful denial of claim. We cannot predict whether any proposals will be adopted or, if adopted, what effect, if any, such proposals would have on our business.

Environmental Matters

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

Although the mortgage loans that we provide and leases covering our properties require the borrower and the lessee to indemnify us for certain environmental liabilities, the scope of such obligations may be limited and we cannot assure that any such borrower or lessee would be able to fulfill its indemnification obligations.

Insurance

It is our current policy and we intend to continue this policy that all borrowers of funds from us and lessees of any of our properties secure adequate comprehensive property and general and professional liability insurance that covers us as well as the borrower and/or lessee. Even though that is our policy, certain borrowers and lessees have been unable to obtain general and professional liability insurance in the specific amounts required by our leases or mortgages because the cost of such insurance has increased substantially and some insurers have stopped offering such insurance for long-term care facilities. Additionally, in the past, insurance companies have filed for bankruptcy protection leaving certain of our borrowers and/or lessees without coverage for periods that were believed to be covered prior to such bankruptcies. The unavailability and associated exposure as well as increased cost of such insurance could have a material adverse effect on the lessees and borrowers, including their ability to make lease or mortgage payments. Although we contend that as a non-possessory landlord we are not generally responsible for what takes place on real estate we do not possess, claims including general and professional liability claims, may still be asserted against us which may result in costs and exposure for which insurance is not available. Certain risks may be uninsurable, not economically insurable or insurance may not be available and there can be no assurance that we, a borrower or lessee will have adequate funds to cover all

contingencies. If an uninsured loss or a loss in excess of insured limits occurs with respect to one or more of our properties, we could be subject to an adverse claim including claims for general or professional liability, could lose the capital that we have invested in the properties, as well as the anticipated future revenue for the properties and, in the case of debt which is with recourse to us, we would remain obligated for any mortgage debt or other financial obligations related to the properties. Certain losses such as losses due to floods or seismic activity if insurance is available may be insured subject to certain limitations including large deductibles or co-payments and policy limits.

Employees

We currently employ 12 people. The employees are not members of any labor union, and we consider our relations with our employees to be excellent.

Taxation of Our Company

General. We believe that we have been organized and have operated in such a manner as to qualify for taxation as a REIT under Sections 856 to 860 of the Internal Revenue Code of 1986, as amended, commencing with our taxable year ended December 31, 1992. We intend to continue to operate in such a manner, but no assurance can be given that we have operated or will be able to continue to operate in a manner so as to qualify or to remain qualified. This summary is qualified in its entirety by the applicable Internal Revenue Code provisions, rules and regulations, and administrative and judicial interpretations.

If we continue to qualify for taxation as a REIT, we will generally not be subject to federal corporate income taxes as long as we distribute all of our taxable income as dividends. This treatment substantially eliminates the double taxation (*i.e.*, at the corporate and stockholder levels) that generally results from investment in a corporation. However, we will continue to be subject to federal income tax as follows:

First, we will be taxed at regular corporate rates on any undistributed taxable income, including undistributed net capital gains.

Second, under certain circumstances, we may be subject to the alternative minimum tax, if our dividend distributions are less than our alternative minimum taxable income.

Third, if we have (i) net income from the sale or other disposition of foreclosure property which is held primarily for sale to customers in the ordinary course of business or (ii) other non-qualifying income from foreclosure property, we may elect to be subject to tax at the highest corporate rate on such income, if necessary to maintain our REIT status.

Fourth, if we have net income from prohibited transactions (which are, in general, certain sales or other dispositions of property (other than foreclosure property) held primarily for sale to customers in the ordinary course of business), such income will be subject to a 100% tax.

Fifth, if we fail to satisfy the 75% gross income test or the 95% gross income test, but nonetheless maintain our qualification as a REIT because certain other requirements have been met, we will be subject to a 100% tax on an amount equal to (a) the gross income attributable to the greater of the amount by which we fail the 75% or 95% test multiplied by (b) a fraction intended to reflect our profitability.

Sixth, if we fail to distribute during each calendar year at least the sum of (i) 85% of our ordinary income for such year, (ii) 95% of our REIT capital gain net income for such year, and (iii) any undistributed taxable income from prior periods, we will be subject to a 4% excise tax on the excess of such required distribution over the amounts actually distributed.

Seventh, if we acquire an asset which meets the definition of a built-in gain asset from a corporation which is or has been a C corporation (*i.e.*, generally a corporation subject to full corporate-level tax) in

certain transactions in which the basis of the built-in gain asset in our hands is determined by reference to the basis of the asset in the hands of the C corporation, and if we subsequently recognize gain on the disposition of such asset during the ten-year period, called the recognition period, beginning on the date on which we acquired the asset, then, to the extent of the built-in gain (i.e., the excess of (a) the fair market value of such asset over (b) our adjusted basis in such asset, both determined as of the beginning of the recognition period), such gain will be subject to tax at the highest regular corporate tax rate, pursuant to IRS regulations.

Eighth, if we have taxable REIT subsidiaries, we will also be subject to a tax of 100% on the amount of any rents from real property, deductions or excess interest paid to us by any of our taxable REIT subsidiaries that would be reduced through reapportionment under certain federal income tax principles in order to more clearly reflect income for the taxable REIT subsidiary.

Requirements for Qualification. The Internal Revenue Code defines a REIT as a corporation, trust or association:

- (1) which is managed by one or more trustees or directors;
- (2) the beneficial ownership of which is evidenced by transferable shares, or by transferable certificates of beneficial interest;
- (3) which would be taxable, but for Sections 856 through 860 of the Internal Revenue Code, as a domestic corporation;
- (4) which is neither a financial institution; nor, an insurance company subject to certain provisions of the Internal Revenue Code;
- (5) the beneficial ownership of which is held by 100 or more persons;
- (6) during the last half of each taxable year not more than 50% in value of the outstanding stock of which is owned, actually or constructively, by five or fewer individuals (including specified entities); and
- (7) which meets certain other tests, described below, regarding the amount of its distributions and the nature of its income and assets.

The Internal Revenue Code provides that conditions (1) to (4), inclusive, must be met during the entire taxable year and that condition (5) must be met during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months.

Income Tests. There presently are two gross income requirements that we must satisfy to qualify as a REIT:

- First, at least 75% of our gross income (excluding gross income from prohibited transactions, as defined below) for each taxable year must be derived directly or indirectly from investments relating to real property or mortgages on real property, including rents from real property, or from certain types of temporary investment income.
- Second, at least 95% of our gross income (excluding gross income from prohibited transactions) for each taxable year must be derived from income that qualifies under the 75% test or from dividends, interest and gain from the sale or other disposition of stock or securities.

Cancellation of indebtedness income generated by us is not taken into account in applying the 75% and 95% income tests discussed above. A prohibited transaction is a sale or other disposition of property (other than foreclosure property) held for sale to customers in the ordinary course of business. Any gain realized from a prohibited transaction is subject to a 100% penalty tax.

If we fail to satisfy one or both of the 75% or 95% gross income tests for any taxable year, we may nevertheless qualify as a REIT for the year if we are eligible for relief. These relief provisions will be generally available if: our failure to meet the tests was due to reasonable cause and not due to willful neglect, we attach a schedule of the sources of our income to our return; and any incorrect information on the schedule was not due to fraud with intent to evade tax.

Asset Tests. We, at the close of each quarter of our taxable year, must also satisfy four tests relating to the nature of our assets.

- First, at least 75% of the value of our total assets must be represented by real estate assets (including stock or debt instruments held for not more than one year purchased with the proceeds of a stock offering or long-term (at least five years) public debt offering of our company), cash, cash items and government securities.
- Second, not more than 25% of our total assets may be represented by securities other than those in the 75% asset class.
- Third, of the investments included in the 25% asset class, the value of any one issuer's securities owned by us may not exceed 5% of the value of our total assets and we may not own more than 10% of any one issuer's outstanding voting securities.
- Fourth, the Tax Relief Extension Act of 1999 (or 99 Act), provides that, subject to certain exceptions, for taxable years commencing after December 31, 2000, we may not own more than 10% of the total value of the securities of any issuer. See the 99 Act description beginning on page 12.
- Fifth, the 99 Act also provides that not more than 20% of our value may be represented by securities of one or more taxable REIT subsidiaries.

With the passage of the American Jobs Creation Act of 2004 (2004 Act), for years beginning after the effective date of October 22, 2004, if we meet certain requirements, a violation of the prohibition of owning securities of any one issuer that exceeds 5% of the value of our assets or owning securities of any one issuer that exceeds 10% of that issuer's voting securities or 10% of the value of that issuer's outstanding securities may not result in disqualification as a REIT.

The 2004 Act provides that a de minimis failure, where we dispose of assets in order to meet these requirements within six months of the last day of the quarter in which the failure is identified or the requirements are otherwise met within this time frame, will not result in disqualification. A de minimis failure is one where the failure is due to ownership of assets the total value of which does not exceed the lesser of one percent of the total value of our assets at the end of the quarter or \$10.0 million.

In addition, a failure exceeding the de minimis amount is considered to have satisfied the requirements if such failure is due to reasonable cause and not due to willful neglect, a description of each asset that causes the failure is filed with the Internal Revenue Service, a certain tax is paid, and the assets that cause the failure are disposed of within six months of the last day of the quarter in which we identify the failure. The tax is the greater of \$50,000 or the net income generated by such assets during the period beginning on the date of failure until disposal taxed at the highest corporate rate.

Ownership of a Partnership Interest or Stock in a Corporation. We own an interest in a partnership. In the case of a REIT that is a partner in a partnership, Treasury regulations provide that for purposes of the REIT income and asset tests the REIT will be deemed to own its proportionate share of the assets of the partnership, and will be deemed to be entitled to the income of the partnership attributable to such share. The ownership of an interest in a partnership by a REIT may involve special tax risks, including the challenge by the Internal Revenue Service of the allocations of income and expense items of the partnership, which would affect the computation of taxable income of the REIT, and the status of the

partnership as a partnership (as opposed to an association taxable as a corporation) for federal income tax purposes.

We also own interests in a number of subsidiaries which are intended to be treated as qualified real estate investment trust subsidiaries. The Internal Revenue Code provides that such subsidiaries will be ignored for federal income tax purposes and all assets, liabilities and items of income, deduction and credit of such subsidiaries will be treated as assets, liabilities and such items of ours.

If any partnership or qualified real estate investment trust subsidiary in which we own an interest were treated as a regular corporation (and not as a partnership or qualified real estate investment trust subsidiary) for federal income tax purposes, we would likely fail to satisfy the REIT asset test prohibiting a REIT from owning greater than 10% of the voting power of the stock or value of securities of any issuer, as described above, and would therefore fail to qualify as a REIT. As described above, the 2004 Act provides relief for certain failures of the REIT asset test for years beginning after October 22, 2004. We believe that each of the partnerships and subsidiaries in which we own an interest will be treated for tax purposes as a partnership or qualified real estate investment trust subsidiary, respectively, although no assurance can be given that the Internal Revenue Service will not successfully challenge the status of any such organization.

REMIC. A regular or residual interest in a REMIC will be treated as a real estate asset for purposes of the REIT asset tests, and income derived with respect to such interest will be treated as interest on an obligation secured by a mortgage on real property, assuming that at least 95% of the assets of the REMIC are real estate assets. If less than 95% of the assets of the REMIC are real estate assets, only a proportionate share of the assets of and income derived from the REMIC will be treated as qualifying under the REIT asset and income tests. All of our historical REMIC Certificates were secured by real estate assets, therefore we believe that our historic REMIC interests fully qualified for purposes of the REIT income and asset tests.

Annual Distribution Requirements. In order to qualify as a REIT, we are required to distribute dividends (other than capital gain dividends) to our stockholders annually in an amount at least equal to:

- (1) the sum of:
 - (a) 90% (95% for taxable years ending prior to January 1, 2001) of our real estate investment trust taxable income (computed without regard to the dividends paid deduction and our net capital gain); and
 - (b) 90% (95% for taxable years ending prior to January 1, 2001) of the net income, if any (after tax), from foreclosure property; minus
- (2) the excess of certain items of non-cash income over 5% of our real estate investment trust taxable income.

These annual distributions are paid in the taxable year to which they relate. Alternatively, they must be declared and payable to stockholders of record in either October, November, or December and paid during January of the following year. In addition, if we elect, the dividends may be declared before the due date of the tax return (including extensions) and paid on or before the first regular dividend payment date after such declaration, and we must specify the dollar amount in our tax returns.

Amounts distributed must not be preferential; that is, every stockholder of the class of stock with respect to which a distribution is made must be treated the same as every other stockholder of that class, and no class of stock may be treated otherwise than in accordance with its dividend rights as a class.

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To the extent that we do not distribute all of our net long-term capital gain or distribute at least 90% (95% for taxable years ending prior to January 1, 2001), but less than 100%, of our real estate investment trust taxable income, as adjusted, it will be subject to tax on such amounts at regular corporate tax rates. Furthermore, if we should fail to distribute during each calendar year (or, in the case of distributions with declaration and record dates in the last three months of the calendar year, by the end of the following January) at least the sum of:

- (1) 85% of our real estate investment trust ordinary income for such year;
- (2) 95% of our real estate investment trust capital gain net income for such year; and
- (3) any undistributed taxable income from prior periods;

we would be subject to a 4% excise tax on the excess of such required distributions over the amounts actually distributed. Any real estate investment trust taxable income and net capital gain on which this excise tax is imposed for any year is treated as an amount distributed during that year for purposes of calculating such tax.

Failure to Qualify. If we fail to qualify for taxation as a REIT in any taxable year, and certain relief provisions do not apply, we will be subject to tax (including any applicable alternative minimum tax) on our taxable income at regular corporate rates. Distributions to stockholders in any year in which we fail to qualify as a REIT will not be deductible by us, nor will any distributions be required to be made. Unless entitled to relief under specific statutory provisions, we will also be disqualified from taxation as a REIT for the four taxable years following the year during which qualification was lost. It is not possible to state whether in all circumstances we would be entitled to the statutory relief. Failure to qualify for even one year could substantially reduce distributions to stockholders and could result in our incurring substantial indebtedness (to the extent borrowings are feasible) or liquidating substantial investments in order to pay the resulting taxes.

99 Act. The 99 Act made a number of substantial changes to the qualification and tax treatment of REITs. Certain of those provisions were subsequently modified by the 2004 Act effective concurrently with the 99 Act. The following is a brief summary of certain of the significant REIT provisions in the 99 Act, as modified by the 2004 Act.

- 1) *Investment limitations and taxable REIT subsidiaries.* The 99 Act modified the REIT asset test by adding a requirement effective for years beginning after December 31, 2000 that, with the exception of the stock of a taxable REIT subsidiary, a REIT cannot own more than 10% of the total value of the securities of any issuer (10% Rule). Excluded from the definition of securities are straight debt securities, a REIT's interest as a partner in a partnership, any loan to an individual or an estate, certain rental agreements, any obligation to pay rents from real property, certain securities issued by States, the District of Columbia, a foreign government, or the Commonwealth of Puerto Rico, any security issued by a REIT, and any other arrangement that is determined by the Internal Revenue Service. Straight debt securities are non-convertible, non-contingent debt provided that the REIT or any controlled taxable REIT subsidiaries does not own any other securities of the issuer that have an aggregate value greater than 1% of the issuer's outstanding securities.
- 2) For a corporation to qualify as a taxable REIT subsidiary the following requirements must be satisfied.
 - (1) The REIT must own stock in the subsidiary corporation.
 - (2) Both the REIT and the subsidiary corporation must join in an election that the subsidiary corporation be treated as a taxable REIT subsidiary of the REIT.

(3) The subsidiary corporation cannot directly or indirectly operate or manage either a lodging or health care facility.

(4) The subsidiary corporation generally cannot provide to any person rights to any brand name under which lodging or health care facilities are operated.

A taxable REIT subsidiary can provide a limited amount of services to tenants of REIT property (even if such services were not considered customarily furnished in connection with the rental of real property) and can manage or operate properties, generally for third parties, without causing the rents received by the REIT from such parties not to be treated as rent from real properties. The rule that rents paid to a REIT do not qualify as rental from real property if the REIT owns more than 10% of the corporation paying the rent is modified by excepting rents paid by taxable REIT subsidiaries provided that 90% of the space is leased to third parties at comparable rents for comparable space. The 2004 Act prospectively removes the safe harbor for rents received by a REIT for customary services performed by a taxable REIT subsidiary. Instead, such payments will satisfy the existing safe harbor if the REIT pays the taxable REIT subsidiary 150% of the cost to the taxable REIT subsidiary of providing any services.

Interest paid by a taxable REIT subsidiary to the related REIT is subject to the earnings stripping rules contained in Section 163(j) of the Code and therefore the taxable REIT subsidiary cannot deduct interest in any year that it would exceed 50% of the subsidiary's adjusted gross income. If any amount of interest, rent, or other deductions of the taxable REIT subsidiary to be paid to the REIT is determined not to be at arm's length, an excise tax of 100% is imposed on the portion that is determined to be excessive. However, rent received by a REIT shall not fail to qualify as rents from real property by reason of the fact that all or any portion of such rent is redetermined for purposes of the excise tax.

The Act permits a REIT to own up to 100% of the stock of a taxable REIT subsidiary. However, the value of all of the securities of taxable REIT subsidiaries owned by the REIT cannot exceed 20% of the value of the REIT's assets.

The 10% Rule generally will not apply to securities owned by a REIT on July 12, 1999 (or Transition Rule). However, the Transition Rule would cease to apply to securities of an issuer if, after July 12, 1999, the REIT acquires additional securities of such issuer or if such issuer engages in a substantial new line of business, or acquires any substantial assets, other than in a reorganization or in a transaction qualifying under Section 1031 or 1033 of the Code.

3) *Ownership of health care facilities.* The 99 Act permits a REIT to own and operate a health care facility for at least two years, and treat it as permitted foreclosure property, if the facility is acquired as the result of a default (or imminent default) of a lease or indebtedness.

4) *REIT distribution requirements.* The 99 Act reduces the requirement that a REIT must distribute at least 95% of its income as deductible dividends to 90% of its income.

5) *Rents from personal property.* A REIT may treat rent from personal property as rent from real property so long as the rent from personal property does not exceed 15% of the total rent from both real and personal property for the taxable year. The Act provides that this determination will be made by comparing the fair market value of the personal property to the fair market value of the real and personal property.

State and local taxation. We may be subject to state or local taxation in various state or local jurisdictions, including those in which we transact business or reside. Our state and local tax treatment may not conform to the federal income tax consequences discussed above.

Investor Information

We make available to the public free of charge through our internet website our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after we electronically file such reports with, or furnish such reports to, the Securities and Exchange Commission. Our internet website address is www.ltcproperties.com. We are not including the information contained on our website as part of, or incorporating it by reference into, this Annual Report on Form 10-K.

Posted on our website and available upon request of any stockholders to our Investor Relations Department are the charters for our Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee, our Corporate Governance Guidelines and a Code of Business Conduct and Ethics governing our directors, officers and employees. Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any amendment to the Code Business Conduct and Ethics and any waiver applicable to our senior financial officers and our executive officers or directors. In addition, our website includes information concerning purchases and sales of our equity securities by our executive officers and directors. Our Investor Relations Department can be contacted at:

LTC Properties, Inc.
31365 Oak Crest Drive, Suite #200
Westlake Village, California 91361
Attn: Investor Relations
(805) 981-8655

You may read and copy materials that we file with the SEC at the SEC's Public Reference Room at 100 F Street, N.E., Washington D.C. 20549. Information on the operation of the Public Reference Room is available by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy statements and other information we file. The address of the SEC website is www.sec.gov.

Our company is listed on the New York Stock Exchange (or NYSE), ticker symbol LTC. Section 303A.12(a) of the NYSE Listed Company Manual requires that listed companies disclose in their annual report to stockholders that the previous year's NYSE Annual CEO Certification has been filed with the NYSE and disclose any qualifications. We filed, with the NYSE, our Annual CEO Certification for our Annual Report on Form 10-K for the fiscal year ended December 31, 2005 without any qualifications.

Item 1A. RISK FACTORS

Certain information contained in this annual report includes statements that are not purely historical and are forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding our expectations, beliefs, intentions or strategies regarding the future. All statements other than historical facts contained in this annual report are forward looking statements. These forward looking statements involve a number of risks and uncertainties. All forward looking statements included in this annual report are based on information available to us on the date hereof, and we assume no obligation to update such forward looking statements. Although we believe that the assumptions and expectations reflected in such forward looking statements are reasonable, no assurance can be given that such expectations will prove to have been correct. The actual results achieved by us may differ materially from any forward looking statements due to the risks and uncertainties of such statements.

