

UNIVERSAL HEALTH REALTY INCOME TRUST
Form 10-Q
August 08, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended June 30, 2018

OR

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

For the transition period from _____ to _____

Commission file number 1-9321

UNIVERSAL HEALTH REALTY INCOME TRUST

(Exact name of registrant as specified in its charter)

MARYLAND	23-6858580
(State or other jurisdiction of	(I. R. S. Employer
incorporation or organization)	Identification No.)

UNIVERSAL CORPORATE CENTER

367 SOUTH GULPH ROAD

KING OF PRUSSIA, PENNSYLVANIA 19406

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(Address of principal executive offices) (Zip Code)

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

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

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

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

Large accelerated filer Accelerated Filer

Non-accelerated filer Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Number of common shares of beneficial interest outstanding at July 31, 2018—13,745,138

HEALTH REALTY INCOME TRUST

INDEX

	PAGE NO.
<u>PART I. FINANCIAL INFORMATION</u> (unaudited)	
Item 1. <u>Financial Statements</u>	
<u>Condensed Consolidated Statements of Income—Three and Six Months Ended June 30, 2018 and 2017</u>	3
<u>Condensed Consolidated Statements of Comprehensive Income—Three and Six Months Ended June 30, 2018 and 2017</u>	4
<u>Condensed Consolidated Balance Sheets—June 30, 2018 and December 31, 2017</u>	5
<u>Condensed Consolidated Statements of Cash Flows—Six Months Ended June 30, 2018 and 2017</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	7 through 15
Item 2. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	16 through 26
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	26
Item 4. <u>Controls and Procedures</u>	27
<u>PART II. OTHER INFORMATION</u>	28
Item 6. <u>Exhibits</u>	28
<u>EXHIBIT INDEX</u>	29
<u>Signatures</u>	30

This Quarterly Report on Form 10-Q is for the quarter ended June 30, 2018. In this Quarterly Report, “we,” “us,” “our” and the “Trust” refer to Universal Health Realty Income Trust and its subsidiaries.

As disclosed in this Quarterly Report, including in Note 2 to the Condensed Consolidated Financial Statements—Relationship with Universal Health Services, Inc. (“UHS”) and Related Party Transactions, a wholly-owned subsidiary of UHS (UHS of Delaware, Inc.) serves as our Advisor pursuant to the terms of an annually renewable Advisory Agreement dated December 24, 1986. Our officers are all employees of UHS through its wholly-owned subsidiary, UHS of Delaware, Inc. In addition, three of our hospital facilities are leased to subsidiaries of UHS, and subsidiaries of UHS are tenants of seventeen medical office buildings or free-standing emergency departments, that are either wholly or jointly-owned by us. Any reference to “UHS” or “UHS facilities” in this report is referring to Universal Health Services, Inc.’s subsidiaries, including UHS of Delaware, Inc.

In this Quarterly Report, the term “revenues” does not include the revenues of the four unconsolidated limited liability companies (“LLCs”) in which we have various non-controlling equity interests ranging from 33% to 95%. We currently account for our share of the income/loss from these investments by the equity method (see Note 5 to the Condensed Consolidated Financial Statements included herein).

Part I. Financial Information

Item I. Financial Statements

Universal Health Realty Income Trust

Condensed Consolidated Statements of Income

For the Three and Six Months Ended June 30, 2018 and 2017

(amounts in thousands, except per share amounts)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenues:				
Base rental - UHS facilities	\$4,187	\$4,303	\$8,363	\$8,383
Base rental - Non-related parties	10,217	10,116	20,544	20,086
Bonus rental - UHS facilities	1,204	1,242	2,530	2,530
Tenant reimbursements and other - Non-related parties	4,200	2,239	6,615	4,432
Tenant reimbursements and other - UHS facilities	303	245	598	464
	20,111	18,145	38,650	35,895
Expenses:				
Depreciation and amortization	6,111	6,295	12,398	12,440
Advisory fees to UHS	948	874	1,852	1,740
Other operating expenses	5,445	4,923	10,653	9,628
Transaction costs	-	56	-	126
	12,504	12,148	24,903	23,934
Income before equity in income of unconsolidated limited liability companies ("LLCs"), interest expense, hurricane insurance recovery proceeds and gain	7,607	5,997	13,747	11,961
Equity in income of unconsolidated LLCs	425	498	854	1,575
Hurricane insurance recovery proceeds in excess of damaged property write-downs	-	-	4,535	-
Hurricane business interruption insurance recovery proceeds	194	-	1,162	-
Gain on Arlington transaction	-	-	-	27,196
Interest expense, net	(2,421)	(2,462)	(4,889)	(5,137)
Net income	\$5,805	\$4,033	\$15,409	\$35,595
Basic earnings per share	\$0.42	\$0.30	\$1.12	\$2.62
Diluted earnings per share	\$0.42	\$0.30	\$1.12	\$2.62
Weighted average number of shares outstanding - Basic and Diluted	13,720	13,583	13,719	13,581

See accompanying notes to these condensed consolidated financial statements.

Universal Health Realty Income Trust

Condensed Consolidated Statements of Comprehensive Income

For the Three and Six Months Ended June 30, 2018 and 2017

(dollar amounts in thousands)

(unaudited)

	Three Months		Six Months Ended	
	Ended		June 30,	
	June 30,	June 30,	June 30,	June 30,
	2018	2017	2018	2017
Net income	\$5,805	\$4,033	\$15,409	\$35,595
Other comprehensive income/(loss):				
Unrealized derivative gain/(loss) on interest rate caps	6	(75)	154	(93)
Total other comprehensive income/(loss):	6	(75)	154	(93)
Total comprehensive income	\$5,811	\$3,958	\$15,563	\$35,502

See accompanying notes to these condensed consolidated financial statements.