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

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

- the status of the economy;
- the status of capital markets, including prevailing interest rates;
- compliance with and changes to regulations and payment policies within the health care industry;
- changes in financing terms;
- competition within the health care and senior housing industries; and
- changes in federal, state and local legislation.

A Failure to Maintain or Increase our Dividend Could Reduce the Market Price of Our Stock. In January 2007, we declared a \$0.125 per share monthly dividend for the first quarter of calendar 2007. During calendar 2006, we paid a \$0.12 monthly dividend in each of the first, second, third and fourth quarters on our common stock. During calendar 2005, we paid a \$0.30 dividend in the first quarter and a \$0.11 monthly dividend in each of the second, third and fourth quarters on our common stock. The ability to maintain or raise our common dividend is dependent, to a large part, on growth of funds from operations. This growth in turn depends upon increased revenues from additional investments and loans, rental increases and mortgage rate increases.

At Times, We May Have Limited Access to Capital Which Will Slow Our Growth. A REIT is required to make dividend distributions and retains little capital for growth. As a result, growth for a REIT is generally through the steady investment of new capital in real estate assets. Presently, we believe capital is readily available to us. However, there will be times when we will have limited access to capital from the equity and/or debt markets. During such periods, virtually all of our available capital will be required to meet existing commitments and to reduce existing debt. We may not be able to obtain additional equity or debt capital or dispose of assets on favorable terms, if at all, at the time we require additional capital to acquire health care properties on a competitive basis or meet our obligations.

Income and Returns from Health Care Facilities Can be Volatile. The possibility that the health care properties in which we invest will not generate income sufficient to meet operating expenses, will generate income and capital appreciation, if any, at rates lower than those anticipated or will yield returns lower than those available through investments in comparable real estate or other investments are additional risks of investing in health care 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 and government payment), general or local economic conditions (such as fluctuations in interest rates and employment conditions), the available local supply of 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 hurricanes, earthquakes and floods) or similar factors.

We Depend on Lease Income and Mortgage Payments from Real Property. Since a substantial portion of our income is derived from mortgage payments and lease income from real property, our income would be adversely affected if a significant number of our borrowers or lessees were unable to meet their obligations to us or if we were unable to lease our properties or make mortgage loans on economically favorable terms. There can be no assurance that any lessee will exercise its option to renew its lease upon the expiration of the initial term or that if such failure to renew were to

occur, we could lease the property to others on favorable terms.

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We Rely on a Few Major Operators. Extencicare REIT and Assisted Living Concepts, Inc (or ALC) lease 37 assisted living properties with a total of 1,427 units owned by us representing approximately 11.6%, or \$66.0 million, of our total assets at December 31, 2006.

Alterra Healthcare Corporation (or Alterra), a wholly owned subsidiary of Brookdale Senior Living, Inc., leases 35 assisted living properties with a total of 1,416 units owned by us representing approximately 11.5%, or \$65.2 million, of our total assets at December 31, 2006.

Preferred Care, Inc. (or Preferred Care) operates 32 skilled health care properties with a total of 3,871 beds that we own or on which we hold mortgages secured by first trust deeds. This represents approximately 10.9% or \$62.1 million of our total assets at December 31, 2006.

Our financial position and ability to make distributions may be adversely affected by financial difficulties experienced by any of our other lessees and borrowers, including bankruptcies, inability to emerge from bankruptcy, insolvency or general downturn in business of any such operator, or in the event any such operator does not renew and/or extend its relationship with us or our borrowers when it expires.

Our Borrowers and Lessees Face Competition in the Health Care Industry. The long-term care industry is highly competitive and we expect that it may become more competitive in the future. Our borrowers and lessees are competing with numerous other companies providing similar long-term care services or alternatives such as home health agencies, hospices, life care at home, community-based service programs, retirement communities and convalescent centers. There can be no assurance that our borrowers and lessees will not encounter increased competition in the future which could limit their ability to attract residents or expand their businesses and therefore affect their ability to make their debt or lease payments to us.

The Health Care Industry is Heavily Regulated by the Government. Our borrowers and lessees who operate health care facilities are subject to extensive regulation by federal, state and local governments. These laws and regulations are subject to frequent and substantial changes resulting from legislation, adoption of rules and regulations, and administrative and judicial interpretations of existing law. These changes may have a dramatic effect on the definition of permissible or impermissible activities, the relative costs associated with doing business and the amount of reimbursement by both government and other third-party payors. These changes may be applied retroactively. The ultimate timing or effect of these changes cannot be predicted. The failure of any borrower of funds from us or lessee of any of our properties to comply with such laws, requirements and regulations could affect its ability to operate its facility or facilities and could adversely affect such borrower's or lessee's ability to make debt or lease payments to us. Also see *Government Regulation* beginning on page 5.

Congress and the States Have Enacted Health Care Reform Measures. The health care industry continues to face various challenges, including increased government and private payor pressure on health care providers to control costs. For instance, the Balanced Budget Act of 1997 enacted significant changes to the Medicare and Medicaid programs designed to modernize payment and health care delivery systems while achieving substantial budgetary savings. In seeking to limit Medicare reimbursement for long-term care services, Congress established the prospective payment system for skilled nursing facility services to replace the cost-based reimbursement system. Skilled nursing facilities needed to restructure their operations to accommodate the new Medicare prospective payment system reimbursement. Since the skilled nursing facility prospective payment system was enacted, several then publicly held operators of long-term care facilities and at least two then publicly held operators of assisted living facilities filed for reorganization under Chapter 11 of the federal bankruptcy laws. During their reorganizations and in some instances subsequent thereto, long-term care operators and assisted living operators reduced their operations by rejecting leases and/or defaulting on loans resulting in properties being returned to lessors or lenders. There can be no assurances given that there will not be additional bankruptcies of skilled nursing and assisted living operators in the future.

In recent years, Congress has adopted legislation to somewhat mitigate the impact of the Balanced Budget Act on providers, including skilled nursing facilities. For instance, on December 8, 2003, President Bush signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (P.L. 108-173). In addition to providing expanded Medicare prescription drug coverage, the new act modifies Medicare payments to a variety of health care providers. With respect to skilled nursing facilities, the act provides a temporary 128% increase in the Medicare payment for skilled nursing facility residents with acquired immune deficiency syndrome, applicable to services furnished on or after October 1, 2004. This temporary increase is still in effect as of December 31, 2006.

On the other hand, in February 2006 Congress gave final approval to the Deficit Reduction Act (or DRA), which will reduce net Medicare and Medicaid spending by approximately \$11.0 billion over five years. Among other things, the legislation reduces Medicare skilled nursing facility bad debt payments by 30 percent for those individuals who are not dually eligible for Medicare and Medicaid, and strengthens Medicaid asset transfer restrictions for persons seeking to qualify for Medicaid long-term care coverage.

Most recently, on December 20, 2006, President Bush signed into law the Tax Relief and Health Care Act of 2006 (P.L. 109-432), which also modifies a number of Medicare and Medicaid policies. Among other things, the law reduces the limit on Medicaid provider taxes from 6% (set forth in regulations) to 5.5% from January 1, 2008 through September 30, 2011. The Bush Administration had been expected to issue regulations calling for deeper cuts in funding, which is used by many states to finance state health programs. President Bush's proposed 2008 fiscal year budget also would reduce Medicare and Medicaid payments to providers. Congress may consider legislation in the future that would further restrict Medicare and Medicaid funding. No assurances can be given that any additional Medicare or Medicaid legislation enacted by Congress would not reduce Medicare or Medicaid reimbursement to skilled nursing facilities or result in additional costs for operators of skilled nursing facilities.

In addition, comprehensive reforms affecting the payment for and availability of health care services have been proposed at the federal and state levels and major reform proposals have been adopted by certain states. Congress and state legislatures can be expected to continue to review and assess alternative health care delivery systems and payment methodologies. Changes in the law, new interpretations of existing laws, or changes in payment methodology may have a dramatic effect on the definition of permissible or impermissible activities, the relative costs associated with doing business and the amount of reimbursement by the government and other third party payors. The DRA also gives states greater flexibility to expand access to home and community based services by allowing states to provide these services as an optional benefit without undergoing the waiver approval process. Moreover, the DRA includes a new demonstration to encourage states to provide long-term care services in a community setting to individuals who currently receive Medicaid services in nursing homes. Together the provisions could increase state funding for home and community based services, while prompting states to cut funding for nursing facilities and homes for persons with disabilities. In light of continuing state Medicaid program reforms, budget cuts, and regulatory initiatives, no assurance can be given that the implementation of such regulations and reforms will not have a material adverse effect on the financial condition or results of operations of our lessees and/or borrowers which, in turn, could effect their ability to meet their contractual obligations to us. Also see *Government Regulation* beginning on page 5.

Our Borrowers and Lessees Rely on Government and Third Party Reimbursement. The ability of our borrowers and lessees to generate revenue and profit determines the underlying value of that property to us. Revenues of our borrowers and lessees are generally derived from payments for patient care. Sources of such payments include the federal Medicare program, state Medicaid programs, private insurance carriers, health care service plans, health maintenance organizations, preferred provider arrangements, self-insured employers, as well as the patients themselves. Also see *Government Regulation* beginning on page 5.

We Could Incur More Debt. We operate with a policy of incurring debt when, in the opinion of our Directors, it is advisable. We may incur additional debt by issuing debt securities in a public offering or in a private transaction. Accordingly, we could become more highly leveraged. The degree of leverage could have important consequences to stockholders, including affecting our ability to obtain additional financing in the future for working capital, capital expenditures, acquisitions, development or other general corporate purposes and making us more vulnerable to a downturn in business or the economy generally.

We Could Fail to Collect Amounts Due Under Our Straight-line Rent Receivable Asset. Straight-line accounting requires us to calculate the total rent we will receive as a fixed amount over the life of the lease and recognize that revenue evenly over that life. In a situation where a lease calls for fixed rental increases during the life of the lease rental income recorded in the early years of a lease is higher than the actual cash rent received, which creates an asset on the balance sheet called deferred rent receivable. At some point during the lease, depending on the rent levels and terms, this reverses and the cash rent payments received during the later years of the lease are higher than the rental income recognized, which reduces the deferred rent receivable balance to zero by the end of the lease. We periodically assess the collectibility of the deferred rent receivable. If during our assessment we determined that we were unlikely to collect a portion or all of the deferred rent receivable balance, we may record an impairment charge in current period earnings for the portion, up to its full value, that we estimate will not be recovered.

Our Assets May be Subject to Impairment Charges. We periodically but not less than quarterly evaluate our real estate investments and other assets for impairment indicators. The judgment regarding the existence of impairment indicators is based on factors such as market conditions, operator performance and legal structure. If we determine that a significant impairment has occurred, we would be required to make an adjustment to the net carrying value of the asset, which could have a material adverse affect on our results of operations and a non-cash impact on funds from operations in the period in which the write-off occurs.

A Failure to Reinvest Cash Available to Us Could Adversely Affect Our Future Revenues and Our Ability to Increase Dividends to Stockholders; There is Considerable Competition in Our Market for Attractive Investments. From time to time, we will have cash available from (1) proceeds of sales of shares of securities, (2) proceeds from new debt issuances, (3) principal payments on our mortgages and other investments, (4) sale of properties, and (5) funds from operations. We may reinvest this cash in health care investments in accordance with our investment policies, repay outstanding debt or invest in qualified short-term or long-term investments. We compete for real estate investments with a broad variety of potential investors. The competition for attractive investments negatively affects our ability to make timely investments on acceptable terms. Delays in acquiring properties or making loans will negatively impact revenues and perhaps our ability to increase distributions to our stockholders.

Our Failure to Qualify as a REIT Would Have Serious Adverse Consequences to Our Stockholders. We intend to operate so as to qualify as a REIT under the Internal Revenue Code (the Code). We believe that we have been organized and have operated in a manner which would allow us to qualify as a REIT under the Code beginning with our taxable year ended December 31, 1992. However, it is possible that we have been organized or have operated in a manner which would not allow us to qualify as a REIT, or that our future operations could cause us to fail to qualify. Qualification as a REIT requires us to satisfy numerous requirements (some on an annual and quarterly basis) established under highly technical and complex Code provisions for which there are only limited judicial and administrative interpretations, and involves the determination of various factual matters and circumstances not entirely within our control. For example, in order to qualify as a REIT, at least 95% of our gross income in any year must be derived from qualifying sources, and we must pay dividends to stockholders aggregating annually at least 90% (95% for taxable years ending prior to January 1, 2001) of our REIT taxable income (determined without regard to the dividends paid deduction and by excluding capital gains). Legislation, new regulations, administrative interpretations or court decisions could significantly change the tax laws with respect to qualification as a

REIT or the federal income tax consequences of such qualification. However, we are not aware of any pending tax legislation that would adversely affect our ability to operate as a REIT.

If we fail to qualify as a REIT in any taxable year, we will be subject to federal income tax (including any applicable alternative minimum tax) on our taxable income at regular corporate rates. Unless we are entitled to relief under statutory provisions, we would be disqualified from treatment as a REIT for the four taxable years following the year during which we lost qualification. If we lose our REIT status, our net earnings available for investment or distribution to stockholders would be significantly reduced for each of the years involved. In addition, we would no longer be required to make distributions to stockholders.

Our real estate investments are relatively illiquid. Real estate investments are relatively illiquid and, therefore, tend to limit our ability to vary our portfolio promptly in response to changes in economic or other conditions. All of our properties are special purpose properties that cannot be readily converted to general residential, retail or office use. Health care facilities that participate in Medicare or Medicaid must meet extensive program requirements, including physical plant and operational requirements, which are revised from time to time. Such requirements may include a duty to admit Medicare and Medicaid patients, limiting the ability of the facility to increase its private pay census beyond certain limits. Medicare and Medicaid facilities are regularly inspected to determine compliance, and may be excluded from the programs in some cases without a prior hearing for failure to meet program requirements. Transfers of operations of nursing homes and other healthcare-related facilities are subject to regulatory approvals not required for transfers of other types of commercial operations and other types of real estate. Thus, if the operation of any of our properties becomes unprofitable due to competition, age of improvements or other factors such that our lessee or mortgagor becomes unable to meet its obligations on the lease or mortgage loan, the liquidation value of the property may be substantially less, particularly relative to the amount owing on any related mortgage loan, than would be the case if the property were readily adaptable to other uses. The receipt of liquidation proceeds or the replacement of an operator that has defaulted on its lease or loan could be delayed by the approval process of any federal, state or local agency necessary for the transfer of the property or the replacement of the operator with a new operator licensed to manage the facility. In addition, certain significant expenditures associated with real estate investment, such as real estate taxes and maintenance costs, are generally not reduced when circumstances cause a reduction in income from the investment. Should such events occur, our income and cash flows from operations would be adversely affected.

Our Remedies May Be Limited When Mortgage Loans Default. To the extent we invest in mortgage loans, such mortgage loans may or may not be recourse obligations of the borrower and generally will not be insured or guaranteed by governmental agencies or otherwise. In the event of a default under such obligations, we may have to foreclose on the property underlying the mortgage or protect our interest by acquiring title to a property and thereafter make substantial improvements or repairs in order to maximize the property's investment potential. Borrowers may contest enforcement of foreclosure or other remedies, seek bankruptcy protection against such enforcement and/or bring claims for lender liability in response to actions to enforce mortgage obligations. If a borrower seeks bankruptcy protection, the Bankruptcy Court may impose an automatic stay that would preclude us from enforcing foreclosure or other remedies against the borrower. Relatively high loan to value ratios and declines in the value of the property may prevent us from realizing an amount equal to our mortgage loan upon foreclosure.

We are Subject to Risks and Liabilities in Connection with Properties Owned Through Limited Liability Companies and Partnerships. We have ownership interests in limited liability companies and/or partnerships. We may make additional investments through these ventures in the future. Partnership or limited liability company investments may involve risks such as the following:

- our partners or co-members might become bankrupt (in which event we and any other remaining general partners or members would generally remain liable for the liabilities of the partnership or limited liability company);
- our partners or co-members might at any time have economic or other business interests or goals which are inconsistent with our business interests or goals;
- our partners or co-members may be in a position to take action contrary to our instructions, requests, policies or objectives, including our policy with respect to maintaining our qualification as a REIT; and
- agreements governing limited liability companies and partnerships often contain restrictions on the transfer of a member's or partner's interest or buy-sell or other provisions which may result in a purchase or sale of the interest at a disadvantageous time or on disadvantageous terms.

We will, however, generally seek to maintain sufficient control of our partnerships and limited liability companies to permit us to achieve our business objectives. Our organizational documents do not limit the amount of available funds that we may invest in partnerships or limited liability companies. The occurrence of one or more of the events described above could have a direct and adverse impact on us.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

Investment Portfolio

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At December 31, 2006, our direct real estate investment portfolio (properties that we own or on which we hold promissory notes secured by first mortgages) consisted of investments in 121 skilled nursing properties with 13,953 beds, 94 assisted living properties with 4,449 units and two schools in 32 states. We had approximately \$488.3 million (before accumulated depreciation of \$102.1 million) invested in properties we own and lease to lessees and approximately \$118.3 million invested in mortgage loans (before allowance for doubtful accounts of \$1.3 million). Subsequent to December 31, 2006, we sold a closed, previously impaired skilled nursing property to a third party for \$0.2 million. As a result of the sale, we will recognize a gain of \$0.1 million in 2007.

Skilled nursing facilities provide restorative, rehabilitative and nursing care for people not requiring the more extensive and sophisticated treatment available at acute care hospitals. Many skilled nursing facilities provide ancillary services that include occupational, speech, physical, respiratory and IV therapies, as well as provide sub-acute care services which are paid either by the patient, the patient's family, or through federal Medicare or state Medicaid programs.

Assisted living facilities serve elderly persons who require assistance with activities of daily living, but do not require the constant supervision skilled nursing facilities provide. Services are usually available 24-hours a day and include personal supervision and assistance with eating, bathing, grooming and administering medication. The facilities provide a combination of housing, supportive services, personalized assistance and health care designed to respond to individual needs.

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The schools in our real estate investment portfolio are charter schools. Charter schools provide an alternative to the traditional public school. Charter schools are generally autonomous entities authorized by the state or locality to conduct operations independent from the surrounding public school district. Laws vary by state, but generally charters are granted by state boards of education either directly or in conjunction with local school districts or public universities. Operators are granted charters to establish and operate schools based on the goals and objectives set forth in the charter. Upon receipt of a charter, schools receive an annuity from the state for each student enrolled.

Owned Properties. At December 31, 2006, we owned 63 skilled nursing properties with a total of 7,304 beds, 84 assisted living properties with a total of 3,744 units and one school in 23 states, representing a gross investment of approximately \$488.3 million. The properties are leased pursuant to non-cancelable leases generally with an initial term of 10 to 30 years. The leases provide for a fixed minimum base rent during the initial and renewal periods. Most of the leases provide for annual fixed rent increases or increases based on consumer price indices over the term of the lease. In addition, certain of our leases provide for additional rent through revenue participation (as defined in the lease agreement) in incremental revenues generated by the facilities over a defined base period, effective at various times during the term of the lease. Each lease is a triple net lease which requires the lessee to pay additional charges including all taxes, insurance, assessments, maintenance and repair (capital and non-capital expenditures), and other costs necessary in the operation of the facility. Most of the leases contain renewal options. Subsequent to December 31, 2006, we sold a closed, previously impaired skilled nursing property to a third party for \$0.2 million. As a result of the sale, we will recognize a gain of \$0.1 million in 2007.

The following table sets forth certain information regarding our owned properties as of December 31, 2006 (*dollar amounts in thousands*):

Location	No. of SNFs	No. of ALFs	No. of Schools	No. of Beds/Units(1)	Encumbrances	Lease Term(2)	Current Investment
Alabama	3	1		458	\$	81	\$ 16,539
Arizona	5	2		1,029		156	41,053
California	1	2		343	16,712	62	29,305
Colorado	4	6		562	6,294	181	27,401
Florida	3	6		776	2,130	161	32,831
Georgia	2	1		292		58	6,550
Idaho		4		148		96	9,756
Indiana		2		78		96	5,070
Iowa	7	1		645		168	17,087
Kansas	3	4		398		172	17,313
Nebraska		4		156		96	9,332
New Jersey		1	1	39		111	12,195
New Mexico	7			860		149	48,503
N. Carolina		5		210		168	13,096
Ohio	4	11		683	14,814	124	53,210
Oklahoma		6		221	4,252	168	12,315
Oregon	1	3		218		101	10,652
Pennsylvania		1		69		136	8,327
S. Carolina		3		128		168	7,610
Tennessee	3			201		142	3,866
Texas(5)	16	13		2,660	4,064	147	67,904
Virginia	3			443		174	12,168
Washington	1	8		431	5,545	98	26,204
TOTAL	63	84	1	11,048	\$ 53,811 (3)		\$ 488,287 (4)

1. See *Item 1. Business General Owned Properties* for discussion of bed/unit count.

2. Weighted average remaining months in lease term as of December 31, 2006.

3. Consists of: i) \$48,266 of non-recourse mortgages payable by us secured by 16 assisted living properties with 828 units and ii) \$5,545 of tax-exempt bonds secured by five assisted living properties in Washington with 188 units. As of December 31, 2006 our gross investment in properties encumbered by mortgage loans, bonds and capital leases was \$83,771.

4. Of the total, \$230,159 relates to investments in skilled nursing properties, \$248,858 relates to investments in assisted living properties and \$9,270 relates to an investment in a school.

5. Subsequent to December 31, 2006, we sold a closed, previously impaired skilled nursing property to a third party for \$166. As a result of the sale, we will recognize a gain of \$149 in 2007.

Mortgage Loans. At December 31, 2006, we had 58 mortgage loans secured by first mortgages on 58 skilled nursing properties with a total of 6,649 beds, 10 assisted living properties with 705 units and one school located in 19 states. See *Item 8. FINANCIAL STATEMENTS Note 6. Real Estate Investments* for further description.

The following table sets forth certain information regarding our mortgage loans as of December 31, 2006 (*dollar amounts in thousands*):

Location	No. of SNFs	No. of ALFs	No. of Schools	No. of Beds/ Units(3)	Interest Rate %	Average Months to Maturity	Face Amount of Mortgage Loans	Current Amount of Mortgage Loans	Current Annual Debt Service(1)
Alabama	1			120	9.63%	39	\$ 3,788	\$ 3,730	\$ 402
Arkansas	1			174	11.45	51	2,000	1,436	251
California	8	1		1,177	9.85-12.10	96	20,016	15,132	2,727
Florida	5			537	11.20-13.13	21	13,860	12,864	1,907
Georgia	4			419	10.13-12.17	34	10,900	10,332	1,218
Iowa	1	1		104	12.12-12.64	15	5,600	5,120	714
Louisiana	1			127	12.02	119	1,600	1,234	212
Michigan	1			196	12.13	47	3,000	2,122	392
Minnesota			1		6.64	150	3,751	3,751	249
Missouri	2			190	9.88-10.35	75	3,000	2,488	339
Montana	2	1		197	12.12-12.89	29	7,946	7,195	1,015
Nebraska	1	4		245	11.03-12.64	18	12,111	11,272	1,524
Nevada	1			100	11.63	43	1,200	827	152
Oklahoma	2			273	12.15	80	2,600	1,382	243
S. Dakota		1		34	12.64	27	2,346	2,242	301
Tennessee	2			190	9.85-10.38	74	5,675	4,686	656
Texas	23	2		2,981	10.05-12.95	59	42,264	29,013	5,190
Washington	2			175	12.40-12.75	68	2,600	1,721	532
Wisconsin	1			115	11.00	122	2,200	1,725	272
TOTAL	58	10	1	7,354			\$ 146,457	\$ 118,272 (2)	\$ 18,296

1. Includes principal and interest payments.

2. Of the total current principal balance, \$89,328 relates to investments in skilled nursing properties, \$25,193 relates to investments in assisted living properties and \$3,751 relates to an investment in a school. This balance is gross of allowance for doubtful accounts.

3. See *Item 1. Business General Owned Properties* for discussion of bed/unit count.

In general, the mortgage loans may not be prepaid except in the event of the sale of the collateral property to a third party that is not affiliated with the borrower, although partial prepayments (including the prepayment premium) are often permitted where a mortgage loan is secured by more than one property upon a sale of one or more, but not all, of the collateral properties to a third party which is not an

affiliate of the borrower. The terms of the mortgage loans generally impose a premium upon prepayment of the loans depending upon the period in which the prepayment occurs, whether such prepayment was permitted or required, and certain other conditions such as upon the sale of the property under a pre-existing purchase option, destruction or condemnation, or other circumstances as approved by us. On certain loans, such prepayment amount is based upon a percentage of the then outstanding balance of the loan, usually declining ratably each year. For other loans, the prepayment premium is based on a yield maintenance formula. In addition to a lien on the mortgaged property, the loans are generally secured by certain non-real estate assets of the properties and contain certain other security provisions in the form of letters of credit, pledged collateral accounts, security deposits, cross-default and cross-collateralization features and certain guarantees.

Item 3. LEGAL PROCEEDINGS

We are a party from time to time to various general and professional liability claims and lawsuits asserted against the lessees or borrowers of our properties, which in our opinion are not singularly or in the aggregate material to our results of operations or financial condition. These types of claims and lawsuits may include matters involving general or professional liability, which we believe under applicable legal principles are not our responsibility as a non-possessory landlord or mortgage holder. We believe that these matters are the responsibility of our lessees and borrowers pursuant to general legal principles and pursuant to insurance and indemnification provisions in the applicable leases or mortgages. We intend to continue to vigorously defend such claims.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

Item 5. MARKET FOR THE COMPANY'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock is listed on the New York Stock Exchange (or NYSE). Set forth below are the high and low reported sale prices for our common stock as reported on the NYSE for each of the periods indicated below.

	2006		2005	
	High	Low	High	Low
First Quarter	\$ 23.51	\$ 20.78	\$ 20.00	\$ 16.87
Second Quarter	\$ 23.44	\$ 19.99	\$ 21.95	\$ 16.50
Third Quarter	\$ 25.00	\$ 20.77	\$ 23.92	\$ 19.26
Fourth Quarter	\$ 27.99	\$ 23.84	\$ 22.23	\$ 19.30

Holdings of Record

As of December 31, 2006 we had approximately 450 stockholders of record of our common stock.

Dividend Information

We declared and paid total cash distributions on common stock as set forth below:

	Declared		Paid	
	2006	2005	2006	2005
First Quarter	\$ 0.360	\$ 0.300	\$ 0.360	\$ 0.300
Second Quarter	\$	\$ 0.660	\$ 0.360	\$ 0.330
Third Quarter	\$ 0.360	\$ 0.330	\$ 0.360	\$ 0.330
Fourth Quarter	\$ 0.360	\$ 0.360	\$ 0.360	\$ 0.330
	\$ 1.080	\$ 1.650	\$ 1.440	\$ 1.290

We intend to distribute to our stockholders an amount at least sufficient to satisfy the distribution requirements of a REIT. Cash flows from operating activities available for distribution to stockholders will be derived primarily from interest and rental payments from our real estate investments. All distributions will be made subject to approval of the Board of Directors and will depend on our earnings, our financial condition and such other factors as the Board of Directors deem relevant. In order to qualify for the beneficial tax treatment accorded to REITs by Sections 856 through 860 of the Internal Revenue Code, we are required to make distributions to holders of our shares equal to at least 90% of our REIT taxable income. (See Annual Distribution Requirements beginning on page 11.)

Securities Authorized for Issuance under Equity Compensation Plans

Securities authorized for issuance under equity compensation plans as of December 31, 2006 is as follows:

Equity Compensation Plan Information

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	64,000	\$ 10.33	577,850
Equity compensation plans not approved by security holders			
Total	64,000	\$ 10.33	577,850

Stock Performance Graph

This graph compares the cumulative total stockholder return on our common stock from December 31, 2001 to December 31, 2006 with the cumulative stockholder total return of (1) the Standard & Poor's 500 Stock Index and (2) the NAREIT Hybrid REIT Index. The comparison assumes \$100 was invested on December 31, 2001 in our common stock and in each of the foregoing indices and assumes the reinvestment of dividends.

Total Return Stock Performance

The following companies comprise the NAREIT Hybrid REIT Index: Presidential Realty Corporation (Class B), iStar Financial Inc., Capital Lease Funding Inc., Arizona Land Income Corporation, PMC Commercial Trust, National Health Investors Inc., and LTC Properties Inc.

The stock performance depicted in the above graph is not necessarily indicative of future performance. The stock performance graph and compensation committee report shall not be deemed incorporated by reference into any filing by us under the Securities Act of 1933 or the Securities Exchange Act of 1934 except to the extent that we specifically incorporate such information by reference, and shall not otherwise be deemed filed under such Acts.

Item 6. SELECTED FINANCIAL INFORMATION

The following table of selected financial information should be read in conjunction with our financial statements and related notes thereto included elsewhere in this Annual Report on Form 10-K.

	2006	2005	2004	2003	2002
	(In thousands, except per share amounts)				
Operating Information:					
Total revenues	\$ 73,163	\$ 72,408	\$ 62,177	\$ 58,825	\$ 63,056
Income from continuing operations	45,485	50,637	32,252	17,106	16,643
Preferred stock dividends	(17,157)	(17,343)	(17,356)	(16,596)	(15,042)
Preferred stock redemption charge			(4,029)	(1,241)	
Net income available to common stockholders	61,631	35,366	15,003	6,482	16,761
Per share Information:					
Net Income per Common Share from Continuing Operations Net of Preferred Stock Dividends:					
Basic	\$ 1.21	\$ 1.49	\$ 0.56	\$ 0.08	\$ 0.03
Diluted	\$ 1.21	\$ 1.47	\$ 0.56	\$ 0.08	\$ 0.03
Net Income Per Common Share Available to Common Stockholders:					
Basic	\$ 2.64	\$ 1.58	\$ 0.77	\$ 0.36	\$ 0.91
Diluted	\$ 2.51	\$ 1.56	\$ 0.77	\$ 0.36	\$ 0.91
Common Stock Distributions declared	\$ 1.08	\$ 1.65	\$ 1.125	\$ 0.65	\$ 0.40
Common Stock Distributions paid	\$ 1.44	\$ 1.29	\$ 1.125	\$ 0.65	\$ 0.40
Balance Sheet Information:					
Total assets	\$ 567,767	\$ 585,271	\$ 547,880	\$ 574,924	\$ 599,925
Total debt(1)	53,811	92,361	96,764	149,765	223,787

(1) Includes bank borrowings, mortgage loans payable, bonds payable and capital lease obligations and senior participation payable

Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Executive Overview

Business

LTC Properties, Inc. a self-administered, health care real estate investment trust (or REIT) commenced operations in 1992. We invest primarily in long-term care and other health care related properties through mortgage loans, property lease transactions and other investments. The following table summarizes our portfolio as of December 31, 2006:

Type of Property	Gross Investments (in thousands)	For the twelve months ended 12/31/06		Percentage of Revenues of Revenues	Number of Properties	Number of Beds/Units(4)	Investment per Bed/Unit (in thousands)	Number of	
		Percentage of Investments	Revenues(2) (in thousands)					Operators(1)	States(1)
Assisted Living Properties	\$ 274,052 (3)	45.2 %	\$ 31,672	46.2 %	94	4,449	\$ 61.60	9	22
Skilled Nursing Properties	319,487	52.6 %	35,411	51.7 %	121	13,953	22.90	46	24
Schools	13,020	2.2 %	1,428	2.1 %	2	N/A	N/A	2	2
Totals	\$ 606,559	100.0 %	\$ 68,511	100.0 %	217	18,402			

(1) We have investments in 32 states leased or mortgaged to 54 different operators.

(2) Revenues exclude interest and other income from non-mortgage loan sources and include \$725,000 of revenue from properties that were sold in the first quarter of 2006.

(3) In January 2006, we sold four assisted living properties operated by Sunwest with a total of 431 units to an entity formed by the principals of Sunwest for \$58.5 million. We received \$54.5 million in proceeds after paying approximately \$3.8 million of 8.75% State of Oregon bond obligations related to one of the properties sold. As a result of the sale, we recognized a gain of \$31.9 million in 2006.

(4) See Item 1. Business General Owned Properties for discussion of bed/unit count.

Our primary objectives are to sustain and enhance stockholder equity value and provide current income for distribution to stockholders through real estate investments in long-term care properties and other health care related properties managed by experienced operators. To meet these objectives, we attempt to invest in properties that provide opportunity for additional value and current returns to our stockholders and diversify our investment portfolio by geographic location, operator and form of investment.

Substantially all of our revenues and sources of cash flows from operations are derived from operating lease rentals and interest earned on outstanding loans receivable. Our investments in mortgage loans and owned properties represent our primary source of liquidity to fund distributions and are dependent upon the performance of the operators on their lease and loan obligations and the rates earned thereon. To the extent that the operators experience operating difficulties and are unable to generate sufficient cash to make payments to us, there could be a material adverse impact on our consolidated results of operations, liquidity and/or financial condition. To mitigate this risk, we monitor our investments through a variety of methods determined by the type of health care facility and operator. Our monitoring process includes review of financial statements for each facility, periodic review of operator credit, scheduled property inspections and review of covenant compliance relating to real estate taxes and insurance.

In addition to our monitoring and research efforts, we also structure our investments to help mitigate payment risk. We typically invest in or finance up to 90 percent of the stabilized appraised value of a property. Operating leases and loans are normally credit enhanced by guaranties and/or letters of credit. In addition, operating leases are typically structured as master leases and loans are generally cross-defaulted

and cross-collateralized with other loans, operating leases or agreements between us and the operator and its affiliates.

For the twelve months ended December 31, 2006, rental income and interest income represented 72% and 21%, respectively, of total gross revenues. Our lease structure most often contains fixed annual rental escalations, which are generally recognized on a straight-line basis over the minimum lease period. Certain leases have annual rental escalations that are contingent upon changes in the Consumer Price Index and/or changes in the gross operating revenues of the property. This revenue is not recognized until the appropriate contingencies have been resolved. This lease structure initially generates lower revenues and net income but enables us to generate additional growth and minimized non-cash straight-line rent over time.

Depending upon the availability and cost of external capital, we anticipate making additional investments in health care related properties. New investments are generally funded from invested cash on hand and temporary borrowings under our unsecured line of credit and internally generated cash flows. Our investments generate internal cash from rent and interest receipts and principal payments on mortgage loans receivable. Permanent financing for future investments, which replaces funds drawn under our unsecured line of credit, is expected to be provided through a combination of public and private offerings of debt and equity securities and the incurrence of secured debt. We believe our liquidity and various sources of available capital are sufficient to fund operations, meet debt service obligations (both principal and interest), make dividend distributions and finance future investments.

Key Transactions

During 2006, we sold four assisted living properties with a total of 431 units and one 174-bed skilled nursing property. We recognized a gain of \$32.6 million on the two transactions and received total net cash proceeds of \$54.0 million after paying \$3.8 million of 8.75% State of Oregon bond obligations related to one of the properties sold. Also during 2006 we purchased five skilled nursing properties with a total of 373 beds for \$13.5 million in cash. One of the properties was acquired in a like-kind exchange transaction with a fair market value of \$3.4 million.

Key Performance Indicators, Trends and Uncertainties

We utilize several key performance indicators to evaluate the various aspects of our business. These indicators are discussed below and relate to concentration risk and credit strength. Management uses these key performance indicators to facilitate internal and external comparisons to our historical operating results in making operating decisions and for business planning purposes.

Concentration Risk. We evaluate our concentration risk in terms of asset mix, investment mix, operator mix and geographic mix. Concentration risk is valuable to understand what portion of our investments could be at risk if certain sectors were to experience downturns. Asset mix measures the portion of our investments that are real property. In order to qualify as an equity REIT, at least 75 percent of our total assets must be represented by real estate assets, cash, cash items and government securities. Investment mix measures the portion of our investments that relate to our various property types. Operator mix measures the portion of our investments that relate to our top three operators. Geographic mix measures the portion of our investment that relate to our top five states. The following table reflects our recent historical trends of concentration risk:

	Period Ended				
	12/31/06	9/30/06	6/30/06	3/31/06	12/31/05
	(gross investment, in thousands)				
Asset mix:					
Real property	\$ 488,287	\$ 485,460	\$ 476,541	\$ 468,435	\$ 500,723
Loans receivable	118,272	119,523	127,192	133,264	149,332
Investment asset mix:					
Assisted living properties	\$ 274,052	\$ 273,711	\$ 276,720	\$ 280,748	\$ 313,628
Skilled nursing properties	319,487	318,252	313,993	307,931	323,407
School	13,020	13,020	13,020	13,020	13,020
Operator asset mix:					
Alterra	\$ 84,210	\$ 84,194	\$ 84,194	\$ 84,194	\$ 84,194
Preferred Care, Inc.(2)	80,506	72,422	71,969	71,550	71,580
Extendicare REIT & ALC	88,034	88,034	88,034	88,034	88,034
Sunwest(1)					64,803
Remaining operators	353,809	360,333	359,536	357,921	341,444
Geographic asset mix:					
California	\$ 44,439	\$ 44,697	\$ 44,950	\$ 45,198	\$ 54,185
Florida	45,693	45,204	48,032	47,536	53,935
Ohio	53,210	52,838	52,488	45,939	50,511
Texas	96,947	97,339	97,636	96,952	98,781
Washington	27,925	28,002	20,952	21,024	21,094
Remaining states	338,345	336,903	426,542	345,050	371,549

(1) In January 2006, we sold four assisted living properties operated by Sunwest with a total of 431 units to an entity formed by the principals of Sunwest for \$58.5 million. We received \$54.0 million in proceeds after paying \$3.8 million of 8.75% State of Oregon bond obligations related to one of the properties sold. As a result of the sale, we recognized a gain of \$31.9 million. As of March 31, 2006, Sunwest operates four assisted living properties which do not represent more than 10% of total assets. Therefore, beginning with March 31, 2006, the value of the assets operated by Sunwest is grouped into the Remaining Operators category.

(2) In October 2006 we entered into a lease termination agreement with Centers For Long Term Care, Inc. As of November 1, 2006 these assets are under a master lease with Preferred Care, Inc.

Credit Strength. We measure our credit strength both in terms of leverage ratios and coverage ratios. Our leverage ratios include debt to book capitalization and debt to market capitalization. The leverage ratios indicate how much of our balance sheet capitalization is related to long-term debt. Our coverage ratios include interest coverage ratio and fixed charge coverage ratio. The coverage ratios indicate our ability to service interest and fixed charges (interest plus preferred dividends). The coverage ratios are

based on earnings before interest, taxes, depreciation and amortization. Leverage ratios and coverage ratios are widely used by investors, analysts and rating agencies in the valuation, comparison, rating and investment recommendations of companies. The following table reflects the recent historical trends for our credit strength measures:

	Three Months Ended				
	12/31/06	9/30/06	6/30/06	3/31/06	12/31/05
Debt to book capitalization ratio	9.7 %	11.6 %	12.8 %	13.0 %	16.9 %
Debt to market capitalization ratio	5.9 %	7.7 %	9.1 %	8.8 %	11.9 %
Interest coverage ratio	10.4 x	8.9 x(1)	9.7 x	9.1 x	8.7 x
Fixed charge coverage ratio	2.8 x	2.6 x(1)	2.8 x	2.8 x	2.7 x

(1) As a result of including the \$1.0 million proposed IRS settlement (see *Item 8. FINANCIAL STATEMENTS Note 2. Summary of Significant Accounting Policies Federal Income Taxes*) in the annualized calculation of coverage ratios, our ratios were lower than as of six months ended June 30, 2006. Excluding this charge, our Interest Coverage ratio would have been 9.4x and our Fixed Charge ratio would have been 2.8x.

We evaluate our key performance indicators in conjunction with current expectations to determine if historical trends are indicative of future results. Our expected results may not be achieved and actual results may differ materially from our expectations. This may be a result of various factors, including, but not limited to

- The status of the economy;
- The status of capital markets, including prevailing interest rates;
- Compliance with and changes to regulations and payment policies within the health care industry;
- Changes in financing terms;
- Competition within the health care and senior housing industries; and
- Changes in federal, state and local legislation.

Management regularly monitors the economic and other factors listed above. We develop strategic and tactical plans designed to improve performance and maximize our competitive position. Our ability to achieve our financial objectives is dependent upon our ability to effectively execute these plans and to appropriately respond to emerging economic and company-specific trends.