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Universal Health Realty Income Trust

Condensed Consolidated Balance Sheets

(dollar amounts in thousands)

(unaudited)

	June 30, 2018	December 31, 2017
Assets:		
Real Estate Investments:		
Buildings and improvements and construction in progress	\$ 553,970	\$ 546,634
Accumulated depreciation	(163,434)	(153,379)
	390,536	393,255
Land	53,396	53,142
Net Real Estate Investments	443,932	446,397
Investments in limited liability companies ("LLCs")	4,655	4,671
Other Assets:		
Cash and cash equivalents	5,732	3,387
Base and bonus rent and other receivables from UHS	2,610	2,680
Rent receivable - other	6,829	6,422
Intangible assets (net of accumulated amortization of \$25.7 million and \$28.7 million at June 30, 2018 and December 31, 2017, respectively)	19,253	20,559
Deferred charges and other assets, net	7,991	5,892
Total Assets	\$ 491,002	\$ 490,008
Liabilities:		
Line of credit borrowings	\$ 197,250	\$ 181,050
Mortgage notes payable, non-recourse to us, net	52,806	75,359
Accrued interest	504	540
Accrued expenses and other liabilities	12,193	12,188
Dividends payable	9,156	-
Tenant reserves, deposits and deferred and prepaid rents	11,103	10,310
Total Liabilities	283,012	279,447
Equity:		
Preferred shares of beneficial interest, \$.01 par value; 5,000,000 shares authorized; none issued and outstanding	-	-
Common shares, \$.01 par value; 95,000,000 shares authorized; issued and outstanding: 2018 - 13,744,229; 2017 - 13,735,369	137	137
Capital in excess of par value	265,544	265,335

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Cumulative net income	633,529	618,120
Cumulative dividends	(691,518)	(673,175)
Accumulated other comprehensive income	298	144
Total Equity	207,990	210,561
Total Liabilities and Equity	\$491,002	\$ 490,008

See accompanying notes to these condensed consolidated financial statements.

Universal Health Realty Income Trust

Condensed Consolidated Statement of Cash Flows

(dollar amounts in thousands)

(unaudited)

	Six months ended June 30,	
	2018	2017
Cash flows from operating activities:		
Net income	\$ 15,409	\$ 35,595
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	12,288	12,476
Amortization of debt premium	(23)	(100)
Stock-based compensation expense	254	252
Hurricane insurance recovery proceeds in excess of damaged property write-downs	(4,535)	—
Gain on Arlington transaction	—	(27,196)
Changes in assets and liabilities:		
Rent receivable	(337)	(683)
Accrued expenses and other liabilities	(445)	(398)
Tenant reserves, deposits and deferred and prepaid rents	713	79
Accrued interest	(36)	(62)
Leasing costs paid	(597)	(403)
Other, net	517	783
Net cash provided by operating activities	23,208	20,343
Cash flows from investing activities:		
Investments in LLCs	(369)	(532)
Repayments of advances made to LLC	—	216
Cash distributions in excess of income from LLCs	501	734
Additions to real estate investments, net	(4,246)	(6,537)
Cash proceeds received from divestiture of property, net of restricted cash	—	53,967
Restricted cash proceeds from divestiture of property	—	11,253
Hurricane insurance recovery proceeds in excess of damaged property write-downs	4,535	—
Hurricane remediation payments	(192)	—
Deposits on real estate	—	(150)
Net cash paid for acquisition of property	(4,053)	—
Cash paid to acquire minority interests in majority-owned LLCs	—	(7,890)
Net cash (used in)/provided by investing activities	(3,824)	51,061
Cash flows from financing activities:		
Net borrowings/(repayments) on line of credit	16,200	(18,650)
Repayments of mortgage notes payable	(22,585)	(36,473)
Proceeds from mortgage notes payable	—	13,200
Financing costs paid	(1,527)	(284)
Dividends paid	(9,187)	(17,887)
Issuance of shares of beneficial interest, net	60	122

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Net cash used in financing activities	(17,039)	(59,972)
Increase in cash, cash equivalents and restricted cash	2,345	11,432
Cash, cash equivalents and restricted cash, beginning of period	3,387	3,930
Cash, cash equivalents and restricted cash, end of period	\$5,732	\$15,362
Supplemental disclosures of cash flow information:		
Interest paid	\$4,711	\$5,039

See accompanying notes to these condensed consolidated financial statements.

UNIVERSAL HEALTH REALTY INCOME TRUST

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2018

(unaudited)

(1) General

This Quarterly Report on Form 10-Q is for the quarter ended June 30, 2018. In this Quarterly Report, “we,” “us,” “our” and the “Trust” refer to Universal Health Realty Income Trust and its subsidiaries.

In this Quarterly Report on Form 10-Q, the term “revenues” does not include the revenues of the unconsolidated LLCs in which we have various non-controlling equity interests ranging from 33% to 95%. As of June 30, 2018, we had investments in four jointly-owned LLCs/LPs which own medical office buildings, all of which are accounted for by the equity method (see Note 5). These LLCs are included in our financial statements for all periods presented on an unconsolidated basis since they are not variable interest entities for which we are the primary beneficiary, nor do we hold a controlling voting interest.

The financial statements included herein have been prepared by us, without audit, pursuant to the rules and regulations of the SEC and reflect all normal and recurring adjustments which, in our opinion, are necessary to fairly present results for the interim periods. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although we believe that the accompanying disclosures are adequate to make the information presented not misleading. It is suggested that these financial statements be read in conjunction with the financial statements, the notes thereto and accounting policies included in our Annual Report on Form 10-K for the year ended December 31, 2017.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the amounts reported in our consolidated financial statements and accompanying notes. Certain prior period amounts on our statement of cash flows have been reclassified to conform to the current period presentation in connection with our adoption of ASU No. 2016-18, Restricted Cash.