Operating Results

Year ended December 31, 2006 compared to year ended December 31, 2005

Revenues for the year ended December 31, 2006, were \$73.2 million compared to \$72.4 million for the same period in 2005. Rental income increased \$2.6 million primarily as a result of properties acquired in 2005 and 2006 (\$3.2 million), new leases and rental increases provided for in existing lease agreements (\$1.6 million) and increase in straight-line rental income (\$1.5 million) partially offset by the receipt of a note payoff in 2005 as described in *Item 8. FINANCIAL STATEMENTS Note 8. Notes Receivable*, part of which related to past due rents that were not accrued (\$3.7 million). Same store rental income, (rental income from properties owned for both years ended December 31, 2006 and 2005 and excluding straight-line rental income) decreased \$2.1 million due to the receipt in 2005 of past due rents that were not previously accrued (\$3.7 million) partially offset by rental increases provided for in existing lease agreements (\$1.6 million).

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Interest income from mortgage loans and notes receivable increased \$0.9 million primarily as a result of new loans (\$2.9 million) partially offset by the payoff of loans (\$1.7 million), the conversion of a mortgage loan to an owned property (\$0.1 million) and principal payments (\$0.2 million).

Interest income from REMIC Certificates decreased \$3.5 million due to the dissolution of the 1994-1 and 1996-1 REMIC Pools, and the effective repurchase of the mortgage loans in the remaining REMIC pool as discussed in *Item 8. FINANCIAL STATEMENTS Note 6. Real Estate Investments*.

Interest and other income increased \$0.7 million in 2006 from the prior year primarily as a result of new notes, temporary investments income resulting from higher cash balances, and interest and dividend income from our investment in marketable securities, partially offset by the effects of a note payoff in 2005, as described in *Item 8. FINANCIAL STATEMENTS Note 8. Notes Receivable*, part of which related to past due interest on the note that was not accrued, and interest received in 2005 on notes that paid off in 2005.

Interest expense decreased \$1.3 million in 2006 from the prior year primarily due to a decrease in average borrowings outstanding during the period as a result of the payoff of mortgage loans, capital leases and bond obligations.

Depreciation and amortization expense for 2006 increased \$1.2 million from the prior year due to acquisitions, the conversions of mortgage loans into owned properties, and the renovation projects on owned properties. See *Item 8. FINANCIAL STATEMENTS Note 6. Real Estate Investments*.

Legal expenses during 2006 were comparable to 2005.

Operating and other expenses increased \$0.3 million due to a \$0.5 million reimbursement in 2005 partially offset by a \$0.2 million reimbursement in 2006 of certain expenses we paid in prior years on behalf of two operators.

Non-operating income decreased by \$5.7 million due to a \$0.5 million gain recognized in 2006 from the sale of the National Health Investors, Inc. (or NHI) common stock, as described in *Item 8. FINANCIAL STATEMENTS Note 9. Marketable Securities*, offset by the \$6.2 million income related to the note payoff in 2005, as described in *Item 8. FINANCIAL STATEMENTS Note 8. Notes Receivable*.

Minority interest expense was comparable for 2006 and 2005.

For the year ended December 31, 2006, net income from discontinued operations was \$33.3 million. During 2006 we sold four assisted living properties in various states with a total of 431 units and one 174-bed skilled nursing property in Arizona. We recognized a gain of \$32.6 million on the two transactions. During 2006 we realized \$0.7 million in income from discontinued operations related to the properties that were sold in 2006. For the year ended December 31, 2005, net income from discontinued operations was \$2.1 million. During 2005 we sold a closed skilled nursing property located in Texas and a 53-bed skilled nursing property in New Mexico. We realized a \$1.5 million loss on the two transactions. During 2005 we realized \$3.6 million in income from discontinued operations related to properties that were sold in 2005 and 2006. This reclassification was made in accordance with SFAS No. 144 which requires that the financial results of properties meeting certain criteria be reported on a separate line item called Discontinued Operations.

Net income available to common stockholders for the year ended December 31, 2006, was \$61.6 million compared to \$35.4 million for the year ended December 31, 2005. This increase is due primarily to an increase in rental income and a gain on the sale of assets as previously discussed. Excluding the effects of the note payoff, as described in *Item 8. FINANCIAL STATEMENTS Note 8. Notes Receivable*, net income available to common stockholders was \$23.7 million in 2005.

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Year ended December 31, 2005 compared to year ended December 31, 2004

Revenues for the year ended December 31, 2005, were \$72.4 million compared to \$62.2 million for the same period in 2004. Rental income increased \$7.9 million primarily as a result of receiving the note payoff, as described in *Item 8. FINANCIAL STATEMENTS Note 8. Notes Receivable*, part of which related to past due rents that were not accrued (\$3.7 million), the receipt of rent from properties acquired in 2004 and 2005 (\$1.4 million), new leases and rental increases provided for in existing lease agreements (\$2.4 million) and an increase in straight-line rental income (\$0.4 million). Same store rental income, (rental income from properties owned for both years ended December 31, 2005 and 2004 and excluding straight-line rental income) increased \$6.0 million due to the effect of receiving the note payoff, part of which related to past due rents that were not accrued (\$3.7 million) and rental increases provided for in existing lease agreements (\$2.3 million).

Interest income from mortgage loans and notes receivable increased \$5.4 million primarily as a result of new loans (\$6.1 million) partially offset by the payoff of loans (\$0.3 million), the conversion of a mortgage loan to an owned property (\$0.3 million) and principal payments (\$0.1 million).

Interest income from REMIC Certificates decreased \$3.9 million in 2005 due to the dissolution of the 1994-1 and 1996-1 REMIC Pools, the amortization of our remaining REMIC Certificates, the early payoff of certain mortgage loans underlying our investment in REMIC Certificates, and the effective repurchase of the mortgage loans in the remaining REMIC pool as discussed in *Item 8. FINANCIAL STATEMENTS Note 6. Real Estate Investments*.

Interest and other income increased \$0.9 million in 2005 from the prior year primarily as a result of receiving the note payoff, as described in *Item 8. FINANCIAL STATEMENTS Note 8. Notes Receivable*, part of which related to past due interest on the note that was not accrued (\$2.3 million), partially offset by conversions of notes receivable to mortgage loans, a reduction in loan modification and extension fees received from the REMIC Trust as per our subservicing agreement and a decrease in interest income from our investment in Assisted Living Concepts, Inc. Senior and Junior Notes that were redeemed in the first quarter of 2004.

Interest expense decreased \$3.2 million in 2005 from the prior year primarily due to a decrease in average borrowings outstanding during the period as a result of the payoff of mortgage loans.

Depreciation and amortization expense for 2005 increased \$0.9 million from the prior year due to acquisitions. See *Item 8. FINANCIAL STATEMENTS Note 6. Real Estate Investments*.

We perform periodic comprehensive evaluations of our investments. During 2005 we did not record an impairment charge. During 2004, we recorded a \$0.3 million impairment charge related to the reclassification of the fair market value adjustment on available-for-sale interest-only REMIC Certificates from comprehensive income to realized loss.

Legal expenses during 2005 were comparable to 2004.

Operating and other expenses increased \$1.2 million due to a special \$1.0 million bonus paid out related to the realization of the value of a note receivable, as described in *Item 8. FINANCIAL STATEMENTS Note 8. Notes Receivable*, and expenses paid in the current year on behalf of certain operators.

During 2005, we realized \$6.2 million of non-operating income related to the note payoff, as described in *Item 8. FINANCIAL STATEMENTS Note 8. Notes Receivable* (\$3.6 million of which was in Accumulated Comprehensive Income at December 31, 2004). The \$6.2 million of non-operating income is net of \$1.3 million of legal and investment advisory fees associated with the transaction that resulted in the note payoff. No non-operating income was recognized in 2004.

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Minority interest in income decreased \$0.5 million due to the conversion of all but one of the interests in eight of our limited partnerships to common stock and cash in 2004.

For the year ended December 31, 2005, net income from discontinued operations was \$2.1 million. During 2005, we sold a closed skilled nursing property located in Texas to a third party who wanted to use the property to house victims of hurricane Katrina. As part of our company's hurricane relief efforts, we sold the property for \$1,000 and in addition, donated \$50,000 in cash to the American Red Cross hurricane Katrina relief fund. As a result of the sale, we recognized a loss of \$0.8 million. Also, we sold a skilled nursing property with 53 beds in New Mexico for \$0.5 million in cash and recognized a loss of \$0.7 million. During 2005 we realized \$3.6 million in income from discontinued operations related to properties that were sold in 2005 and 2006. This reclassification was made in accordance with SFAS No. 144 which requires that the financial results of properties meeting certain criteria be reported on a separate line item called "Discontinued Operations" for all periods presented.

For the year ended December 31, 2004, net income from discontinued operations was \$4.1 million. During 2004 we sold five skilled nursing properties, two of which were formerly operated by Sun Healthcare Group, Inc. (or Sun) resulting in a gain on sale of \$0.6 million. We also realized \$3.5 million in income from discontinued operations related to properties that were sold during 2004, 2005 and 2006. This reclassification was made in accordance with SFAS No. 144 which requires that the financial results of properties meeting certain criteria be reported on a separate line item called "Discontinued Operations" for all periods presented.

We did not redeem any of our preferred stock during 2005. During 2004, we redeemed all of our outstanding Series A and Series B preferred stock. Accordingly, we recognized a \$4.0 million preferred stock redemption charge related to the original issue costs of the preferred stock redeemed. Preferred stock dividends in 2005 were comparable to 2004.

Net income available to common stockholders for the year ended December 31, 2005, was \$35.4 million compared to \$15.0 million for the year ended December 31, 2004. This increase is due primarily to an increase in rental income and non-operating income and a decrease in interest expense and preferred stock redemption charges as previously discussed. Excluding the effects of the note payoff, net income available to common stockholders was \$23.7 million in 2005. Excluding the effects of the preferred stock redemption charge, net income available to common stockholders was \$19.0 million in 2004.

Critical Accounting Policies

Preparation of the consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. See *Item 8. FINANCIAL STATEMENTS Note 2. Summary of Significant Accounting Policies* for a description of the significant accounting policies we followed in preparing the consolidated financial statements for all periods presented. We have identified the following significant accounting policies as critical accounting policies in that they require significant judgment and estimates and have the most impact on financial reporting.

Impairments. Impairment losses are recorded when events or changes in circumstances indicate the asset is impaired and the estimated undiscounted cash flows to be generated by the asset are less than its carrying amount. Management assesses the impairment of properties individually and impairment losses are calculated as the excess of the carrying amount over the fair value of assets to be held and used, and the carrying amount over the fair value less cost to sell in instances where management has determined that we will dispose of the property as required by SFAS No. 144

Accounting for the Impairment or Disposal of Long-Lived Assets. In determining fair value, we use current appraisals or other third party opinions of value and other estimates of fair value such as estimated undiscounted future cash flows.

In accordance with SFAS No. 114 *Accounting by Creditors for Impairment of a Loan* we evaluate the carrying values of mortgage loans receivable on an individual basis. Management periodically evaluates the realizability of future cash flows from the mortgages when events or circumstances, such as the non-receipt of principal and interest payments and/or significant deterioration of the financial condition of the borrower, indicate that the carrying amount of the mortgage loan receivable may not be recoverable. An impairment charge is recognized in current period earnings and is calculated as the difference between the carrying amount of the mortgage loan receivable and the discounted cash flows expected to be received, or if foreclosure is probable, the fair value of the collateral securing the mortgage.

Mortgage Loans Receivable. Mortgage loans receivable are recorded on an amortized cost basis. We maintain a valuation allowance based upon the expected collectibility of our mortgage loans receivable. Changes in the valuation allowance are included in current period earnings.

Revenue Recognition. Interest income on mortgage loans and REMIC Certificates is recognized using the effective interest method. We follow a policy related to mortgage interest whereby we consider a loan to be non-performing after 60 days of non-payment of amounts due and do not recognize unpaid mortgage interest income from that loan until the amounts have been received.

Base rents under operating leases are accrued as earned over the terms of the leases. Substantially all of our leases contain provisions for specified annual increases over the rents of the prior year and are generally computed in one of four methods depending on specific provisions of each lease as follows: (i) a specified annual increase over the prior year's rent, generally 2%; (ii) an increase based on the change in the Consumer Price Index from year to year; (iii) an increase derived as a percentage of facility net patient revenues in excess of base revenue amounts or (iv) specific dollar increases over prior years. SEC Staff Bulletin No. 101 *Revenue Recognition in Financial Statements* (or SAB 101) does not provide for the recognition of contingent revenue until all possible contingencies have been eliminated. We consider the operating history of the lessee and the general condition of the industry when evaluating whether all possible contingencies have been eliminated and have historically, and expect in the future, to not include contingent rents as income until received. We follow a policy related to rental income whereby we consider a lease to be non-performing after 60 days of non-payment of amounts due and do not recognize unpaid rental income from that lease until the amounts have been received.

Rental revenues relating to leases that contain specified rental increases over the life of the lease are recognized on the straight-line basis when we believe that all of the rent related to a particular lease will be collected according to the terms of the lease. In evaluating whether we believe all the rent will be collected we have determined that all of the following conditions must be met: (i) the property has been operated by the same operator for at least six months (adding a new property to a master lease with an operator that otherwise qualifies does not disqualify the lease from being straight-lined); (ii) payments for any monetary obligations due under the lease, or any other lease such operator has with us have been received late no more than (four) times during last eight fiscal quarters; (iii) the operator of the property has not during the last eight fiscal quarters (a) been under the protection of any Bankruptcy court; (b) admitted in writing its inability to pay its debts generally as they come due; (c) made an assignment for the benefit of creditors; or, (d) been under the supervision of a trustee, receiver or similar custodian; and (iv) the property operating income has covered the applicable lease payment in each of the prior four fiscal quarters.

We will discontinue booking rent on a straight-line basis if the lessee becomes delinquent in rent owed under the terms of the lease and has been put on non-accrual status (i.e. we have stopped booking rent on an accrual basis for a particular lease because the collection of rent is uncertain). Once a lease is on non-accrual status, we will evaluate the collectibility of the related straight-line rent asset. If it is determined that the collection problem is temporary, we will resume booking rent on a straight-line basis once payment is received for past due rents. If it appears that we will not collect future rent under the non-accrual lease we will record an impairment charge related to the straight-line rent asset.

Historically, management periodically evaluated the realizability of future cash flows from the mortgages underlying our REMIC Certificates. Included in our evaluation, management considered such factors as actual and/or expected loan prepayments, actual and/or expected credit losses, and other factors that may have impacted the amount and timing of REMIC Certificate future cash flows. Impairments were recorded when an adverse change in cash flows was evident and was determined to be other than temporary in nature. Additionally, interest recognition amortization schedules were adjusted periodically to reflect changes in expected future cash flows from the REMIC Certificates, thus, accordingly adjusting future interest income recognized. At December 31, 2006 and 2005 we did not have any investment in REMIC Certificates. See *Item 8. FINANCIAL STATEMENTS Note 6. Real Estate Investments* for discussion of our historical investment in REMIC Certificates.

Net loan fee income and commitment fee income are amortized over the life of the related loan. Costs associated with leases are deferred and allocated over the lease term in proportion to the recognition of rental income as required by SFAS No. 13 *Accounting for Leases*.

Liquidity and Capital Resources

Financing Activities:

During 2006, we used \$89.8 million in cash in financing activities. We borrowed \$2.0 million and repaid \$18.0 million under our Unsecured Revolving Credit. Additionally, \$11.5 million in principal was received by the non-recourse senior mortgage participation holder and we paid \$11.0 million in principal payments on mortgage loans and bonds payable.

During 2006, we repurchased and retired 71,493 shares of common stock for an aggregate purchase price of \$1.5 million, an average of \$20.65 per share. The shares were purchased on the open market under a Board authorization to purchase up to 5,000,000 shares. Including these purchases, 2,604,393 shares have been purchased under this authorization. Therefore, we continue to have an open Board authorization to purchase an additional 2,395,607 shares.

We also paid cash dividends on our Series C, Series E, and Series F preferred stocks totaling \$3.3 million, \$0.6 million and \$13.3 million respectively. Additionally, we declared cash dividends on our common stock totaling \$25.3 million and paid cash dividends on our common stock totaling \$33.7 million. Subsequent to December 31, 2006, we increased the monthly common dividend by 4% and we declared a monthly cash dividend of \$0.125 per share on our common stock for the months of January, February and March 2007, payable on January 31, February 28, and March 30, 2007, respectively, to stockholders of record on January 23, February 20, and March 22, 2007.

During 2006, we received \$0.2 million, which represented payment in full, on a note receivable from a stockholder. We also received \$0.4 million in conjunction with the exercise of 46,200 stock options. The total market value as of the dates of exercise was approximately \$1.1 million. Subsequent to December 31, 2006, a total of 15,000 options were exercised at a total option value of approximately \$0.1 million and a total market value as of the exercise dates of approximately \$0.4 million.

During 2006, holders of 159,031 shares of our 8.5% Series E Cumulative Convertible Preferred Stock (or Series E Preferred Stock) notified us of their election to convert such shares into 318,062 shares of our common stock at the Series E Preferred Stock conversion rate of \$12.50 per share. Subsequent to December 31, 2006, holders of 2,497 shares of our Series E Preferred Stock notified us of their election to convert such shares into 4,994 shares of common stock. Subsequent to this most recent conversion, there are 191,147 shares of our Series E Preferred Stock outstanding.

As of December 31, 2006, we are obligated to make scheduled principal payments on our mortgage loans payable and bonds payable. The total scheduled principal payments and debt maturities in 2007

through 2011 and thereafter is approximately \$1.5 million, \$15.5 million, \$24.8 million, \$8.2 million, \$0.5 million, and \$3.2 million, respectively.

Available Shelf Registrations:

During 2004, we filed a Form S-3 shelf registration statement which became effective April 5, 2004 and provides us with the capacity to offer up to \$200.0 million in our debt and/or equity securities. We currently have \$104.8 million of availability under our effective shelf registration. We may from time to time raise capital under our currently effective shelf registration or a new shelf registration by issuing, in public or private transactions, our equity and debt securities, but the availability and terms of such issuance will depend upon then prevailing market and other conditions.

Operating and Investing Activities:

During the year ended December 31, 2006, net cash provided by operating activities was \$56.6 million. At December 31, 2006 we had accrued \$1.0 million, which is included in operating and other expenses, related to a proposed closing agreement pending with the Internal Revenue Service (or IRS). During the 2006 we voluntarily approached the IRS to correct our filing for the year 2000, which is a closed year. In September 2006 we submitted a closing agreement for IRS approval to correct a technical violation which occurred in the spring of 2000. Subsequent to December 31, 2006, we received a draft closing agreement from the IRS. We anticipate signing a final agreement and paying the \$1.0 million settlement to them in the first quarter of 2007.

In 2006 we had net cash provided by investing activities of \$59.6 million. We acquired five skilled nursing properties in various states with a total of 373 beds for \$13.5 million in cash and \$3.4 million in property. These properties were leased to two third parties under 10-year master leases, each with two five-year renewal options. The combined initial annual rent is approximately \$1.9 million, an 11.4% current yield. We also invested \$5.0 million at an average yield of 9.7% under agreements to renovate ten properties operated by seven different operators. Additionally, we invested \$1.2 million in capital improvements to existing properties under various lease agreements whose rental rates already reflected this investment.

During 2006, we received total net cash proceeds from the sale of four assisted living properties of \$54.0 million after paying both closing costs and \$3.8 million in principal and accrued interest to fully repay the 8.75% State of Oregon bond obligation related to one of the properties sold as discussed in *Item 8. FINANCIAL STATEMENTS Note 6. Real Estate Investments*. See *Item 8. FINANCIAL STATEMENTS Note 10. Debt Obligations* for further discussion of the debt payoff. Additionally, we exchanged one 174-bed skilled nursing property located in Arizona for a 100-bed skilled nursing property located in Arizona with a fair market value of \$3.4 million. We also received \$31.5 million in principal payments on mortgage loans including \$26.7 million related to the payoff of twelve mortgage loans secured by nine skilled nursing properties and three assisted living properties and the partial principal pay down of two mortgage loans secured by two skilled nursing properties. During 2006, we invested \$1.4 million in 60,000 shares of National Health Investors, Inc. common stock and subsequently sold the shares in 2006 for \$1.9 million and recognized a gain of \$0.5 million.