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

Leases: We commenced operations in 1986 by purchasing properties of certain subsidiaries from UHS and immediately leasing the properties back to the respective subsidiaries. Most of the leases were entered into at the time we commenced operations and provided for initial terms of 13 to 15 years with up to six additional 5-year renewal terms. The current base rentals and lease and rental terms for each of the three hospital facilities leased to subsidiaries of UHS are provided below. The base rents are paid monthly and each lease also provides for additional or bonus rents which are computed and paid on a quarterly basis based upon a computation that compares current quarter revenue to a corresponding quarter in the base year. The three hospital leases with subsidiaries of UHS are unconditionally guaranteed by UHS and are cross-defaulted with one another.

The combined revenues generated from the leases on the UHS hospital facilities accounted for approximately 20% and 22% of our consolidated revenues for the three months ended June 30, 2018 and 2017, respectively, and approximately 21% and 23% of our consolidated revenues for the six months ended June 30, 2018 and 2017, respectively. In addition, we have seventeen medical office buildings (“MOBs”), or free-standing emergency departments (“FEDs”), that are either wholly or jointly-owned by us, that include tenants which are subsidiaries of UHS. The aggregate revenues generated from UHS-related tenants comprised approximately 28% and 32% of our consolidated revenues during the three-month periods ended June 30, 2018 and 2017, respectively, and approximately 30% and 32% of our consolidated revenues during the six-month periods ended June 30, 2018 and 2017, respectively.

Pursuant to the Master Lease Document by and among us and certain subsidiaries of UHS, dated December 24, 1986 (the “Master Lease”), which governs the leases of all hospital properties with subsidiaries of UHS, UHS has the option to renew the leases at the lease terms described below by providing notice to us at least 90 days prior to the termination of the then current term. UHS also has the right to purchase the respective leased facilities at the end of the lease terms or any renewal terms at the appraised fair market value. In addition, the Master Lease, as amended during 2006, includes a change of control provision whereby UHS has the right, upon one month’s notice should a change of control of the Trust occur, to purchase any or all of the three leased hospital properties listed below at their appraised fair market value. Additionally, UHS has rights of first refusal to: (i) purchase the respective leased facilities during and for 180 days after the lease terms at the same price, terms and conditions of any third-party offer, or; (ii) renew the lease on the respective leased facility at the end of, and for 180 days after, the lease term at the same terms and conditions pursuant to any third-party offer.

In June, 2018, McAllen Medical Center, a wholly-owned subsidiary of UHS, provided notice to us, exercising the 5-year renewal option on their lease. The renewal extended the lease term on this facility, at the existing lease rate, to December, 2026.

The table below details the existing lease terms and renewal options for our three acute care hospitals operated by wholly-owned subsidiaries of UHS:

Hospital Name	Annual		Renewal	
	Minimum	End of	Term	
	Rent	Lease Term	(years)	
McAllen Medical Center	\$5,485,000	December, 2026	5	(a)
Wellington Regional Medical Center	\$3,030,000	December, 2021	10	(b)
Southwest Healthcare System, Inland Valley Campus	\$2,648,000	December, 2021	10	(b)

(a) UHS has one 5-year renewal option at the existing lease rate (through 2031).

(b) UHS has two 5-year renewal options at fair market value lease rates (2022 through 2031).

Management cannot predict whether the leases with subsidiaries of UHS, which have renewal options at existing lease rates or fair market value lease rates, or any of our other leases, will be renewed at the end of their lease term. If the leases are not renewed at their current rates or the fair market value lease rates, we would be required to find other operators for those facilities and/or enter into leases on terms potentially less favorable to us than the current leases. In addition, if subsidiaries of UHS exercise their options to purchase the respective leased hospital or FED facilities upon expiration of the lease terms, our future revenues could decrease if we were unable to earn a favorable rate of return on the sale proceeds received, as compared to the rental revenue currently earned pursuant to these leases.

In April, 2017, the recently constructed Henderson Medical Plaza MOB received its certificate of occupancy. Henderson Medical Plaza is located on the campus of the Henderson Hospital Medical Center, a newly constructed acute care hospital that is owned and operated by a subsidiary of UHS and was completed and opened during the fourth quarter of 2016. A ground lease has been executed between the limited liability company that owns the MOB and a subsidiary of UHS, the terms of which include a seventy-five year lease term with two, ten-year renewal options at the lessee's option at an adjusting lease rate. We have invested net cash of approximately \$13.0 million on the development and construction of this MOB as of June 30, 2018.

Advisory Agreement: UHS of Delaware, Inc. (the "Advisor"), a wholly-owned subsidiary of UHS, serves as Advisor to us under an Advisory Agreement (the "Advisory Agreement") dated December 24, 1986. Pursuant to the Advisory Agreement, the Advisor is obligated to present an investment program to us, to use its best efforts to obtain investments suitable for such program (although it is not obligated to present any particular investment opportunity to us), to provide administrative services to us and to conduct our day-to-day affairs. All transactions between us and UHS must be approved by the Trustees who are unaffiliated with UHS (the "Independent Trustees"). In performing its services under the Advisory Agreement, the Advisor may utilize independent professional services, including accounting, legal, tax and other services, for which the Advisor is reimbursed directly by us. The Advisory Agreement may be terminated for any reason upon sixty days written notice by us or the Advisor. The Advisory Agreement expires on December 31 of each year; however, it is renewable by us, subject to a determination by the Independent Trustees, that the Advisor's performance has been satisfactory. Our advisory fee is 0.70% of our average invested real estate assets, as derived from our consolidated balance sheet. In December of 2017, based upon a review of our advisory fee and other general and administrative expenses as compared to an industry peer group, the Advisory Agreement was renewed for 2018 pursuant to the same terms as the Advisory Agreement in place since 2013.

The average real estate assets for advisory fee calculation purposes exclude certain items from our consolidated balance sheet such as, among other things, accumulated depreciation, cash and cash equivalents, base and bonus rent receivables, deferred charges and other assets. The advisory fee is payable quarterly, subject to adjustment at year-end based upon our audited financial statements. In addition, the Advisor is entitled to an annual incentive fee equal to 20% of the amount by which cash available for distribution to shareholders for each year, as defined in the Advisory Agreement, exceeds 15% of our equity as shown on our consolidated balance sheet, determined in accordance with generally accepted accounting principles without reduction for return of capital dividends. The Advisory Agreement defines cash available for distribution to shareholders as net cash flow from operations less deductions for, among other things, amounts required to discharge our debt and liabilities and reserves for replacement and capital improvements to our properties and investments. No incentive fees were paid at any time since our inception since the incentive fee requirements were not achieved. Advisory fees incurred and paid (or payable) to UHS amounted to \$948,000 and \$874,000 for the three months ended June 30, 2018 and 2017, respectively, and were based upon average invested real estate assets of \$542 million and \$499 million for the three-month periods ended June 30, 2018 and 2017, respectively. Advisory fees incurred and paid (or payable) to UHS amounted to \$1.9 million and \$1.7 million for the six months ended June 30, 2018 and 2017, respectively, and were based upon average invested real estate assets of \$529 million and \$497 million for the six-month periods ended June 30, 2018 and 2017, respectively

Officers and Employees: Our officers are all employees of a wholly-owned subsidiary of UHS and although as of June 30, 2018 we had no salaried employees, our officers do typically receive annual stock-based compensation awards in the form of restricted stock.

In special circumstances, if warranted and deemed appropriate by the Compensation Committee of the Board of Trustees, our officers may also receive one-time special compensation awards in the form of restricted stock and/or cash bonuses.

Share Ownership: At each of June 30, 2018 and December 31, 2017, UHS owned 5.7%, of our outstanding shares of beneficial interest.

SEC reporting requirements of UHS: UHS is subject to the reporting requirements of the SEC and is required to file annual reports containing audited financial information and quarterly reports containing unaudited financial information. Since the aggregate revenues generated from the UHS-related tenants comprised 28% and 32% of our consolidated revenues during the three-month periods ended June 30, 2018 and 2017, respectively, and 30% and 32% of our consolidated revenues during the six-month periods ended June 30, 2018 and 2017, respectively, and since a subsidiary of UHS is our Advisor, you are encouraged to obtain the publicly available filings for Universal Health Services, Inc. from the SEC's website. These filings are the sole responsibility of UHS and are not incorporated by reference herein.

(3) Dividends

Dividends:

We declared dividends of \$9.2 million, or \$.67 per share, during the second quarter of 2018, which were paid on July 3, 2018. We declared and paid dividends of \$9.0 million, or \$.66 per share, during the second quarter of 2017. During the six-month period ended June 30, 2018, we declared dividends of \$18.3 million, or \$1.335 per share, \$9.2 million of which was paid on July 3, 2018. We declared and paid dividends of \$17.9 million, or \$1.315 per share, during the six-month period ended June 30, 2017.

(4) Acquisitions and Dispositions

Six Months Ended June 30, 2018:

Acquisitions:

In June, 2018, we acquired the Beaumont Medical Sleep Center Building located in Southfield, Michigan for a purchase price of approximately \$4.0 million. This building is 100% leased under the terms of a triple net lease with a remaining initial lease term of approximately 9.5 years at the time of purchase, with two, five year renewal options.

Dispositions:

There were no dispositions during the first six months of 2018.

Six Months Ended June 30, 2017:

Acquisitions:

There were no acquisitions during the first six months of 2017.

Disposition:

During March, 2017, Arlington Medical Properties, LLC, a formerly jointly-owned limited liability company in which we held an 85% noncontrolling ownership interest, sold the real estate assets of St. Mary's Professional Office Building ("St. Mary's") as part of a series of planned tax deferred like-kind exchange transactions pursuant to Section 1031 of the Internal Revenue Code. St. Mary's is a multi-tenant medical office building located in Reno, Nevada. A third party member owned the remaining 15% of Arlington Medical Properties LLC, which we acquired prior to the divestiture of St. Mary's for a purchase price of \$7.9 million. The divestiture of St. Mary's generated an aggregate of approximately \$57.3 million of net cash proceeds to us (approximately \$11.3 million of which was held as restricted cash by a qualified 1031 exchange intermediary until the third quarter of 2017). These proceeds, which were net of closing costs and the purchase price paid for the minority member's ownership interest in the LLC, include repayment to us of a \$21.4 million member loan. Our results of operations for the six-month period ended June 30, 2017 included a net gain of \$27.2 million (net of related transaction costs) recorded in connection with this transaction.

(5) Summarized Financial Information of Equity Affiliates

In accordance with the Financial Accounting Standards Board's ("FASB") standards and guidance relating to accounting for investments and real estate ventures, we account for our unconsolidated investments in LLCs/LPs which we do not control using the equity method. The third-party members in these investments have equal voting rights with regards to issues such as, but not limited to: (i) divestiture of property; (ii) annual budget approval, and; (iii) financing commitments. These investments, which represent 33% to 95% non-controlling ownership interests, are recorded initially at our cost and subsequently adjusted for our net equity in the net income, cash contributions to, and distributions from, the investments. Pursuant to certain agreements, allocations of sales proceeds

and profits and losses of some of the LLC investments may be allocated disproportionately as compared to ownership interests after specified preferred return rate thresholds have been satisfied.

In the Condensed Consolidated Statements of Cash Flows, distributions and equity in net income are presented net as cash flows from operating activities. Cumulative distributions received exceeding cumulative equity in earnings represent returns of investments and are classified as cash flows from investing activities in the Condensed Consolidated Statements of Cash Flows.

At June 30, 2018, we have non-controlling equity investments or commitments in four jointly-owned LLCs/LPs which own MOB. As of June 30, 2018, we accounted for these LLCs/LPs on an unconsolidated basis pursuant to the equity method since they are not variable interest entities and we do not have a controlling voting interest. The majority of these entities are joint-ventures between us and non-related parties that hold minority ownership interests in the entities. Each entity is generally self-sustained from a cash flow perspective and generates sufficient cash flow to meet its operating cash flow requirements and service the third-party debt (if applicable) that is non-recourse to us. Although there is typically no ongoing financial support required from us to these entities since they are cash-flow sufficient, we may, from time to time, provide funding for certain purposes such as, but not limited to, significant capital expenditures, leasehold improvements and debt financing. Although we are not obligated to do so, if approved by us at our sole discretion, additional cash fundings are typically advanced as equity or member loans. These entities maintain property insurance on the properties.