During 2006 we funded \$1.5 million under various loans and line of credit agreements with certain operators. At December 31, 2005, we held a Promissory Note (or Note) from Sunwest in the amount of \$1.5 million. During the fourth quarter of 2005, we sold an option to purchase four of our assisted living properties to Sunwest. The price of the option was \$0.5 million in cash and the Note. During 2006, the option to purchase the properties was exercised and the proceeds from the payoff of the Note were applied to the purchase price of the four properties (see *Item 8. FINANCIAL STATEMENTS Note 6. Real Estate Investments*). Additionally, we received \$4.2 million in principal payments on notes receivable.

During 2006, we paid \$9.5 million in deferred lease costs related to the termination of our master lease with Centers for Long Term Care, Inc. (or CLC) effective November 1, 2006. Also on that date we entered into a new 15-year master lease with Preferred Care for the 25 skilled nursing properties formerly leased to CLC. The Preferred Care master lease has two five-year renewal options and provided that monthly rent for November and December 2006 would be \$551,500 per month. The initial annual minimum rent beginning in January 2007 is \$8,188,000 and increases annually by 2.5% on each November 1st thereafter. We committed to provide Preferred Care with up to \$3.0 million for capital improvements and will invest this amount, if requested by Preferred Care, at no additional investment return. This commitment expires March 31, 2010. Additionally, we committed to provide Preferred Care with up to \$7.1 million for capital improvements for specific properties. Preferred Care's annual minimum rent will increase by an amount equal to 11.0% of our funding of part or all of the \$7.1 million including capitalized interest during any construction project. As part of the new agreement, we agreed to provide \$0.3 million for inventory and equipment needs during the transition of the 25 properties from CLC to Preferred Care.

Commitments:

As of December 31, 2006, we had the following commitments outstanding:

We committed to provide to Alterra \$2.5 million over three years ending December 4, 2009 to expand the 35 properties they lease from us. This investment would be made at a 10% annual return to us. To date, Alterra has not requested any funds under this agreement.

We committed to provide Extendicare REIT & ALC up to \$5.0 million per year, under certain conditions, for expansion of the 37 properties they lease from us under certain conditions. Should we expend such funds, Extendicare REIT & ALC's monthly minimum rent would increase by an amount equal to (a) 9.5% plus the positive difference, if any, between the average yield on the U.S. Treasury 10-year note for the five days prior to funding, minus 420 basis points (expressed as a percentage), multiplied by (b) the amounts funded. To date, Extendicare REIT & ALC have not requested any funds under this agreement.

We committed to provide Preferred Care \$3.0 million for capital improvements on 25 of the skilled nursing properties they lease from us under a master lease. During 2006, we funded \$0.1 million under this agreement. Subsequent to 2006, we funded \$0.2 million under this agreement. We also committed to invest up to \$7.1 million on specific projects on five skilled nursing properties they lease from us. The \$7.1 million commitment includes interest capitalized at 11% on each advance made from each disbursement date until final distribution by specific project. Upon final distribution for each specific project, minimum rent shall increase by the total project cost multiplied by 11%. To date no funds have been requested under this agreement. These commitments expire on March 31, 2010. We also committed to provide Preferred Care with a \$0.5 million capital allowance for a skilled nursing property they lease from us under a separate lease. This commitment expires on June 30, 2007. Monthly minimum rent increases by the previous month's capital funding multiplied by 10%. To date no funds have been requested under this agreement.

We committed to provide a lessee of a skilled nursing property an accounts receivable financing. The loan has a credit limit not to exceed \$0.2 million and an interest rate of 10%. The commitment expires on July 31, 2007. To date \$0.1 million has been funded under this agreement. We also committed to invest \$1.2 million in capital improvements for this property. During 2006, we funded \$0.7 million under this agreement.

We committed to provide a lessee of a skilled nursing property an accounts receivable financing. The loan has a credit limit not to exceed \$0.1 million and an interest rate of 10%. The commitment expires on June 30, 2007. To date \$25,000 has been requested under this agreement. We have also committed to replace the roof and install a fire sprinkler system for this property. The lessee's monthly minimum rent

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will increase by an amount equal to 11% of our investment in these capital improvements. During 2006, we funded \$0.1 million under this agreement.

We committed to provide a lessee of three skilled nursing properties with the following: up to \$0.3 million to invest in capital improvements to a property they lease from us; up to \$0.7 million to invest in capital improvements on two properties they lease from us, however, under this commitment, the monthly minimum rent will increase by the amount of the capital funding multiplied by 11%; and up to \$3.0 million to purchase land, construct and equip a new property in the general vicinity of an existing property they lease from us with a corresponding increase in the monthly minimum rent of 11% multiplied by the amount funded plus capitalized interest costs associated with the construction of the new property.

We committed to provide a lessee with a \$0.4 million capital improvement allowance for two skilled nursing properties and an assisted living property they lease from us. The commitment includes interest capitalized at 10% on each advance made from each disbursement date until final distribution of the commitment. The commitment expires on March 31, 2007. Upon final distribution of the capital allowance, minimum rent shall increase by the total commitment multiplied by 10%. During 2006, we funded \$0.2 million under these agreements.

We committed to provide a lessee with a \$0.2 million capital improvement allowance for three skilled nursing properties they lease from us. The commitment includes interest capitalized at 10.3% on each advance made from each disbursement date until final distribution of the commitment. The commitment expires on June 30, 2007. Upon final distribution of the capital allowance, minimum rent shall increase by the total commitment multiplied by 10.3%. During 2006, we funded \$0.2 million under this agreement.

We committed to provide a lessee of a skilled nursing property \$1.7 million to invest in leasehold improvements to the property they lease from us. The commitment includes interest capitalized at 10% on each advance made from each disbursement date until final distribution of the commitment. The leasehold improvements must be completed by March 31, 2007. Upon final distribution of the capital allowance, minimum rent shall increase by the total commitment multiplied by 10%. During 2006, we funded \$0.9 million under this agreement. Subsequent to December 31, 2006, we funded an additional \$0.1 million under this agreement.

We committed to provide a lessee of an assisted living property with a \$1.0 million capital improvement allowance for a property they lease from us. Monthly minimum rent increases by the previous month's capital funding multiplied by 8%. The commitment will mature in February 2008. During 2006, we funded \$0.4 million under this agreement. Subsequent to December 31, 2006, we funded an additional \$0.3 million under this agreement.

Contractual Obligations:

We monitor our contractual obligations and commitments detailed above to ensure funds are available to meet obligations when due. The following table represents our long-term contractual obligations as of December 31, 2006, and excludes the effects of interest (*amounts in thousands*):

	Total	Less than 1 year	1-2 years	3-5 years	After 5 years
Mortgage loans payable	\$ 48,266	\$ 1,101	\$ 39,480	\$ 7,685	\$
Bonds payable	5,545	415	905	1,025	3,200
Operating lease obligation	672	164	344	164	
	\$ 54,483	\$ 1,680	\$ 40,729	\$ 8,874	\$ 3,200

The total maximum funds committed as of December 31, 2006 with specific termination dates were \$21.8 million from 2007 through 2010 at interest rates from 8.0% to 11.0%. Additionally, we committed to provide Extencicare REIT & ALC up to \$5.0 million per year at a minimum interest rate of 9.5%.

Off-Balance Sheet Arrangements:

We had no off-balance sheet arrangements as of December 31, 2006.

Liquidity:

In 2005 we increased our Unsecured Credit Agreement from \$65.0 million to \$90.0 million and extended its maturity to November 2008. As a result of the sale of assets described in *Item 8. FINANCIAL STATEMENTS Note 6. Real Estate Investments*, we have significant cash on hand and the entire \$90.0 million available for liquidity.

We believe we have additional liquidity and financing capability to fund additional investments in 2007, maintain our preferred dividend payments, pay common dividends at least sufficient to maintain our REIT status and repay borrowings at or prior to their maturity through our generation of funds from operations, borrowings under our Unsecured Credit Agreement, additional opportunistic asset sales, proceeds from mortgage notes receivable, and/or additional financings. We believe our liquidity and sources of capital are adequate to satisfy our cash requirements. We cannot, however, be certain that some or all of these sources of funds will be available at a time and upon terms acceptable to us in sufficient amounts to meet our liquidity needs.

Item 7a. Quantitative and Qualitative Disclosures About Market Risk

Readers are cautioned that statements contained in this section **Quantitative and Qualitative Disclosures About Market Risk** are forward looking and should be read in conjunction with the disclosure under the heading **Risk Factors** set forth above.

We are exposed to market risks associated with changes in interest rates as they relate to our mortgage loans receivable and debt. Interest rate risk is sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors that are beyond our control.

We do not utilize interest rate swaps, forward or option contracts or foreign currencies or commodities, or other types of derivative financial instruments nor do we engage in off-balance sheet transactions. The purpose of the following disclosure is to provide a framework to understand our sensitivity to hypothetical changes in interest rates as of December 31, 2006.

Our future earnings, cash flows and estimated fair values relating to financial instruments are dependent upon prevalent market rates of interest, such as LIBOR or term rates of U.S. Treasury Notes. Changes in interest rates generally impact the fair value, but not future earnings or cash flows, of mortgage loans receivable and fixed rate debt. For variable rate debt, such as our revolving line of credit, changes in interest rates generally do not impact the fair value, but do affect future earnings and cash flows.

At December 31, 2006, based on the prevailing interest rates for comparable loans and estimates made by management, the fair value of our mortgage loans receivable was approximately \$129.9 million. A 1% increase in such rates would decrease the estimated fair value of our mortgage loans by approximately \$4.1 million while a 1% decrease in such rates would increase their estimated fair value by approximately \$4.4 million. A 1% increase or decrease in applicable interest rates would not have a material impact on the fair value of our fixed rate debt.

The estimated impact of changes in interest rates discussed above are determined by considering the impact of the hypothetical interest rates on our borrowing costs, lending rates and current U.S. Treasury rates from which our financial instruments may be priced. We do not believe that future market rate risks related to our financial instruments will be material to our financial position or results of operations. These analyses do not consider the effects of industry specific events, changes in the real estate markets, or other overall economic activities that could increase or decrease the fair value of our financial instruments. If such events or changes were to occur, we would consider taking actions to mitigate and/or reduce any negative exposure to such changes. However, due to the uncertainty of the specific actions that would be taken and their possible effects, the sensitivity analysis assumes no changes in our capital structure.

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Item 8. FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of LTC Properties, Inc.

We have audited the accompanying consolidated balance sheets of LTC Properties, Inc. as of December 31, 2006 and 2005, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedules listed in the index at Item 15(a). These financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of LTC Properties, Inc. at December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 21, 2007, expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

Los Angeles, California
February 21, 2007

LTC PROPERTIES, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)

	December 31, 2006	2005
ASSETS		
Real Estate Investments:		
Buildings and improvements, net of accumulated depreciation and amortization: 2006 \$102,091; 2005 \$88,652	\$ 351,148	\$ 342,664
Land	35,048	32,956
Properties held for sale, net of accumulated depreciation and amortization: 2006 \$0; 2005 \$7,119		29,332
Mortgage loans receivable, net of allowance for doubtful accounts: 2006 and 2005 \$1,280	116,992	148,052
Real estate investments, net	503,188	553,004
Other Assets:		
Cash and cash equivalents	29,887	3,569
Debt issue costs, net	548	1,268
Interest receivable	3,170	3,436
Prepaid expenses and other assets	16,771	5,130
Notes receivable	4,264	8,931
Marketable debt securities	9,939	9,933
Total assets	\$ 567,767	\$ 585,271
LIABILITIES AND STOCKHOLDERS EQUITY		
Bank borrowings	\$	\$ 16,000
Mortgage loans payable	48,266	58,891
Bonds payable and capital lease obligations	5,545	5,935
Senior mortgage participation payable		11,535
Accrued interest	358	524
Accrued expenses and other liabilities	6,223	8,427
Accrued expenses and other liabilities related to properties held for sale		3,852
Distributions payable	3,423	11,890
Total liabilities	63,815	117,054
Minority interests	3,518	3,524
Stockholders Equity:		
Preferred stock \$0.01 par value: 15,000 shares authorized; shares issued and outstanding: 2006 8,834; 2005 8,993	209,341	213,317
Common stock: \$0.01 par value; 45,000 shares authorized; shares issued and outstanding: 2006 23,569; 2005 23,276	236	233
Capital in excess of par value	332,149	331,415
Cumulative net income	442,833	364,045
Other	1,693	(941)
Cumulative distributions	(485,818)	(443,376)
Total stockholders equity	500,434	464,693
Total liabilities and stockholders equity	\$ 567,767	\$ 585,271

See accompanying notes.

LTC PROPERTIES, INC.**CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME**

(In thousands, except per share amounts)

	Years ended December 31,		
	2006	2005	2004
Revenues:			
Rental income	\$ 52,342	\$ 49,709	\$ 41,844
Interest income from mortgage loans and notes receivable	15,444	14,500	9,138
Interest income from REMIC Certificates		3,480	7,342
Interest and other income	5,377	4,719	3,853
Total revenues	73,163	72,408	62,177
Expenses:			
Interest expense	7,028	8,310	11,523
Depreciation and amortization	13,892	12,738	11,823
Impairment charge			274
Legal expenses	236	194	193
Operating and other expenses	6,696	6,397	5,216
Total expenses	27,852	27,639	29,029
Income before non-operating income and minority interest	45,311	44,769	33,148
Non-operating income	517	6,217	
Minority interest	(343)	(349)	(896)
Income from continuing operations	45,485	50,637	32,252
Discontinued operations:			
Income from discontinued operations	746	3,576	3,528
Gain (loss) on sale of assets, net	32,557	(1,504)	608
Net income from discontinued operations	33,303	2,072	4,136
Net income	78,788	52,709	36,388
Preferred stock redemption charge			(4,029)
Preferred stock dividends	(17,157)	(17,343)	(17,356)
Net income available to common stockholders	\$ 61,631	\$ 35,366	\$ 15,003
Net Income per Common Share from Continuing Operations Net of Preferred Stock			
Dividends:			
Basic	\$ 1.21	\$ 1.49	\$ 0.56
Diluted	\$ 1.21	\$ 1.47	\$ 0.56
Net Income Per Common Share from Discontinued Operations:			
Basic	\$ 1.43	\$ 0.09	\$ 0.21
Diluted	\$ 1.41	\$ 0.09	\$ 0.21
Net Income Per Common Share Available to Common Stockholders:			
Basic	\$ 2.64	\$ 1.58	\$ 0.77
Diluted	\$ 2.51	\$ 1.56	\$ 0.77
Basic weighted average shares outstanding	23,366	22,325	19,432
Comprehensive Income:			
Net income	\$ 78,788	\$ 52,709	\$ 36,388
Unrealized gain on available-for-sale securities		3,743	378
Reclassification adjustment	(715)	(4,141)	274
Comprehensive income	\$ 78,073	\$ 52,311	\$ 37,040

See accompanying notes.

LTC PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
(In thousands, except per share amounts)

	Shares Preferred Stock	Common Stock	Preferred Stock	Common Stock	Capital in Excess of Par Value	Cumulative Net Income	Other	Cumulative Distributions
Balance December 31, 2003	8,026	17,807	\$ 189,163	\$ 178	\$ 250,055	\$ 274,948	\$ (638)	\$ (344,924)
Payments on stockholder notes							2,285	
Stock option exercises		99		1	546			
Reclassification adjustment							274	
Unrealized gain on available-for-sale securities							378	
Conversion of 8.5% Series E Preferred Stock	(1,639)	3,278	(40,968)	33	40,935			
Conversion of minority interests		208		2	3,192			
Issue restricted stock		12			202		(202)	
Issue stock options					77		(77)	
9.5% Series A Preferred Stock redemption	(1,838)		(45,963)		1,861			(1,861)
8.0% Series B Preferred Stock redemption	(1,988)		(49,700)		2,168			(2,168)
Net income						36,388		
Vested stock options							16	
Vested restricted stock					399		34	
Canceled restricted stock		(30)						
8.0% Series F Preferred Stock offering	6,640		166,000		(6,695)			
Preferred stock dividends								(17,356)
Common stock cash distributions (\$1.125 per share)								(22,376)
Balance December 31, 2004	9,201	21,374	218,532	214	292,740	311,336	2,070	(388,685)
Conversion of 8.5% Series E Preferred Stock	(208)	416	(5,215)	4	5,211			
Common stock offering		1,500		15	32,611			
Payments on stockholder notes							282	
Reclassification adjustment							(4,141)	
Unrealized gain on available-for-sale securities							3,743	
Repurchase of stock		(184)		(2)	(3,294)			
Net income						52,709		
Vested stock options							39	
Stock option exercises		101		1	674			
Issue stock options					43		(43)	
Change restricted stock vesting					1,435		(1,435)	
Cancel restricted stock		(11)			(6)		6	
Vested restricted stock					283		257	
Issue restricted stock		80		1	1,718		(1,719)	
Preferred stock dividends								(17,343)
Common stock cash distributions (\$1.29 per share paid and \$0.36 per share accrued)								(37,348)
Balance December 31, 2005	8,993	23,276	213,317	233	331,415	364,045	(941)	(443,376)
Conversion of 8.5% Series E Preferred Stock	(159)	318	(3,976)	3	3,973			
Payments on stockholder notes							226	
Reclassification adjustment					(3,123)		2,408	
Repurchase of stock		(71)		(1)	(1,476)			
Net income						78,788		
Vested stock options					43			
Stock option exercises		46		1	368			
Vested restricted stock					949			
Preferred stock dividends								(17,157)
Common stock cash distributions (\$1.44 per share)								(25,285)
Balance December 31, 2006	8,834	23,569	\$ 209,341	\$ 236	\$ 332,149	\$ 442,833	\$ 1,693	\$ (485,818)

See accompanying notes.

LTC PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year ended December 31,		
	2006	2005	2004
OPERATING ACTIVITIES:			
Net income	\$ 78,788	\$ 52,709	\$ 36,388
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization continuing operations	13,892	12,738	11,823
Depreciation and amortization discontinued operations	52	960	1,104
Minority interest	343	349	896
(Gain) loss on sale of real estate and other investments, net	(33,074)	1,504	(608)
Realization of reserve on note receivable		(3,905)	
Realization of deferred gain on note receivable		(3,610)	
Non-cash impairment charge			274
Straight-line rental income	(3,085)	(1,614)	(1,121)
Other non-cash items, net	(772)	2,021	3,079
Decrease (increase) in interest receivable	487	(115)	603
Decrease (increase) in prepaid, other assets and allowance	161	(362)	145
Decrease in accrued interest	(172)	(97)	(303)
(Decrease) increase in accrued expenses and other liabilities	(45)	2,975	(154)
Net cash provided by operating activities	56,575	63,553	52,126
INVESTING ACTIVITIES:			
Investment in real estate properties and capital improvements, net	(19,685)	(30,135)	(6,768)
Conversion of mortgage loans to owned properties		(459)	(80)
Proceeds from sale of real estate investments, net	54,035	605	4,733
Payment of deferred lease cost	(9,500)		
Principal payments on mortgage loans receivable and REMIC Certificates	31,509	17,443	17,563
Investment in real estate mortgages		(38,219)	(19,389)
Conversion of REMIC certificates to mortgage loans		(855)	
Investment in marketable debt and equity securities	(1,440)	(9,933)	
Proceeds from the sale of marketable equity securities	1,957		
Advances under notes receivable	(1,486)	(4,088)	(1,903)
Principal payments received on notes receivable	4,180	15,225	202
Investment in REMIC certificates			(3,898)
Proceeds from redemption of investment in debt securities			12,281
Net cash provided by (used in) investing activities	59,570	(50,416)	2,741
FINANCING ACTIVITIES:			
Bank borrowings	2,000	30,700	36,500
Repayment of bank borrowings	(18,000)	(14,700)	(36,500)
Repayment of senior mortgage participation	(11,535)	(3,872)	(2,843)
Principal payments on mortgage loans, bonds payable and capital leases	(11,021)	(9,478)	(53,359)
Proceeds from common and preferred stock offerings		32,626	159,305
Repurchase of common stock	(1,476)	(3,296)	
Distributions paid to stockholders	(50,909)	(46,419)	(38,498)
Repayment of stockholder loans	226	282	2,285
Preferred Stock redemption			(126,305)
Distributions paid to minority interests	(349)	(531)	(1,189)
Conversion of minority interests			(8,496)
Other	1,237	805	629
Net cash used in financing activities	(89,827)	(13,883)	(68,471)
Increase (decrease) in cash and cash equivalents	26,318	(746)	(13,604)
Cash and cash equivalents, beginning of year	3,569	4,315	17,919
Cash and cash equivalents, end of year	\$ 29,887	\$ 3,569	\$ 4,315
Supplemental disclosure of cash flow information:			
Interest paid	\$ 7,045	\$ 8,216	\$ 11,653
Non-cash investing and financing transactions:			
<i>See Note 4: Supplemental Cash Flow Information for further discussion.</i>			

See accompanying notes.

LTC PROPERTIES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. The Company

LTC Properties, Inc. (LTC), a Maryland corporation, commenced operations on August 25, 1992. LTC is a real estate investment trust (or REIT) that invests primarily in long-term care properties through mortgage loans, property lease transactions and other investments.

2. Summary of Significant Accounting Policies

Basis of Presentation. The accompanying consolidated financial statements include the accounts of LTC, our wholly-owned subsidiaries and our controlled partnership. All intercompany investments, accounts and transactions have been eliminated. Control over the partnership is based on the provisions of the partnership agreement that provides us with a controlling financial interest in the partnership. Under the terms of the partnership agreement, we are responsible for the management of the partnership's assets, business and affairs. Our rights and duties in management of the partnership include making all operating decisions, setting the capital budget, executing all contracts, making all employment decisions, and the purchase and disposition of assets, among others. The general partner is responsible for the ongoing, major, and central operations of the partnership and makes all management decisions. In addition, the general partner assumes the risk for all operating losses, capital losses, and is entitled to substantially all capital gains (appreciation).

Emerging Issues Task Force (or EITF) Issue No. 04-5 *Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners have Certain Rights* (or EITF 04-5) creates a framework for evaluating whether a general partner or a group of general partners controls a limited partnership or a managing member or a group of managing members controls a limited liability company and therefore should consolidate the entity. EITF 04-5 states that the presumption of general partner or managing member control would be overcome only when the limited partners or non-managing members have certain specific rights as described in EITF 04-5. The limited partners have virtually no rights and are precluded from taking part in the operation, management or control of the partnership. The limited partners are also precluded from transferring their partnership interests without the expressed permission of the general partner. However we can transfer our interest without consultation or permission of the limited partners. We consolidate our partnerships in accordance with EITF 04-5.

Statement of Accounting Financial Standard (or SFAS) No. 150 *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* requires certain financial instruments that embody obligations of the issuer and have characteristics of both liabilities and equity to be classified as liabilities. Any non-controlling minority interest that may be redeemed with equity of any entity (including equity of an entity other than the subsidiary) does not meet the definition of a mandatorily redeemable financial instrument and thus does not fall under SFAS No. 150 guidelines. Since the partnership agreement with our limited partners (minority interests) specifies that the limited partners' exchange rights may be settled in our common stock or cash at our option SFAS No. 150 does not have an impact on the financial statement presentation or accounting for our minority interests.

Financial Accounting Standards Board (or FASB) Interpretation No. 46(R) *Consolidation of Variable Interest Entities* (or FIN 46) addresses when a company should include in its financial statements the assets, liabilities and activities of another entity. FIN 46 requires that we consolidate a variable interest entity if we are subject to a majority of the risk of loss from the variable interest entity's activities, or are entitled to receive a majority of the entity's residual returns, or both. FIN 46 also requires disclosure about

LTC PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

variable interest entities that we are not required to consolidate but in which we have a significant variable interest. We believe that as of December 31, 2006, we do not have investments in any entities that meet the definition of a variable interest entity.

Certain reclassifications have been made to the prior period financial statements to conform to the current year presentation as required by SFAS No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*.

Use of Estimates. Preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Cash Equivalents. Cash equivalents consist of highly liquid investments with a maturity of three months or less when purchased and are stated at cost which approximates market.

Land, Buildings and Improvements. Land, buildings and improvements are recorded at cost. Depreciation is computed principally by the straight-line method for financial reporting purposes and includes depreciation associated with properties we lease that qualify as capital leases under SFAS No. 13 *Accounting for Leases*. Estimated useful lives for financial reporting purposes range from 3 years for computers to 7 years for equipment and 35 to 40 years for buildings.

Mortgage Loans Receivable. Mortgage loans receivable we originate are recorded on an amortized cost basis. Mortgage loans we acquire are recorded at fair value at the time of purchase net of any related premium or discount which is amortized as a yield adjustment to interest income over the life of the loan.

Allowance for Loan Losses. We maintain an allowance for loan losses in accordance with SFAS No. 114 *Accounting by Creditors for Impairment of a Loan, as amended, and SEC Staff Bulletin No. 102 Selected Loan Loss Allowance Methodology and Documentation Issues*. The allowance for loan losses based upon the expected collectibility of the mortgage loans receivable and is maintained at a level believed adequate to absorb potential losses in our loans receivable. In determining the allowance we perform a quarterly evaluation of all outstanding loans. If this evaluation indicates that there is a greater risk of loan charge-offs, additional allowances are recorded in current period earnings.

Impairments. Impairment losses are recorded when events or changes in circumstances indicate the asset is impaired and the estimated undiscounted cash flows to be generated by the asset are less than its carrying amount. Management assesses the impairment of properties individually and impairment losses are calculated as the excess of the carrying amount over the fair value of assets to be held and used, and carrying amount over the fair value less cost to sell in instances where management has determined that we will dispose of the property, as required by SFAS No. 144

Accounting for the Impairment or Disposal of Long-Lived Assets. In determining fair value, we use current appraisals or other third party opinions of value and other estimates of fair value such as estimated discounted future cash flows.

In accordance with SFAS No. 114 *Accounting by Creditors for Impairment of a Loan* we evaluate the carrying values of mortgage loans receivable on an individual basis. Management periodically evaluates the realizability of future cash flows from the mortgages when events or circumstances, such as the non-receipt of principal and interest payments and/or significant deterioration of the financial condition of the borrower, indicate that the carrying amount of the mortgage loan receivable may not be recoverable. An impairment charge is recognized in current period earnings and is calculated as the difference between the

LTC PROPERTIES, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

carrying amount of the mortgage loan receivable and the discounted cash flows expected to be received, or if foreclosure is probable, the fair value of the collateral securing the mortgage.

EITF 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* gives guidance to be used to determine when an investment is considered impaired, whether that impairment is other-than-temporary and the measurement of an impairment loss. The guidance also includes accounting considerations subsequent to the recognition of an other-than-temporary impairment and requires certain disclosures about unrealized losses that have not been recognized as other-than-temporary impairments. Comparative information for periods prior to initial application is not required. On November 3, 2005, the FASB issued FASB Staff Position (or FSP) FAS No. 115-1 which replaces the impairment evaluation guidance of EITF No. 03-1. We have adopted FSP FAS No. 115-1 as required.

Fair Value of Financial Instruments. SFAS No. 107 *Disclosures about Fair Value of Financial Instruments* requires the disclosure of fair value information about financial instruments for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. SFAS No. 107 excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair market value amounts presented in the notes to these financial statements do not represent our underlying value in financial instruments.

The carrying amount of cash and cash equivalents approximates fair value because of the short-term maturity of these instruments. The fair value of investments in marketable debt securities at December 31, 2006 is based upon the market rate for those securities. The fair values of mortgage loans receivable, REMIC Certificates and long-term debt obligations are based upon the estimates of management and on rates currently prevailing for comparable loans, and instruments of comparable maturities.

The carrying value and fair value of our financial instruments as of December 31, 2006 and 2005 were as follows (*in thousands*):

	At December 31, 2006		At December 31, 2005	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Mortgage loans receivable	\$ 116,992	\$ 129,882	\$ 148,052	\$ 153,606
Marketable debt securities	9,939	11,000	9,933	9,933
Mortgage loans payable	48,266	48,266	58,891	58,891
Bonds payable	5,545	5,545	9,759	9,759
Senior mortgage participation payable			11,535	11,860

For discussion of our investments in mortgage loans receivable see *Note 6. Real Estate Investments*. For discussion of our investment in marketable debt securities see *Note 9. Marketable Securities*. For discussion of our mortgage loans payable, bonds payable and senior mortgage participation payable, see *Note 10. Debt Obligations*.

Investments. Investments and marketable debt and equity securities are accounted for in accordance with SFAS No. 115 *Accounting for Certain Investments in Debt and Equity Securities* which requires that we categorize our investments as trading, available-for-sale or held-to-maturity. Available-for-sale

LTC PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

securities are stated at fair value, with the unrealized gains and losses, reported in other comprehensive income until realized. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are included in net income. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in interest and other income. Our investment in marketable debt securities is classified as held-to-maturity because we have the positive intent and ability to hold the securities to maturity. Held-to-maturity securities are stated at amortized cost, adjusted for amortization of premiums and accretion of discounts to maturity.

Revenue Recognition. Interest income on mortgage loans is recognized using the effective interest method. We follow a policy related to mortgage interest whereby we consider a loan to be non-performing after 60 days of non-payment of amounts due and do not recognize unpaid mortgage interest income from that loan until the past due amounts have been received.

Base rents under operating leases are accrued as earned over the terms of the leases. Substantially all of our leases contain provisions for specified annual increases over the rents of the prior year and are generally computed in one of four methods depending on specific provisions of each lease as follows: (i) a specified annual increase over the prior year's rent, generally 2%; (ii) an increase based on the change in the Consumer Price Index from year to year; (iii) an increase derived as a percentage of facility net patient revenues in excess of base revenue amounts or (iv) specific dollar increases over prior years. SEC Staff Bulletin No. 101 *Revenue Recognition in Financial Statements* (or SAB 101) does not provide for the recognition of contingent revenue until all possible contingencies have been eliminated. We consider the operating history of the lessee and the general condition of the industry when evaluating whether all possible contingencies have been eliminated and have historically, and expect in the future, to not include contingent rents as income until received. We follow a policy related to rental income whereby we consider a lease to be non-performing after 60 days of non-payment of past due amounts and do not recognize unpaid rental income from that lease until the amounts have been received.

Rental revenues relating to leases that contain specified rental increases over the life of the lease are recognized on the straight-line basis when we believe that all of the rent related to a particular lease will be collected according to the terms of the lease. In evaluating whether we believe all the rent will be collected we have determined that all of the following conditions must be met: (i) the property has been operated by the same operator for at least six months (adding a new property to a master lease with an operator that otherwise qualifies does not disqualify the lease from being straight-lined); (ii) payments for any monetary obligations due under the lease, or any other lease such operator has with us have been received late no more than four times during last eight fiscal quarters; (iii) the operator of the property has not during the last eight fiscal quarters (a) been under the protection of any Bankruptcy court; (b) admitted in writing its inability to pay its debts generally as they come due; (c) made an assignment for the benefit of creditors; or, (d) been under the supervision of a trustee, receiver or similar custodian; and (iv) the property operating income has covered the applicable lease payment in each of the prior four fiscal quarters.

We will discontinue booking rent on a straight-line basis if the lessee becomes delinquent in rent owed under the terms of the lease and has been put on non-accrual status (i.e. we have stopped booking rent on an accrual basis for a particular lease because the collection of rent is uncertain). Once a lease is on non-accrual status, we will evaluate the collectibility of the related straight-line rent asset. If it is determined that the delinquency is temporary, we will resume booking rent on a straight-line basis once

LTC PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

payment is received for past due rents. If it appears that we will not collect future rent under the non-accrual lease we will record an impairment charge related to the straight-line rent asset.

During the period that we owned REMIC Certificates, management periodically evaluated the realizability of future cash flows from the mortgages underlying REMIC Certificates. Included in our evaluation, management considered such factors as actual and/or expected loan prepayments, actual and/or expected credit losses, and other factors that may impact the amount and timing of Certificate future cash flows. Impairments were recorded when an adverse change in cash flows was evident and was determined to be other than temporary in nature. Additionally, interest recognition amortization schedules were adjusted periodically to reflect changes in expected future cash flows from the REMIC certificates, thus, accordingly adjusting future interest income recognized. For the year ended December 31, 2005 and 2004, we recognized \$3.5 million and \$7.3 million, respectively, in interest income from our investment in REMIC Certificates. At December 31, 2006 and 2005, we did not have any investment in REMIC Certificates. See *Note 6. Real Estate Investments* for discussion of our historical investment in REMIC Certificates.

Net loan fee income and commitment fee income are amortized over the life of the related loan. Costs associated with leases are deferred and allocated over the lease term in proportion to the recognition of rental income as required by SFAS No. 13 *Accounting for Leases*.

Federal Income Taxes. LTC qualifies as a REIT under the Internal Revenue Code of 1986, as amended, and as such, no provision for Federal income taxes has been made. A REIT is required to distribute at least 90% of its taxable income to its stockholders and a REIT may deduct dividends in computing taxable income. If a REIT distributes 100% of its taxable income and complies with other Internal Revenue Code requirements, it will generally not be subject to Federal income taxation.

For Federal tax purposes, depreciation is generally calculated using the straight-line method over a period of 27.5 years. Earnings and profits, which determine the taxability of distributions to stockholders, differs from net income for financial statement purposes principally due to the treatment of certain interest income, other expense items, impairment charges, and depreciable lives and basis of assets. At December 31, 2006, the book basis of our net assets exceeded the tax basis by approximately \$34,164,000, primarily due to additional depreciation taken for tax purposes.

At December 31, 2006 we had accrued \$950,000 related to a proposed closing agreement pending with the Internal Revenue Service (or IRS). During the 2006 we voluntarily approached the IRS to correct our filing for the year 2000, which is a closed year. In September 2006 we submitted a closing agreement for IRS approval to correct a technical violation which occurred in the spring of 2000. Subsequent to December 31, 2006, we received a draft closing agreement from the IRS. We anticipate signing a final agreement and paying the \$950,000 settlement to them in the first quarter of 2007.

Concentrations of Credit Risks. Financial instruments which potentially subject us to concentrations of credit risk consist primarily of cash and cash equivalents, mortgage loans receivable and operating leases on owned properties. Our financial instruments, mortgage loans receivable and operating leases, are subject to the possibility of loss of carrying value as a result of the failure of other parties to perform according to their contractual obligations or changes in market prices which may make the instrument less valuable. We obtain various collateral and other protective rights, and continually monitor these rights, in order to reduce such possibilities of loss. In addition, we provide reserves for potential losses based upon management's periodic review of our portfolio.

LTC PROPERTIES, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Discontinued Operations. In accordance with SFAS No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*, properties held-for-sale on the balance sheet includes only those properties available for immediate sale in their present condition and for which management believes that it is probable that a sale of the property will be completed within one year. Properties held-for-sale are carried at the lower of cost or fair value less estimated selling costs. No depreciation expense is recognized on properties held-for-sale once they have been classified as such. The operating results of real estate assets designated as held-for-sale are included in discontinued operations in the consolidated statement of operations. In addition, all gains and losses from real estate sold are also included in discontinued operations. As required by SFAS No. 144, gains and losses on prior years related to assets included in discontinued operations in 2006 have been reclassified to discontinued operations in prior years for comparative purposes. See *Note 6. Real Estate Investments*, for a detail of the components of the net income from discontinued operations. Additionally, we reclass for the prior period balance sheet to reflect properties sold subsequent to that balance sheet date as held-for-sale as required by SFAS No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*.

Net Income Per Share. Basic earnings per share is calculated using the weighted-average shares of common stock outstanding during the period excluding common stock equivalents. Diluted earnings per share includes the effect of all dilutive common stock equivalents.

Stock-Based Compensation. SFAS No. 123(revised 2004), *Share-Based Payment*, is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*. SFAS No. 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and amends SFAS No. 95 *Statement of Cash Flows*. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. We adopted SFAS No. 123(R), using the modified prospective method, effective January 1, 2006. The adoption of SFAS No. 123(R) did not have a significant impact on our consolidated financial statements. We adopted the fair-value-based method of accounting for share-based payments effective January 1, 2003 under SFAS No. 123 using the prospective method described in SFAS No. 148 *Accounting for Stock-Based Compensation-Transition and Disclosure* and therefore have recognized compensation expense related to all employee stock-based awards granted, modified or settled after January 1, 2003.

We use the Black-Scholes-Merton formula to estimate the value of stock options granted to employees. This model requires management to make certain estimates including stock volatility, discount rate and the termination discount factor. If management incorrectly estimates these variables, the results of operations could be affected. Because No. 123(R) must be applied not only to new awards but to previously granted awards that are not fully vested on the effective date, and because we adopted SFAS No. 123 using the prospective transition method (which applied only to awards granted, modified or settled after the adoption date), compensation cost for some previously granted awards that were not recognized under SFAS No. 123 were be recognized under SFAS No. 123(R). However, had we adopted SFAS No. 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income and earnings per share in *Note 11. Stockholders' Equity*. SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. Because we qualify as a REIT under the Internal Revenue Code of 1986,

LTC PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

as amended, we are not subject to Federal income taxation. Therefore, this new reporting requirement did not have an impact on our statement of cash flows.

Segment Disclosures. SFAS No. 131 *Disclosures About Segments of an Enterprise and Related Information* establishes standards for the manner in which public business enterprises report information about operating segments. Management believes that substantially all of our operations comprise one operating segment.

New Accounting Pronouncements. In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (or FIN 48), which clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 utilizes a two-step approach for evaluating tax positions. Recognition (step one) occurs when a company concludes that a tax position, based solely on its technical merits, is more likely than not to be sustained upon examination. Measurement (step two) is only addressed if step one has been satisfied (i.e., the position is more likely than not to be sustained). Under step two, the tax benefit is measured as the largest amount of benefit (determined on a cumulative probability basis) that is more likely than not to be realized upon ultimate settlement. FIN 48 is effective for fiscal years beginning after December 15, 2006. We do not expect the adoption of FIN 48 to have a significant impact on our financial position or results of operations.

LTC PROPERTIES, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****3. Major Operators**

We have three operators, based on properties subject to lease agreements and secured by mortgage loans that represent between 10% and 20% of our total assets and three operators from each of which we derive over 10% of our rental revenue and interest income. Beginning in fourth quarter of 2006, Extencicare Services, Inc. (or EHSI), one of our major operators, effected a reorganization whereby it completed a spin-off of Assisted Living Concepts, Inc (or ALC). ALC is now a NYSE traded public company operating assisted living centers. The remaining EHSI assets and operations were converted into a Canadian REIT (Extencicare REIT) listed on the Toronto Stock Exchange (or TSX). Both Extencicare REIT and ALC continue to be parties to the leases with us. Alterra Healthcare Corporation (or Alterra) is a wholly owned subsidiary of a publicly traded company, Brookdale Senior Living, Inc. (or Brookdale). Our other operator is privately owned and thus no public financial information is available. The following table summarizes ALC and Brookdale's assets, stockholders' equity, interim revenue and net income from continuing operations as of or for the nine months ended September 30, 2006 per the operator's public filings (*unaudited, in thousands*):

	Extencicare REIT & ALC (in thousands)	Brookdale (in thousands)
Current assets	\$ 26,671	\$ 274,328
Non-current assets	399,113	4,381,328
Current liabilities	37,074	527,440
Non-current liabilities	160,608	2,295,918
Stockholders' equity	228,102	1,832,298
Gross revenue	172,594	877,653
Operating expenses	115,355	886,985
Income(loss) from continuing operations	5,936	(70,730)
Net income (loss)	4,438	(70,730)
Cash provided by operations	27,128	53,677
Cash used in investing activities	(12,439)	(1,820,597)
Cash provided (used in) by financing activities	(9,674)	1,789,498

Extencicare REIT and ALC, collectively lease 37 assisted living properties with a total of 1,427 units owned by us representing approximately 11.6%, or \$66,027,000, our total assets at December 31, 2006 and 15.1% of rental income received and of interest income recognized in 2006 excluding the effects of straight-line rent.

Alterra, a wholly owned subsidiary of Brookdale, leases 35 assisted living properties with a total of 1,416 units owned by us representing approximately 11.5%, or \$65,239,000, of our total assets at December 31, 2006 and 14.7% of rental revenue received and of interest income recognized in 2006 excluding the effects of straight-line rent.

Preferred Care, Inc. (or Preferred Care), through various wholly owned subsidiaries, operates 32 skilled nursing properties with a total of 3,871 beds that we own or on which we hold mortgages secured by first trust deeds. This represents approximately 10.9% or \$62,126,000 of our total assets as December 31, 2006 and 11.8% of rental revenue received and of interest income recognized in 2006 excluding the effects of straight-line rent.