The following property table represents the four LLCs in which we own a noncontrolling interest and were accounted for under the equity method as of June 30, 2018:

Name of LLC/LP	Ownership	Property Owned by LLC/LP
Suburban Properties	33 %	St. Matthews Medical Plaza II
Brunswick Associates (a.)	74 %	Mid Coast Hospital MOB
Grayson Properties (b.)	95 %	Texoma Medical Plaza
FTX MOB Phase II (c.)	95 %	Forney Medical Plaza II

(a.) This LLC has a third-party term loan, which is non-recourse to us, of \$8.4 million outstanding as of June 30, 2018.

(b.) This building is on the campus of a UHS hospital and has tenants that include subsidiaries of UHS. This LP has a third-party term loan, which is non-recourse to us, of \$14.1 million outstanding as of June 30, 2018.

(c.) We have committed to invest up to \$2.5 million in equity and debt financing, of which \$2.1 million has been funded as of June 30, 2018. This LP has a third-party term loan, which is non-recourse to us, of \$5.1 million outstanding as of June 30, 2018.

Below are the condensed combined statements of income (unaudited) for the LLCs/LPs accounted for under the equity method during the three and six months ended June 30, 2018 and 2017. The six months ended June 30, 2017 include the financial results of Arlington Medical Properties, LLC, through the March 13, 2017 divestiture date.

Three Months Ended	Six Months Ended
June 30,	June 30,

	2018	2017	2018	2017
	(amounts in thousands)		(amounts in thousands)	
Revenues	\$2,451	\$2,410	\$4,913	\$5,993
Operating expenses	977	939	1,935	2,189
Depreciation and amortization	438	421	895	1,064
Interest, net	328	337	656	899
Net income	\$708	\$713	\$1,427	\$1,841
Our share of net income (a.)	\$425	\$498	\$854	\$1,575

(a.) Our share of net income for the six months ended June 30, 2017 includes approximately \$284,000 of interest income earned by us on an advance made to Arlington Medical Properties, LLC. This advance was repaid to us effective with the previously mentioned Arlington Medical Properties, LLC transaction during March, 2017, therefore there was no interest income earned by us on this advance subsequent to March, 2017.

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Below are the condensed combined balance sheets (unaudited) for the four above-mentioned LLCs that were accounted for under the equity method as of June 30, 2018 and December 31, 2017:

	June 30, December 31,	
	2018	2017
	(amounts in thousands)	
Net property, including construction in progress	\$32,345	\$ 33,111
Other assets	3,659	3,560
Total assets	\$36,004	\$ 36,671
Other liabilities	\$2,654	\$ 3,067
Mortgage notes payable, non-recourse to us	27,548	27,839
Equity	5,802	5,765
Total liabilities and equity	\$36,004	\$ 36,671
Investments in LLCs before amounts included in		
accrued expenses and other liabilities	\$4,655	\$ 4,671
Amounts included in accrued expenses and other liabilities	(2,011)	(1,895)
Our share of equity in LLCs, net	\$2,644	\$ 2,776

As of June 30, 2018, and December 31, 2017, aggregate principal amounts due on mortgage notes payable by unconsolidated LLCs, which are accounted for under the equity method and are non-recourse to us, are as follows (amounts in thousands):

Name of LLC/LP	Mortgage Loan		Maturity Date
	Balance (a.)		
	6/30/2018	12/31/2017	
FTX MOB Phase II (5.00% fixed rate mortgage loan)	\$5,134	\$ 5,202	October, 2020
Grayson Properties (5.034% fixed rate mortgage loan)	14,060	14,191	September, 2021
Brunswick Associates (3.64% fixed rate mortgage loan)	8,354	8,446	December, 2024
	\$27,548	\$ 27,839	

(a.) All mortgage loans require monthly principal payments through maturity and include a balloon principal payment upon maturity.

Pursuant to the operating and/or partnership agreements of the four LLCs/LPs in which we continue to hold non-controlling ownership interests, the third-party member and/or the Trust, at any time, potentially subject to certain conditions, have the right to make an offer (“Offering Member”) to the other member(s) (“Non-Offering Member”) in which it either agrees to: (i) sell the entire ownership interest of the Offering Member to the Non-Offering Member (“Offer to Sell”) at a price as determined by the Offering Member (“Transfer Price”), or; (ii) purchase the entire ownership interest of the Non-Offering Member (“Offer to Purchase”) at the equivalent proportionate Transfer Price. The Non-Offering Member has 60 to 90 days to either: (i) purchase the entire ownership interest of the Offering Member at the Transfer Price, or; (ii) sell its entire ownership interest to the Offering Member at the equivalent proportionate Transfer Price. The closing of the transfer must occur within 60 to 90 days of the acceptance by the Non-Offering Member.