LTC PROPERTIES, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Our financial position and ability to make distributions may be adversely affected by financial difficulties experienced by Alterra, Extendicare REIT & ALC, Preferred Care, or any of our lessees and borrowers, including any bankruptcies, inability to emerge from bankruptcy, insolvency or general downturn in business of any such operator, or in the event any such operator does not renew and/or extend its relationship with us or our borrowers when it expires.

4. Supplemental Cash Flow Information

	For the year ended December 31,		
	2006	2005	2004
	(in thousands)		
Non-cash investing and financing transactions:			
Assumption of mortgage loans payable related to acquisitions of real estate properties	\$	\$	\$ 2,098
Property exchange	3,410		
Transfer of REMIC certificates to mortgage loans receivable		31,120	12,025
Elimination of loans payable resulting from repurchase of REMIC certificates		7,125	
Loans receivable settled in connection with real estate acquisitions		3,029	9,492
Refinance of notes receivable into mortgage loans receivable			7,059
Exchange of limited partnership units for common stock			3,194
(Decrease) Increase in short term notes receivable related to the disposition of real estate properties	(1,500) 1,500	
Preferred stock redemption charge relating to the original issuance costs of Series A and Series B preferred stock redeemed			4,029
Conversion of preferred stock to common stock	3,976	5,215	40,968
Restricted stock issued, net of cancellations		1,713	202
Modification of vesting on previously issued restricted stock		1,435	
Capital expenditure hold back from investments in notes receivable	432	620	
Application of a prior year capital expenditure funding	489		

5. Impairment Charge

We periodically perform a comprehensive evaluation of our real estate investment portfolio in accordance with SFAS No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets*. We calculate the impairment losses as the excess of the carrying value over the fair value of assets to be held and used, and the carrying value over the fair value less cost to sell in instances where management has determined that we will dispose of the property. In the past the long-term care industry experienced significant adverse changes, which resulted in operating losses by certain of our lessees and borrowers and in some instances the filing by certain lessees and borrowers for bankruptcy protection. As a result we identified certain investments in skilled nursing properties that we determined had been impaired. These assets were determined to be impaired primarily because the estimated undiscounted future cash flows to be received from these investments are less than the carrying values of the investments. We follow the disclosure guidance required by EITF 03-01 *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. See Note 6. *Real Estate Investments* for discussion of the fair value

LTC PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

methodology used in valuing our investment in REMIC Certificates and related disclosures required by EITF 03-1.

No impairment charges were recorded during 2006 or 2005. During 2004, we recorded an impairment charge of \$274,000 reclassifying a portion of the fair market value adjustment on available-for-sale interest-only REMIC Certificates from comprehensive income to realized loss to reflect the estimated impact on future cash flows for loan prepayments related to certain subordinated REMIC Certificates we held. As of December 31, 2005, we no longer had any investments in REMIC Certificates.

We believe we have recorded valuation adjustments on all assets for which there are other than temporary impairments. However in past years, the long-term care industry has experienced significant adverse changes which resulted in operating losses by certain of our lessees and borrowers and in some instances the filing by certain lessees and borrowers for bankruptcy protection. Thus, we cannot predict what, if any, impairment charge may be needed in the future.

6. Real Estate Investments

Mortgage Loans. During the year ended December 31, 2006, we received \$26,716,000 related to the payoff of 12 mortgage loans secured by nine skilled nursing properties and three assisted living properties located in various states and two partial principal pay downs on two mortgage loan secured by two skilled nursing properties. We also received \$4,793,000 in regularly scheduled principal payments.

During the year ended December 31, 2005, a loan was paid off in the last remaining REMIC pool, REMIC 1998-1, which caused the last third party REMIC Certificate holders entitled to any principal payments to be paid off in full. After this transaction, we became the sole holder of the remaining REMIC Certificates and are therefore entitled to the entire principal outstanding of the loan pool underlying the remaining REMIC Certificates. Under EITF No. 02-9 (EITF 02-9) *Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold* , a Special Purpose Entity (SPE) may become non-qualified or tainted which generally results in the repurchase by the transferor of all the assets sold to and still held by the SPE. Since we were the sole REMIC Certificate holder entitled to principal from the underlying loan pool, we had all the risks and were entitled to all the rewards from the underlying loan pool. As required by EITF 02-9, the repurchase for the transferred assets was accounted for at fair value. Prior to the repurchase, the book value of the REMIC Certificates we owned was \$21,553,000 which included a \$1,374,000 impairment recorded in 2003 and a fair market value adjustment of \$1,855,000 included in Accumulated Comprehensive Loss in prior periods. The fair market value of the loans in the REMIC Pool was \$25,296,000. Accordingly a \$3,743,000 fair market value adjustment was recorded in Accumulated Comprehensive Income in 2005. This amount, offset by the \$1,855,000 Accumulated Comprehensive Loss previously discussed is being amortized to increase interest income over the remaining life of the loans. The 13 loans that were effectively repurchased had a weighted average interest rate of 11.2% and an unamortized principal balance of \$25,012,000. The premium of \$284,000 is being amortized to reduce interest income over the life of the loans. The maturity dates of the 13 loans ranged from 2006 through 2017.

At December 31, 2006, we had 58 mortgage loans secured by first mortgages on 58 skilled nursing properties with a total of 6,649 beds, 10 assisted living residences with 705 units and one school located in 19 states. At December 31, 2006, the mortgage loans had interest rates ranging from 6.6% to 13.1% and maturities ranging from 2007 to 2019. In addition, the loans contain certain guarantees, provide for certain facility fees and generally have 25-year amortization schedules. The majority of the mortgage loans provide

LTC PROPERTIES, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

for annual increases in the interest rate based upon a specified increase of 10 to 25 basis points. At December 31, 2006 and 2005, the estimated fair value, based on the net present value of the future cash flows, of the mortgage loans was approximately \$129,882,000 and \$153,606,000, respectively, with a carrying value of \$116,992,000 and \$148,052,000, respectively. Scheduled principal payments on mortgage loans are \$23,955,000; \$7,542,000; \$11,831,000; \$20,839,000; \$12,949,000 and \$41,156,000 in 2007, 2008, 2009, 2010, 2011 and thereafter, respectively.

Owned Properties and Lease Commitments. At December 31, 2006, we owned properties in 23 states consisting of 63 skilled nursing properties with a total of 7,304 beds, 84 assisted living properties with 3,744 units and one school.

During 2006, we sold four assisted living properties in various states with a total of 431 units and one 174-bed skilled nursing property in Arizona. We recognized a gain of \$32,557,000 on the two transactions and received total net proceeds of \$3,410,000 in property associated with the exchange described above and \$54,035,000 in cash, after paying both closing costs and a \$3,800,000 8.75% State of Oregon bond obligation related to one of the properties sold. See *Note 10. Debt Obligations* for further discussion of the debt payoff. In 2005 we sold an option to purchase the four assisted living properties to Sunwest Management Inc. (or Sunwest) for \$2,000,000. In exchange for the right to purchase the properties for \$58,500,000, we received \$500,000 in cash and a note receivable for \$1,500,000. The proceeds from the sale of the purchase option were applied to the proceeds of the sale of the four assisted living properties in 2006.

During the year ended December 31, 2006, we acquired five skilled nursing properties with a total of 373 beds for \$13,536,000 in cash and \$3,410,000 in property in various states. These properties are leased to two third parties under 10-year master leases, each with two five-year renewal options. The combined initial annual rent is approximately \$1,932,000, an 11.4% current yield. Additionally, we have signed agreements and begun to renovate eight skilled nursing properties and two assisted living properties operated by seven different operators for a total commitment of \$7,160,000, of which \$4,968,000 was funded during 2006, at an average yield of approximately 9.7%. At December 31, 2006, \$2,192,000 of the total \$7,160,000 commitment remained to be funded.

During 2006, we paid \$9,500,000 in deferred lease costs related to the termination of our master lease with Centers for Long Term Care, Inc. (or CLC) effective November 1, 2006. Also on that date we entered into a new 15-year master lease with Preferred Care for the 25 skilled nursing properties formerly leased to CLC. The Preferred Care master lease has two five-year renewal options and provided that monthly rent for November and December 2006 would be \$551,500 per month. The initial annual minimum rent beginning in January 2007 is \$8,188,000 and increases annually by 2.5% on each November 1st thereafter. We committed to provide Preferred Care with up to \$3,000,000 for capital improvements and will invest this amount, if requested by Preferred Care, at no additional investment return. This commitment expires March 31, 2010. Additionally, we committed to provide Preferred Care with up to \$7,100,000 for capital improvements for specific properties. Preferred Care's annual minimum rent will increase by an amount equal to 11.0% of our funding of part or all of the \$7,100,000 including capitalized interest during any construction project. As part of the new agreement, we agreed to provide \$300,000 for inventory and equipment needs during the transition of the 25 properties from CLC to Preferred Care.

Subsequent to December 31, 2006, we sold a closed, previously impaired skilled nursing property to third party for \$166,000. As a result of the sale, we will recognize a gain net of all sales expenses of \$149,000 in 2007.

LTC PROPERTIES, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Owned properties are leased pursuant to non-cancelable operating leases generally with an initial term of 10 to 30 years. Many of the leases contain renewal options. The leases provide for fixed minimum base rent during the initial and renewal periods. The majority of our leases contain provisions for specified annual increases over the rents of the prior year and are generally computed in one of four ways depending on specific provisions of each lease: (i) a specified percentage increase over the prior year, generally 2%; (ii) the higher of (i) or a calculation based on the Consumer Price Index; (iii) as a percentage of facility net patient revenues in excess of base amounts or (iv) specific dollar increases. Each lease is a triple net lease which requires the lessee to pay all taxes, insurance, maintenance and repairs, capital and non-capital expenditures and other costs necessary in the operations of the facilities. Contingent rent income for the years ended December 31, 2006, 2005 and 2004 was not significant in relation to contractual base rent income.

Depreciation expense on buildings and improvements, including properties owned under capital leases and properties classified as discontinued operations as required by SFAS No. 144, was \$13,581,000, \$13,302,000 and \$12,586,000 for the years ended December 31, 2006, 2005 and 2004.

Future minimum base rents receivable under the remaining non-cancelable terms of operating leases excluding the effects of straight-line rent are: \$53,382,000; \$54,673,000; \$55,199,000; \$51,232,000; \$51,739,000 and \$430,294,000 for the years ending December 31, 2007, 2008, 2009, 2010, 2011, and thereafter.

Set forth in the table below are the components of the net income from discontinued operations (*in thousands*):

	For the year ended December 31,		
	2006	2005	2004
Rental income	\$ 725	\$ 4,899	\$ 5,060
Interest and other income	97		
Total revenues	822	4,899	5,060
Interest expense	17	338	343
Depreciation and amortization	52	960	1,104
Operating and other expenses	7	25	85
Total expenses	76	1,323	1,532
Income from discontinued operations	\$ 746	\$ 3,576	\$ 3,528

REMIC Certificates. At December 31, 2006 and 2005 we did not have any investments in REMIC Certificates.

During 2005, the 1996-1 REMIC Pool was fully retired. We paid \$855,000 in cash and exchanged our remaining interest in the 1996-1 REMIC Certificates with a book value of \$9,568,000 and we received five mortgage loans with an estimated fair value of \$10,398,000 and an unamortized principal balance of \$10,469,000. Accordingly, we recorded a \$71,000 discount on these loans which is being amortized as a yield adjustment to increase interest income over the remaining life of the loans. Additionally, we are amortizing the \$1,051,000 balance in Other Comprehensive Income that resulted from transferring the loans at fair value as required by SFAS No. 115 *Accounting for Certain Investments in debt and Equity Securities* as a yield adjustment to increase interest income over the life of the related loans. During 2005, a loan was paid off in the 1998-1 REMIC pool, which caused the Senior Certificate holders entitled to any

LTC PROPERTIES, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

principal payments to be paid off in full. See paragraph two under Mortgage Loans for a description of this event.

Income on the subordinated certificates was as follows for the years ended December 31, 2006, 2005 and 2004 (*dollar amounts in thousands*):

	2006	2005	2004
1993-1 Pool	\$	\$	\$
1994-1 Pool			967
1996-1 Pool		551	1,598
1998-1 Pool		2,929	4,777
	\$	\$ 3,480	\$ 7,342

As sub-servicer for all of the above REMIC pools, we were responsible for performing substantially all of the servicing duties relating to the mortgage loans underlying the REMIC Certificates and acted as the special servicer to restructure any mortgage loans that defaulted.

The REMIC Certificates retained by us, represented the non-investment grade certificates issued in the securitizations. Furthermore, because of the highly specialized nature of the underlying collateral (long-term care properties), there was an extremely limited market for these securities. Because REMIC Certificates of this nature trade infrequently, if at all, market comparability to the certificates we retained was very limited.

At December 31, 2006 and 2005 and we did not have any investment in REMIC Certificates. Unrealized holding gains on available-for-sale certificates of \$0, \$3,743,000 and \$378,000 were included in comprehensive income for the years ended December 31, 2006, 2005 and 2004, respectively. We used certain assumptions and estimates in determining the fair value allocated to the retained interest at the time of initial sale and subsequent measurement dates in accordance with SFAS No. 140. These assumptions and estimates included projections concerning the expected level and timing of future cash flows, current interest rate environment, estimated spreads over the U.S. Treasury Rate at which the retained certificates might trade, expectations regarding credit losses, if any, expected weighted-average life of the underlying collateral and discount rates commensurate with the risks involved. These assumptions were reviewed periodically by management.

During the years we had investments in REMIC Certificates, to the extent there were defaults, unrecoverable losses or prepayments of principal on the underlying mortgages resulting in reduced cash flow, the subordinated REMIC Certificates historically held by us would have borne the first risk of loss. During management's periodic evaluation of the realizability of expected future cash flows from the mortgages underlying our historical investment in REMIC Certificates there were indications that a portion of the underlying mortgage collateral would not be realized by the REMIC Trust. Accordingly, we recorded impairment charges of \$274,000 during 2004 to reflect the estimated impact on future cash flows from loan prepayments occurring during, or expected to occur related to certain subordinated REMIC Certificates we held. No impairment charge was recorded in 2005. See *Note 5. Impairment Charge* for a discussion of the impairment indicators.

LTC PROPERTIES, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****7. Asset Securitizations**

LTC is a REIT and, as such, makes investments with the intent to hold them for long-term purposes. However, we have in the past, transferred mortgage loans to a REMIC (securitization) when a securitization provided us with the best available form of capital to fund additional long-term investments. When contemplating a securitization, consideration is given to our current and expected future interest rate posture and liquidity and leverage position, as well as overall economic and financial market trends. As of December 31, 2006 we had completed four securitization transactions, the last being in 1998. We may again employ this type of financing in the future should we determine the financing environment is appropriate for this type of transaction.

From our past securitizations, we received annual sub-servicing fees, which ranged from 1.0 to 2.0 basis points of the outstanding mortgage loan balances in each of the REMIC pools. Additionally, through the REMIC Certificates historically retained by us from past securitizations, we received cash flows and the rights to future cash flows resulting from cash received on the underlying mortgage loans in the REMIC pools. All of the investors in the REMIC Certificates and the REMIC Trusts themselves had no recourse to our assets for failure by any obligor to the REMIC Trust assets (the mortgages) to pay when due, or comply with any provisions of the mortgage contracts. The REMIC Certificates are classified separately on the balance sheet and interest income earned shown separately on the income statement. Sub-servicing fees and related fees associated with the REMIC Certificates are included in other income.

Certain cash flows received from and paid to REMIC Trusts are as follows: *(dollar amounts in thousands)*:

	Year Ended		
	2006	2005	2004
Cash flow received on retained REMIC Certificates	\$	\$ 7,454	\$ 13,303
Servicing and related fees received		25	109
Servicing advances made		176	544
Repayments of servicing advances		193	480

Currently in our portfolio we have no mortgage loans held for securitization. Quantitative information relating to subserviced mortgage loans including delinquencies and net credit losses is as follows: *(dollar amounts in thousands)*

	Year Ended			
	2006	2005	2004	
Average balance of loans in REMIC pools	\$	\$ 39,036	\$ 150,291	
Year-end balance of loans in REMIC pools			\$ 87,351	
Net credit losses			\$ 274	
Net credit losses to average REMIC pool loans			0.2	%
Average delinquencies (greater than 30 days) in REMIC pool loans during the year		1.2	% 1.4	%

8. Notes Receivable

During 2006, we funded \$1,486,000 under various loans and line of credit agreements with certain operators and received \$4,180,000 in principal payments. At December 31, 2006, we had 17 loans outstanding with a weighted average interest rate of 8.4%.

LTC PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

At December 31, 2005, we held a Promissory Note (or Note) from Sunwest in the amount of \$1,500,000. During 2005, we sold an option to purchase four of our assisted living properties to Sunwest. The price of the option was \$500,000 in cash and the Note. During 2006, the option to purchase the properties was exercised and the proceeds from the payoff of the Note were applied to the purchase price of the four properties. See *Note 6. Real Estate Investments* for further discussion of this transaction.

During 2005 we received \$22,309,000 in cash as payment in full for a note receivable and a related \$500,000 mortgage loan, including accrued and unpaid interest through the payoff date. As a result of the payoff, we recognized \$3,667,000 in rental income related to past due rents that were not previously accrued, \$2,335,000 of interest income related to past due interest that was not previously accrued, a \$477,000 reimbursement for certain expenses paid on behalf of an operator in prior years, a \$1,000,000 bonus accrual related to the realization of the value of the note receivable and non-operating income of \$6,217,000 (\$3,610,000 of which was classified as Accumulated Comprehensive Income in the equity section of the balance sheet at December 31, 2004). The \$6,217,000 of non-operating income is net of \$1,298,000 of legal and investment advisory fees related to the transaction that resulted in the note receivable payoff.

9. Marketable Securities

During 2006 we purchased and sold 60,000 shares of National Health Investors, Inc. (or NHI) common stock. We purchased the shares for a total of \$1,440,000, or an average purchase price of \$24.00 per share and sold the shares during 2006 for \$1,957,000 or an average sales price of \$32.62 per share. Accordingly, we recorded a gain on the sale of marketable equity securities of \$517,000 and dividend income of \$58,000 for the year ended December 31, 2006.

At December 31, 2006 and 2005, we had an investment in \$10,000,000 of face value Skilled Healthcare Group, Inc. (or SHG) Senior Subordinated Notes that mature in 2014. The Notes have a stated rate of 11.0% and an effective yield of 11.1%. We recorded \$1,148,000 of interest income from our investment in marketable debt securities for the year ended December 31, 2006. Interest on the notes is payable semi-annually in arrears and the notes mature on January 15, 2014. One of our board members is the chief executive officer of SHG.

10. Debt Obligations

Bank Borrowings. We have an Unsecured Credit Agreement that matures on November 7, 2008 and provides for a revolving line of credit for up to \$90,000,000. We can designate, at the time of funding the pricing of the Unsecured Credit Agreement between LIBOR plus 1.50% and LIBOR plus 2.50% or Prime plus 0.50% and Prime plus 1.50%. The spreads are dependent on our leverage ratio. At December 31, 2006, we had no outstanding balances under the Unsecured Credit Agreement. At December 31, 2005, we had \$16,000,000 outstanding under this agreement with the interest rate at LIBOR plus 1.50%.

Under financial covenants contained in the Unsecured Credit Agreement which are measured quarterly we are required to maintain, among other things, (i) a ratio, of total indebtedness to total asset value, not greater than .5 to 1.0, (ii) a ratio not greater than .35 to 1.0 of secured debt to total asset value (iii) a ratio not less than 2.5 to 1.0 of EBITDA to interest expense, and (iv) a ratio of not less than 1.50 to 1.0 of EBITDA to fixed charges. Based on our covenant compliance at December 31, 2006, any borrowings under the line could be at the lowest interest rates provided for in the Unsecured Credit Agreement.

LTC PROPERTIES, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Mortgage Loans Payable. Maturity dates, weighted average interest rates and year-end balances on our mortgage loans payable were (*dollar amounts in thousands*):

Maturity	Total Loan Balance at December 31, 2006	Rate	Total Loan Balance at December 31, 2005	Rate
2007	\$		\$	
2008	14,813	7.27 %	15,217	7.27 %
2009	25,308	8.68 %	25,790	8.68 %
2010	8,145	8.69 %	8,274	8.69 %
2011				
Thereafter	\$ 48,266		\$ 49,281	

As of December 31, 2006 and 2005, the aggregate carrying value of real estate properties securing our mortgage loans payable was \$72,491,000 and \$88,541,000, respectively.

During 2006, we paid off a mortgage loan at maturity in the amount of \$9,225,000. The mortgage loan was secured by two assisted living properties and had an interest rate of 6.3%. During 2005, we paid off a \$3,762,000 mortgage loan payable to a REMIC Pool we originated. Additionally in 2005, mortgage loans payable decreased \$7,125,000 due to the elimination of two loans payable included in a REMIC pool whose assets were effectively repurchased by us as described in *Note 6. Real Estate Investments*.

Bonds Payable. At December 31, 2006 and 2005, we had outstanding principal of \$5,545,000 and \$5,935,000, respectively on multifamily tax-exempt revenue bonds that are secured by five assisted living properties in Washington. These bonds bear interest at a variable rate that is reset weekly and mature during 2015. For the year ended December 31, 2006, the weighted average interest rate, including letter of credit fees, on the outstanding bonds was 6.0%. Additionally, included in liabilities related to properties held-for-sale at December 31, 2005, we had outstanding principal of \$3,824,000 on a multi-unit housing tax-exempt revenue bond that bore interest at 8.75% and was secured by one assisted living property in Oregon. During, 2006, this bond was fully prepaid from the proceeds received from the sale of the Sunwest properties as described in *Note 6. Real Estate Investments*.

As of December 31, 2006 and 2005, the aggregate gross investment in real estate properties securing our bonds payable was \$11,280,000 and \$19,360,000, respectively.

Senior Mortgage Participation Payable. In 2002, we completed a loan participation transaction whereby we issued a \$30,000,000 Senior Participation interest in 22 of our first mortgage loans that had a total unpaid principal balance of \$58,627,000 in the Participation Loan Pool. The Participation Loan Pool had a weighted average interest rate of 11.6% and a weighted average scheduled term to maturity of 77 months. The Senior Participation was secured by the entire Participation Loan Pool. We received net proceeds from the issuance of the Senior Participation of \$29,750,000 that was used to reduce commitments and amounts outstanding under our Secured Revolving Credit.

The Senior Participation received interest at a rate of 9.25% per annum, payable monthly in arrears, on the then outstanding principal balance of the Senior Participation. In addition, the Senior Participation received all mortgage principal collected on the Participation Loan Pool until the Senior Participation balance was reduced to zero. We retained interest received on the Participation Loan Pool in excess of the 9.25% paid to the Senior Participation. The ultimate extinguishment of the Senior Participation was tied to

LTC PROPERTIES, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the underlying maturities of loans in the Participation Loan Pool. We accounted for the participation transaction as a secured borrowing under SFAS No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

During 2006, the Senior Participation was repaid in full receiving a principal payment of \$10,767,000 from the payoff of three mortgage loans and the refinance of six mortgage loans in the Participation Loan Pool. Also during 2006, the Senior Participation received scheduled principal payments of \$767,000. We had no Senior Participation balance at December 31, 2006.

Scheduled Principal Payments. Total scheduled principal payments for our mortgage loans payable, and bonds payable as of December 31, 2006 were \$1,101,000, \$15,102,000, \$24,377,000, \$8,180,000, \$530,000 and \$3,200,000 in 2007, 2008, 2009, 2010, 2011 and thereafter.

Fair Value. The estimated fair value of the mortgage loans payable, and bonds payable approximated their carrying values at December 31, 2006 based upon prevailing market interest rates for similar debt arrangements.

11. Stockholders Equity

Preferred Stock. Preferred Stock is comprised of the series summarized as follows:

Issuance	Shares outstanding at		Liquidation Value Per share	Dividend Rate	Carrying Value at	
	December 31, 2006	2005			December 31, 2006	2005
Series C Cumulative Convertible Preferred Stock	2,000,000	2,000,000	\$ 19.25	8.5 %	\$ 18.80	\$ 18.80
Series E Cumulative Convertible Preferred Stock	193,644	352,675	\$ 25.00	8.5 %	\$ 23.84	\$ 23.84
Series F Cumulative Preferred Stock	6,640,000	6,640,000	\$ 25.00	8.0 %	\$ 23.99	\$ 23.99

Our Series C Cumulative Convertible Preferred Stock is convertible into 2,000,000 shares of our common stock at \$19.25 per share. Dividends are payable quarterly. Total shares reserved for issuance of common stock related to the conversion of Series C Preferred Stock were 2,000,000 shares at December 31, 2006 and 2005.

Our Series E Cumulative Convertible Preferred Stock (or Series E Preferred Stock) is convertible at any time into shares of our common stock at a conversion price of \$12.50 per share of common stock, subject to adjustment under certain circumstances. On or after September 19, 2006 and before September 19, 2008, we have the right but not the obligation, upon not less than 30 nor more than 60 days written notice, to redeem shares of the Series E Preferred Stock, in whole or in part, if such notice is given within fifteen trading days of the end of the 30 day period in which the closing price of our common stock on the NYSE equals or exceeds 125% of the applicable conversion price for 20 out of 30 consecutive trading days, for cash at a redemption price of \$25.00 per share, plus all accrued and unpaid dividends thereon. We may not otherwise redeem the Series E Preferred Stock before September 19, 2008, except in order to preserve our status as a real estate investment trust. Dividends are payable quarterly. During 2006, holders of 159,031 shares of Series E Preferred Stock notified us of their election to convert such shares into 318,062 shares of common stock. During 2005, holders of 208,594 shares of Series E Preferred Stock notified us of their election to convert such shares into 417,188 shares of common stock. During 2004 holders of 1,638,731 shares of Series E Preferred Stock notified us of their election to convert such shares

LTC PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

into 3,277,462 shares of common stock. Total shares reserved for issuance of common stock related to the conversion of Series E Preferred Stock were 387,288 at December 31, 2006. Subsequent to December 31, 2006, holders of 2,497 shares of Series E Preferred Stock notified us of their election to convert such shares into 4,994 shares of common stock. Subsequent to this most recent conversion, there are 191,147 shares of our Series E Preferred Stock outstanding.

In February 2004, we sold 4,000,000 shares of our Series F Preferred Stock in a registered direct placement. In July 2004, we issued an additional 2,640,000 shares of Series F Preferred Stock in a registered direct placement. The combined issuances of Series F Preferred Stock generated net cash proceeds of \$159,305,000. We used the proceeds to redeem our Series A and Series B Preferred Stock, reduce our mortgage debt and fund new investments. The dividend rate is 8.0% and the liquidation value is \$25.00 per share. Dividends are cumulative from the date of original issue and are payable quarterly to stockholders of record on the first day of each quarter. We may not redeem the Series F Preferred Stock prior to February 23, 2009, except as necessary to preserve our status as a real estate investment trust. On or after February 23, 2009, we may, at our option, redeem the Series F Preferred Stock, in whole or from time to time in part, for \$25.00 per Series F Preferred Stock in cash plus any accrued and unpaid dividends to the date of redemption.

While outstanding, the liquidation preferences of the preferred stocks are *pari passu*. None have any voting rights, any stated maturity, nor are they subject to any sinking fund or mandatory redemption.

Common Stock. During 2005 we sold 1,500,000 shares of common stock in a registered direct placement for \$22.08 per share and used net proceeds of \$32,626,000 for general corporate purposes including acquisitions, loan originations and debt retirement.

During 2006 we repurchased 71,493 shares of common stock for an aggregate purchase price of \$1,476,000 or \$20.65 per share. During 2005, we repurchased and retired 184,700 shares of common stock for an aggregate purchase price of \$3,296,000 at an average purchase price of \$17.85 per share. The shares were purchased on the open market under a Board authorization to purchase up to 5,000,000 shares. Including these purchases, 2,604,393 shares have been purchased under this authorization. Therefore, we continue to have an open Board authorization to purchase an additional 2,395,607 shares. During 2004 we did not repurchase any common stock.

In 2004 we filed a prospectus to cover the possible resale of up to 865,387 shares of our common stock which were contingently issuable under certain partnership agreements. During 2004, partners in seven of our limited partnerships elected to exchange their interests in the partnerships. In accordance with the partnership agreements, at our option, we issued 208,401 shares of our common stock related to five limited partnerships, paid approximately \$109,000 for the redemption of 7,027 shares owned by another limited partner and paid approximately \$8,387,000 to other limited partners in exchange for their partnership interests. At December 31, 2006, we have only one limited partnership remaining and there remains 201,882 shares of our common stock reserved for this partnership agreement.

Available Shelf Registrations. On March 31, 2004, we filed a Form S-3 shelf registration which became effective April 5, 2004 and provides us with the capacity to offer up to \$200,000,000 in our debt and/or equity securities. At December 31, 2006 we had \$104,761,000 available under the shelf registration.

LTC PROPERTIES, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Dividend Distributions. We declared and paid the following cash dividends on our common and preferred stock (*in thousands*):

	Year ended December 31, 2006		Year ended December 31, 2005	
	Declared	Paid	Declared	Paid
Preferred Stock				
Series C	\$ 3,272	\$ 3,272	\$ 3,272	\$ 3,272
Series E	605	689	791	902
Series F	13,280	13,280	13,280	13,280
Total Preferred	17,157	17,241	17,343	17,454
Common Stock	25,285 (2)	33,668 (3)	37,348 (4)	28,965 (5)
Total	\$ 42,442 (1)	\$ 50,909 (1)	\$ 54,691 (1)	\$ 46,419 (1)

- (1) Difference between declared and paid is the change in accrued distributions payable on the balance sheet.
- (2) Represents \$0.12 per share per month declared for April through December. Dividends for the first quarter of 2006 were declared and accrued during fourth quarter of 2005. Common dividends for the first quarter of 2007 were declared subsequent to December 31, 2006.
- (3) Represents \$0.12 per share per month paid for the year ended December 31, 2006.
- (4) Represents \$0.30 per share declared and paid in the first quarter, \$0.11 per share per month declared and paid in April through December and \$0.12 per share per month declared in December and paid in January, February and March 2006.
- (5) Represents \$0.30 per share declared and paid in the first quarter, \$0.11 per share per month declared and paid in April through December 2005.

Subsequent to December 31, 2006, we increased the monthly common dividend by 4% and we declared a monthly cash dividend of \$0.125 per share on our common stock for the months of January, February and March 2007, payable on January 31, February 28, and March 30, 2007, respectively, to stockholders of record on January 23, February 20, and March 22, 2007, respectively.

In 2004, we redeemed all of the remaining 1,838,520 outstanding shares of Series A Preferred Stock and all of the 1,988,000 outstanding shares of Series B Preferred Stock. Accordingly, in 2004 we recognized the \$1,861,000 and \$2,168,000 of original issue costs related to the Series A and Series B Preferred Stock, respectively, as a preferred stock redemption charge in the first quarter of 2004.

Other Equity. Other equity consists of the following (*amounts in thousands*):

	December 31,	
	2006	2005
Notes receivable from stockholders	\$	\$ (226)
Unamortized balance on deferred compensation		(3,123)
Accumulated comprehensive income	1,693	2,408
Total Other Equity	\$ 1,693	\$ (941)

Notes Receivable from Stockholders. In 1997, the Board of Directors adopted a loan program designed to encourage executives, key employees, consultants and directors to acquire common stock

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

through the exercise of options. Under the program, we made full recourse, secured loans to participants equal to the exercise price of vested options plus up to 50% of the taxable income resulting from the exercise of options. Such loans bear interest at the then current Applicable Federal Rate (or AFR). In January 2000, the Board of Directors approved a new loan agreement (or New Agreement) for current executives and directors in the amounts of the then remaining principal balance of the original loans.

The new loan agreements provided that the interest rate would be 6.07% (AFR for an equivalent 3 to 9 year instrument) and interest payments were to be paid from dividends received on shares pledged as security for the New Agreements during the quarter in which the interest is due. If the dividend does not fully pay the interest due or if no dividend is paid, the unpaid interest is added to the principal balance. In addition, the notes also require the borrower to reduce principal by one-half of the difference between the most recent dividend received on the pledged shares and the interest paid on the loans from that dividend.

During 2006, the last remaining note receivable from stockholders with a balance of \$226,000 was paid in full. During 2005, we received \$282,000 in principal payments on a note receivable from stockholders. During 2004, five notes receivable from stockholders with a combined principal balance of \$1,722,000 were paid in full. Two of these notes were from current members of our board of directors. Additionally during 2004 we received \$563,000 in principal payments on notes receivable from stockholders.

We currently have no loan programs for officers and/or directors and do not provide any guarantee to any officer and/or director or third party relating to purchases and sales of our equity securities.

At December 31, 2006, 2005 and 2004, loans totaling \$0, \$226,000 and \$508,000, respectively were outstanding. At December 31, 2006, 2005 and 2004, the market value of the common stock securing these loans was approximately \$0, \$1,262,000 and \$1,195,000, respectively.

Unamortized Balance on Defined Compensation. Deferred compensation is the value of unvested restricted stock awards granted to employees. See *Stock Based Compensation Plans* below.

Accumulated Comprehensive Income. This balance represents the net unrealized holding gains on available-for-sale REMIC Certificates recorded in 2005 when we repurchased the loans in the underlying loan pool. This amount is being amortized to increase interest income over the remaining life of the loans that we repurchased from the REMIC Pool. See *Note 6. Real Estate Investments* for further discussion of the repurchase of the loans underlying our investment in REMIC Certificates.

Stock Based Compensation Plans. During 2004 we adopted and our stockholders approved The 2004 Stock Option Plan under which 500,000 shares of common stock have been reserved for incentive and nonqualified stock option grants to officers, employees, non-employee directors and consultants. The terms of the awards granted under The 2004 Stock Option Plan are set by our compensation committee at its discretion. Total shares available for future grant under The 2004 Stock Option Plan as of December 31, 2006, 2005 and 2004 were 470,000, 470,000 and 470,000, respectively. All options outstanding that were granted under The 2004 Stock Option Plan vest over three years from the original date of grant. Unexercised options expire seven years after the date of vesting.

Our stockholders have approved the 1998 Equity Participation Plan under which 500,000 shares of common stock were reserved. The plan provides for the issuance of incentive and nonqualified stock options, restricted stock and other stock based awards to officers, employees, non-employee directors and consultants. The terms of the awards granted under the Plan are set by our compensation committee at its discretion; however, in the case of incentive stock options, the term may not exceed 10 years from the date

LTC PROPERTIES, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

of grant. Total shares available for future grant under the 1998 Equity Participation Plan as of December 31, 2006, 2005 and 2004 were 99,616, 99,616 and 99,816, respectively. All options outstanding that were granted under the 1998 Equity Participation Plan vest over five years from the original date of grant. Unexercised options expire seven years after the date of vesting.

Nonqualified stock option activity for the years ended December 31, 2006, 2005 and 2004, was as follows:

	Shares			Weighted Average Price		
	2006	2005	2004	2006	2005	2004
Outstanding, January 1	110,200	200,300	285,871	\$ 9.26	\$ 7.15	\$ 5.63
Granted		15,000	30,000		\$ 19.62	\$ 15.13
Exercised	(46,200)	(101,100)	(99,171)	\$ 7.77	\$ 6.68	\$ 5.51
Canceled		(4,000)	(16,400)		\$ 7.63	\$ 5.27
Outstanding, December 31	64,000	110,200	200,300	\$ 10.33	\$ 9.26	\$ 7.15
Exercisable, December 31	40,000	58,600	75,100	\$ 7.07	\$ 5.46	\$ 5.68

During 2006 a total of 46,200 options were exercised at a total option value of \$359,000 and a total market value as of the exercise dates of \$1,087,000. Subsequent to December 31, 2006, a total of 15,000 options were exercised at a total option value of \$81,000 and a total market value as of the exercise date of \$427,000.

Restricted stock activity for the years ended December 31, 2006, 2005 and 2004 was as follows:

	2006	2005	2004
Outstanding, January 1	177,495	132,772	150,912
Granted		80,000	12,100
Vested	(46,973)	(24,143)	
Canceled		(11,134)	(30,240)
Outstanding, December 31	130,522	177,495	132,772
Compensation Expense for the year	\$ 953,000	\$ 540,000	\$ 434,000

During 2004, we adopted and our stockholders approved The 2004 Restricted Stock Plan under which 100,000 shares of common stock have been reserved for restricted stock grants to officers, employees, non-employee directors and consultants. The terms of the awards granted under The 2004 Restricted Stock Plan are set by our compensation committee at its discretion. During 2006 we did not issue any shares of restricted stock. During 2005, we issued 8,000 shares of restricted common stock at \$19.62 per share. These shares vest ratably over a three year period. We also issued 72,000 shares of restricted common stock at \$21.69 per share. These shares vest ratably over a four year period. Total shares available for future grant under The 2004 Restricted Stock Plan as of December 31, 2006, 2005 and 2004 were 478,234, 478,234 and 557,900, respectively.

During 2005 our board of directors approved a change in the vesting criteria for 89,760 shares of restricted stock outstanding. Prior to the change, these shares vested ratably over five years if we met certain financial objectives and the grantees remained employed by us. Compensation expense was recognized over the service period at the market price per share on the date of vesting. Our board modified the awards so that at December 31, 2005, the 89,760 shares of restricted stock vest ratably over

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

four years. Accordingly, we recorded \$1,435,000 in deferred compensation based on the closing market price per share on the date the award was modified. Prior to January 1, 2006, deferred compensation related to the award modification was being amortized to compensation expense over the service period. Effective January 1, 2006, we adopted SFAS No. 123(R) which requires that an equity instrument such as restricted stock, not be recognized until the compensation cost related to that instrument is recognized. This accounting differs from APB Opinion No. 25 *Accounting for Stock Issued to Employees* (or APB 25) whereby we recorded the grant of non-vested restricted stock in capital with an offsetting contra-equity account, deferred compensation, which was amortized to expense over the vesting period. As required by SFAS No. 123(R), we reversed the contra-equity deferred compensation balance (i.e., netted it against additional paid-in capital) on January 1, 2006. Effective January 1, 2006, additional paid-in capital and associated compensation expense related to restricted stock vesting is being recognized over the service period.

Dividends are payable on the restricted shares to the extent and on the same date as dividends are paid on all of our common stock.

Prior to January 1, 2003, we accounted for stock option grants in accordance with APB 25 and related Interpretations. Historically, we granted stock options for a fixed number of shares to employees with an exercise price equal to the fair value of the shares at the date of grant. Under APB 25, because the exercise price of our employee stock options equaled the market price of the underlying stock on the date of grant, no compensation expense was recognized. Therefore, for options that had been granted prior to January 1, 2003 that vested in 2005 and 2004, no compensation expense was recognized in accordance with APB 25. Effective January 1, 2003, we adopted SFAS No. 123 and SFAS No. 148 *Accounting for Stock-Based Compensation Transition and Disclosure*, (or SFAS No. 148) on a prospective basis for all employee awards granted, modified or settled on or after January 1, 2003. Therefore, for options granted since January 1, 2003, compensation expense was recognized in accordance with SFAS No. 123 and SFAS No. 148. Effective January 1, 2006, we adopted SFAS No. 123(R) which requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Thus, for all options that vested during 2006, regardless of when they were granted, compensation expense was recognized during 2006 according to SFAS No. 123(R).

We use the Black-Scholes-Merton formula to estimate the value of stock options granted to employees. This model requires management to make certain estimates including stock volatility, discount rate and the termination discount factor. If management incorrectly estimates these variables, the results of operations could be affected. Because SFAS No. 123(R) must be applied not only to new awards but to previously granted awards that are not fully vested on the effective date, and because we adopted SFAS No. 123 using the prospective transition method outlined in SFAS No. 148 (which applied only to awards granted, modified or settled after the adoption date), compensation cost for some previously granted awards that were not recognized under SFAS No. 123 are recognized under SFAS No. 123(R). However, had we adopted SFAS No. 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income and earnings per share below. SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as previously required. Because we qualify as a REIT under the Internal Revenue Code of 1986, as amended, we are not subject to Federal income taxation. Therefore, this new reporting requirement does not have an impact on our statement of cash flows.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table illustrates the effect on net income and earnings per share as if the fair value recognition provision of SFAS No. 123(R) had been applied to all outstanding and unvested stock options in each period presented. For purposes of this pro forma disclosure, the value of the options is estimated using a Black-Scholes-Merton option-pricing formula and amortized to expense over the options vesting periods (*in thousands*):