(6) Recent Accounting Pronouncements

On January 1, 2018, we adopted ASU No. 2016-15, Classification of Certain Cash Receipts and Cash Payments, which adds or clarifies guidance of the classification of certain cash receipts and payments in the statement of cash flows, and ASU 2016-18, Restricted Cash, which requires an entity to show the changes in total cash, cash equivalents, restricted cash and restricted cash equivalents in the statement of cash flows. We adopted these ASUs by applying a retrospective transition method which requires a reclassification of our Consolidated Statement of Cash Flows for the period ending June 30, 2017. The following table provides a reconciliation of cash, cash equivalents and restricted cash in our Consolidated Balance Sheets to the total amount shown in our Consolidated Statements of Cash Flows:

(In thousands)	June	
	30, 2018	June 30, 2017
Cash and cash equivalents	\$5,732	\$4,109
Restricted cash	-	11,253
Total Cash, Cash Equivalents and Restricted Cash	\$5,732	\$15,362

In February 2016, the FASB issued ASU 2016-02, Leases (“ASU 2016-02”), which introduces a lessee model that brings most leases on the balance sheet and, among other changes, eliminates the requirement in current Generally Accepted Accounting Principles in the United States of America (“GAAP”) for an entity to use bright-line tests in determining lease classification. The FASB also issued an Exposure Draft on January 5, 2018 proposing to amend ASU 2016-02, which would provide lessors with a practical expedient, by class of underlying assets, to not separate non-lease components from the related lease components and, instead, to account for those components as a single lease component, if certain criteria are met. ASU 2016-02 and the related Exposure Draft are not effective for us until January 1, 2019, with early adoption permitted. We are continuing to evaluate this guidance and the impact to us, as both lessor and lessee, on our Consolidated Financial Statements.

On January 1, 2018, we adopted ASU 2014-09, Revenue From Contracts With Customers (“ASU 2014-09”), which outlines a comprehensive model for entities to use in accounting for revenue arising from contracts with customers. We adopted the standard on January 1, 2018, using the modified retrospective approach, which requires a cumulative-effect adjustment to equity as of the date of adoption. ASU 2014-09 states that “an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.” While ASU 2014-09 specifically references contracts with customers, it may apply to certain other transactions such as the sale of real estate or equipment. The adoption of this standard did not have a significant impact on our consolidated financial statements and no cumulative adjustment was recorded upon adoption, as a substantial portion of our revenue consists of rental income from leasing arrangements, which is specifically excluded from ASU 2014-09.

Our revenues consist primarily of rentals received from tenants, which are comprised of minimum rent (base rentals) and bonus rentals and reimbursements from tenants for their pro-rata share of expenses such as common area maintenance costs, real estate taxes and utilities. We apply FASB ASC Topic 606, “Revenue from Contracts with Customers” with respect to tenant reimbursement and other property income, which totaled \$2.8 million and \$2.5 million for the three months ended June 30, 2018 and 2017, respectively, and \$5.5 million and \$4.9 million for the six months ended June 30, 2018 and 2017, respectively. The 2018 three and six month tenant reimbursement and other property income amounts also include a \$1.7 million early lease termination fee recorded during the three months ended June 30, 2018. Tenant reimbursements for operating expenses are accrued as revenue and generally due monthly from tenants. Since payments with respect to tenant reimbursement income are generally due monthly, no contract assets or liabilities have been recognized. Revenue consisting of rental income from leasing arrangements are specifically excluded from FASB ASC Topic 606.

(7) Debt and Financial Instruments

Debt:

Management routinely monitors and analyzes the Trust’s capital structure in an effort to maintain the targeted balance among capital resources including the level of borrowings pursuant to our \$300 million revolving credit agreement, the level of borrowings pursuant to non-recourse mortgage debt secured by the real property of our properties and our level of equity including consideration of additional equity issuances. This ongoing analysis considers factors such as the current debt market and interest rate environment, the current/projected occupancy and financial performance of our properties, the current loan-to-value ratio of our properties, the Trust’s current stock price, the capital resources required for anticipated acquisitions and the expected capital to be generated by anticipated divestitures. This analysis, together with consideration of the Trust’s current balance of revolving credit agreement borrowings, non-recourse

mortgage borrowings and equity, assists management in deciding which capital resource to utilize when events such as refinancing of specific debt components occur or additional funds are required to finance the Trust's growth.

On March 27, 2018, we entered into a revolving credit agreement ("Credit Agreement") which, among other things, increased our borrowing capacity by \$50 million to \$300 million and extended the maturity date from our previously existing facility. The replacement Credit Agreement, which is scheduled to mature in March, 2022, includes a \$40 million sublimit for letters of credit and a \$30 million sub limit for swingline/short-term loans. The Credit Agreement also provides for options to extend the maturity date for two additional six month periods. Additionally, the Credit Agreement includes an option to increase the total facility borrowing capacity up to an additional \$50 million, subject to lender agreement. Borrowings under the Credit Agreement are guaranteed by certain subsidiaries of the Trust. In addition, borrowings under the Credit Agreement are secured by first priority security interests in and liens on all equity interests in certain of the Trust's wholly-owned subsidiaries. Borrowings made pursuant to the Credit Agreement will bear interest, at our option, at one, two, three, or six month LIBOR plus an applicable margin ranging from 1.10% to 1.35% or at the Base Rate plus an applicable margin ranging from 0.10% to 0.35%. The Credit Agreement defines "Base Rate" as the greater of: (a) the administrative agent's prime rate; (b) the federal funds effective rate plus 1/2 of 1%, and; (c) one month LIBOR plus 1%. A facility fee of 0.15% to 0.35% will be charged on the total commitment of the Credit Agreement. The margins over LIBOR, Base Rate and the facility fee are based upon our total leverage ratio. At June 30, 2018, the applicable margin over the LIBOR rate was 1.15%, the margin over the Base Rate was 0.15%, and the facility fee was 0.20%.

At June 30, 2018, we had \$197.3 million of outstanding borrowings under our Credit Agreement and \$102.7 million of available borrowing capacity. There are no compensating balance requirements. As disclosed below, during the first six months of 2018, we repaid an aggregate of \$21.7 million on three mortgages utilizing borrowings under our Credit Agreement.

The Credit Agreement contains customary affirmative and negative covenants, including limitations on certain indebtedness, liens, acquisitions and other investments, fundamental changes, asset dispositions and dividends and other distributions. The Credit Agreement also contains restrictive covenants regarding the Trust's ratio of total debt to total assets, the fixed charge coverage ratio, the ratio of total secured debt to total asset value, the ratio of total unsecured debt to total unencumbered asset value, and minimum tangible net worth, as well as customary events of default, the occurrence of which may trigger an acceleration of amounts outstanding under the Credit Agreement. We are in compliance with all of the covenants at June 30, 2018. We also believe that we would remain in compliance if the full amount of our commitment was borrowed.

The following table includes a summary of the required compliance ratios, giving effect to the covenants contained in the Credit Agreement (dollar amounts in thousands):

		June 30,	
	Covenant	2018	
Tangible net worth	$\geq \$125,000$	\$188,737	
Total leverage	$< 60\%$	39.9	%
Secured leverage	$< 30\%$	8.1	%
Unencumbered leverage	$< 60\%$	36.2	%
Fixed charge coverage	$> 1.50x$	4.1x	

As indicated on the following table, we have eight mortgages, all of which are non-recourse to us, included on our condensed consolidated balance sheet as of June 30, 2018 (amounts in thousands):

Facility Name	Outstanding		
	Balance	Interest	Maturity
	(in thousands)	Rate	Date
Vibra Hospital-Corpus Christi fixed rate mortgage loan	\$ 2,573	6.50 %	July, 2019
700 Shadow Lane and Goldring MOB's fixed rate mortgage loan	5,961	4.54 %	June, 2022
BRB Medical Office Building fixed rate mortgage loan	6,028	4.27 %	December, 2022
Desert Valley Medical Center fixed rate mortgage loan	4,877	3.62 %	January, 2023
2704 North Tenaya Way fixed rate mortgage loan	6,940	4.95 %	November, 2023
Summerlin Hospital Medical Office Building III fixed	13,198	4.03 %	April, 2024

rate mortgage loan			
Tuscan Professional Building fixed rate mortgage loan	4,273	5.56	% June, 2025
Phoenix Children’s East Valley Care Center fixed rate			
mortgage loan	9,307	3.95	% January, 2030
Total, excluding net debt premium and net financing fees	53,157		
Less net financing fees	(625)	
Plus net debt premium	274		
Total mortgages notes payable, non-recourse to us, net	\$ 52,806		

- (a.) All mortgage loans require monthly principal payments through maturity and either fully amortize or include a balloon principal payment upon maturity.

On February 13, 2018, upon its maturity, a \$4.1 million floating rate mortgage loan on the Sparks Medical Building/Vista Medical Terrace was fully repaid utilizing borrowings under our Credit Agreement.

On April 5, 2018, upon its maturity, a \$9.7 million floating rate mortgage loan on the Centennial Hills Medical Office Building was fully repaid utilizing borrowings under our Credit Agreement.

On May 2, 2018, upon its maturity, a \$7.9 million fixed rate mortgage loan on the Rosenberg Children's Medical Plaza was fully repaid utilizing borrowings under our Credit Agreement.

The mortgages are secured by the real property of the buildings as well as property leases and rents. The eight mortgages outstanding as of June 30, 2018 had a combined fair value of approximately \$53.0 million. The fair value of our debt was computed based upon quotes received from financial institutions. We consider these to be "level 2" in the fair value hierarchy as outlined in the authoritative guidance for disclosure in connection with debt instruments. Changes in market rates on our fixed rate debt impacts the fair value of debt, but it has no impact on interest incurred or cash flow.

At December 31, 2017, we had eleven mortgages, all of which were non-recourse to us, included in our consolidated balance sheet. The combined outstanding balance of these eleven mortgages was \$75.7 million and had a combined fair value of approximately \$76.3 million.

Financial Instruments:

During the second quarter of 2016, we entered into an interest rate cap on the total notional amount of \$30 million whereby we paid a premium of \$115,000. In exchange for the premium payment, the counterparties agreed to pay us the difference between 1.50% and one-month LIBOR if one-month LIBOR rises above 1.50% during the term of the cap. This interest rate cap became effective in January, 2017 and expires in March, 2019. From inception through June 30, 2018, we received or accrued approximately \$39,000 in payments made to us by the counterparties (all received during the first six months of 2018) pursuant to the terms of these caps.

During the third quarter of 2016, we entered into an additional interest rate cap agreement on a total notional amount of \$30 million whereby we paid a premium of \$55,000. In exchange for the premium payment, the counterparties agreed to pay us the difference between 1.5% and one-month LIBOR if one-month LIBOR rises above 1.5% during the term of the cap. This interest rate cap became effective in October, 2016 and expires in March, 2019. From inception through June 30, 2018, we received or accrued approximately \$39,000 in payments made to us by the counterparties (all received during the first six months of 2018) pursuant to the terms of these caps.

(8) Segment Reporting

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

Our portfolio is located throughout the United States, however, we do not distinguish or group our operations on a geographical basis for purposes of allocating resources or measuring performance. We review operating and financial data for each property on an individual basis; therefore, we define an operating segment as our individual properties. Individual properties have been aggregated into one reportable segment based upon their similarities with regard to both the nature and economics of the facilities, tenants and operational processes, as well as long-term average financial performance. No individual property meets the requirements necessary to be considered its own segment.

(9) Impact of Hurricane Harvey

In late August, 2017, five of our medical office buildings listed below located in the Houston, Texas area incurred extensive water damage as a result of Hurricane Harvey. Until various times during the second quarter of 2018, these properties were temporarily closed and non-operational as we continued to reconstruct and restore them to operational condition. As of June 30, 2018, reconstruction on all of the occupied space in these properties has been completed and operations have resumed.

During 2018, pursuant to the terms of a global settlement with our commercial property insurance carrier, we received \$5.5 million of additional insurance recovery proceeds bringing the aggregate hurricane-related insurance recoveries to \$12.5 million. The aggregate insurance proceeds recoveries, which are net of applicable deductibles, covered substantially all of the costs incurred related to the remediation, repair and reconstruction of each of these properties as well as business interruption recoveries for the lost income related to each of these properties during the period they were non-operational.

Our financial results for the three months ended June 30, 2018 include approximately \$194,000 of business interruption insurance recovery proceeds. Our financial results for the six months ended June 30, 2018 include approximately \$1.2 million of business interruption insurance recovery proceeds, covering the period of late August, 2017 through June 30, 2018, approximately \$500,000 of which relates to 2017. These business interruption insurance recovery proceeds are included in net cash provided by operating activities in our condensed consolidated statement of cash flows for the six-month period ended June 30, 2018. Additionally, the six months ended June 30, 2018 includes approximately \$4.5 million of hurricane insurance recoveries in excess of property damage write-downs, which are included in net cash provided by investing activities in our condensed consolidated statement of cash flows for the six-month period ended June 30, 2018.

Our properties damaged and temporarily closed from Hurricane Harvey were:

- ◆ Cypresswood Professional Center – located in Spring, Texas and consisting of two MOBs.
- ◆ Professional Buildings at King’s Crossing – located in Kingwood, Texas and consisting of two MOBs.
- ◆ Kelsey-Seybold Clinic at King’s Crossing – located in Kingwood, Texas and consisting of one MOB.

15

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

Overview

We are a real estate investment trust ("REIT") that commenced operations in 1986. We invest in healthcare and human service related facilities currently including acute care hospitals, rehabilitation hospitals, sub-acute facilities, surgery centers, free-standing emergency departments, childcare centers and medical/office buildings. As of July 31, 2018, we have sixty-nine real estate investments located in twenty states consisting of:

- six hospital facilities consisting of three acute care, one rehabilitation and two sub-acute;
- fifty-five medical/office buildings, including four owned by unconsolidated limited liability companies ("LLCs")/limited liability partnerships ("LPs");
- four free-standing emergency departments ("FEDs"), and;
- four pre-school and childcare centers.

Forward Looking Statements and Certain Risk Factors

You should carefully review all of the information contained in this Quarterly Report, and should particularly consider any risk factors that we set forth in this Quarterly Report and in other reports or documents that we file from time to time with the Securities and Exchange Commission (the "SEC"). In this Quarterly Report, we state our beliefs of future events and of our future financial performance. In some cases, you can identify those so-called "forward-looking statements" by words such as "may," "will," "should," "could," "would," "predicts," "potential," "continue," "expects," "anticipates," "intends," "plans," "believes," "estimates," "appears," "projects" and similar expressions, as well as statements in future tense. You should be aware that those statements are only our predictions. Actual events or results may differ materially. In evaluating those statements, you should specifically consider various factors, including the risks outlined herein and in our Annual Report on Form 10-K for the year ended December 31, 2017 in Item 1A Risk Factors and in Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations—Forward Looking Statements. Those factors may cause our actual results to differ materially from any of our forward-looking statements.

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

- a substantial portion of our revenues are dependent upon one operator, Universal Health Services, Inc. ("UHS"). We cannot assure you that subsidiaries of UHS will renew the leases on our three acute care hospitals (two of which are scheduled to expire in December, 2021 and one of which is scheduled to expire in December, 2026) and two FEDs at existing lease rates or fair market value lease rates. In addition, if subsidiaries of UHS exercise their options to purchase the respective leased hospital facilities and FEDs upon expiration of the lease terms, our future revenues and results of operations could decrease if we were unable to earn a favorable rate of return on the sale proceeds received, as compared to the rental revenue currently earned pursuant to these leases;
- in certain of our markets, the general real estate market has been unfavorably impacted by increased competition/capacity and decreases in occupancy and rental rates which may adversely impact our operating results and the underlying value of our properties;
- a number of legislative initiatives have recently been passed into law that may result in major changes in the health care delivery system on a national or state level to the operators of our facilities, including UHS. No assurances can be given that the implementation of these new laws will not have a material adverse effect on the business, financial condition or results of operations of our operators;

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the potential indirect impact of the Tax Cuts and Jobs Act of 2017 (the “2017 Tax Act”), signed into law on December 22, 2017, which makes significant changes to corporate and individual tax rates and calculation of taxes, which could potentially impact our tenants and jurisdictions, both positively and negatively, in which we do business, as well as the overall investment thesis for REITs;

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

• lost revenues resulting from the exercise of purchase options, lease expirations and renewals and other restructuring;

16

- our ability to continue to obtain capital on acceptable terms, including borrowed funds, to fund future growth of our business;
 - the outcome and effects of known and unknown litigation, government investigations, and liabilities and other claims asserted against us, UHS or the other operators of our facilities. UHS and its subsidiaries are subject to pending legal actions, purported shareholder class actions and shareholder derivative cases, governmental investigations and regulatory actions and the effects of adverse publicity relating to such matters. Since UHS comprised approximately 30% of our consolidated revenues during the six-month period ended June 30, 2018, and since a subsidiary of UHS is our Advisor, you are encouraged to obtain and review the disclosures contained in the Legal Proceedings section of Universal Health Services, Inc.'s Forms 10-Q and 10-K, as publicly filed with the Securities and Exchange Commission. Those filings are the sole responsibility of UHS and are not incorporated by reference herein;
 - failure of UHS or the other operators of our hospital facilities to comply with governmental regulations related to the Medicare and Medicaid licensing and certification requirements could have a material adverse impact on our future revenues and the underlying value of the property;
 - the potential unfavorable impact on our business of deterioration in national, regional and local economic and business conditions, including a worsening of credit and/or capital market conditions, which may adversely affect our ability to obtain capital which may be required to fund the future growth of our business and refinance existing debt with near term maturities;
 - a deterioration in general economic conditions which could result in increases in the number of people unemployed and/or insured and likely increase the number of individuals without health insurance; as a result, the operators of our facilities may experience decreases in patient volumes which could result in decreased occupancy rates at our medical office buildings;
 - a worsening of the economic and employment conditions in the United States could materially affect the business of our operators, including UHS, which may unfavorably impact our future bonus rentals (on the UHS hospital facilities) and may potentially have a negative impact on the future lease renewal terms and the underlying value of the hospital properties;
- &n