

UNIVERSAL HEALTH REALTY INCOME TRUST

Form 10-Q

May 08, 2008

[Table of Contents](#)

**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 March 31, 2008

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)

<b>MARYLAND</b> (State or other jurisdiction of Incorporation or Organization)	<b>23-6858580</b> (I. R. S. Employer Identification No.)
--	--

**UNIVERSAL CORPORATE CENTER**

**367 SOUTH GULPH ROAD**

**KING OF PRUSSIA, PENNSYLVANIA 19406**

(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 is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in, Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated Filer  Non-accelerated filer  Smaller reporting company

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

Number of common shares of beneficial interest outstanding at April 30, 2008 11,848,609

**Table of Contents**

UNIVERSAL HEALTH REALTY INCOME TRUST

INDEX

	<b>PAGE NO.</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
Item 1. Financial Statements	
<u>Condensed Consolidated Statements of Income Three Months Ended March 31, 2008 and 2007</u>	3
<u>Condensed Consolidated Balance Sheets March 31, 2008 and December 31, 2007</u>	4
<u>Condensed Consolidated Statements of Cash Flows Three Months Ended March 31, 2008 and 2007</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6 through 13
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	14 through 20
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	20
<u>Item 4. Controls and Procedures</u>	21
<b><u>PART II. Other Information</u></b>	22
<u>Item 1A. Risk Factors</u>	22
<u>Item 6. Exhibits</u>	22
<u>Signatures</u>	23
<b><u>EXHIBIT INDEX</u></b>	24

**Table of Contents****PART I. FINANCIAL INFORMATION****UNIVERSAL HEALTH REALTY INCOME TRUST****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****For the Three Months Ended March 31, 2008 and 2007**

(amounts in thousands, except per share amounts)

(unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Revenues:</b>		
Base rental UHS facilities	\$ 3,062	\$ 3,062
Base rental Non-related parties	2,397	2,335
Bonus rental UHS facilities	1,008	1,037
Tenant reimbursements and other Non-related parties	488	585
Tenant reimbursements and other UHS facilities	24	24
	6,979	7,043
<b>Expenses:</b>		
Depreciation and amortization	1,406	1,260
Advisory fees to UHS	367	351
Other operating expenses	1,135	1,141
	2,908	2,752
Income before equity in income of unconsolidated limited liability companies ( LLCs ), replacement property recovered from UHS (Chalmette) and interest expense	4,071	4,291
Equity in income of unconsolidated LLCs (including recognition of gain on sale of real property of \$252 during the three months ended March 31, 2007)	612	947
Replacement property recovered from UHS Chalmette		789
Interest expense	(525)	(362)
Income from continuing operations	4,158	5,665
Income from discontinued operations, net		146
<b>Net income</b>	<b>\$ 4,158</b>	<b>\$ 5,811</b>
<b>Basic earnings per share:</b>		
From continuing operations	\$ 0.35	\$ 0.48
From discontinued operations	\$ 0.00	\$ 0.01
<b>Total basic earnings per share</b>	<b>\$ 0.35</b>	<b>\$ 0.49</b>
<b>Diluted earnings per share:</b>		
From continuing operations	\$ 0.35	\$ 0.48
From discontinued operations	\$ 0.00	\$ 0.01

## Edgar Filing: UNIVERSAL HEALTH REALTY INCOME TRUST - Form 10-Q

Total diluted earnings per share	\$ 0.35	\$ 0.49
Weighted average number of shares outstanding Basic	11,843	11,792
Weighted average number of share equivalents	38	113
Weighted average number of shares and equivalents outstanding Diluted	11,881	11,905

See accompanying notes to condensed consolidated financial statements.

**Table of Contents**

**UNIVERSAL HEALTH REALTY INCOME TRUST**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(dollar amounts in thousands)

(unaudited)

	March 31, 2008	December 31, 2007
<b>Assets:</b>		
<b>Real Estate Investments:</b>		
Buildings and improvements	\$ 186,255	\$ 178,655
Accumulated depreciation	(62,016)	(60,627)
	124,239	118,028
Land	18,819	18,258
Construction in progress	8,808	7,511
Net Real Estate Investments	151,866	143,797
Investments in and advances to limited liability companies ( LLCs )	53,416	52,030
<b>Other Assets:</b>		
Cash and cash equivalents	1,089	1,131
Bonus rent receivable from UHS	1,008	960
Rent receivable - other	536	746
Deferred charges, notes receivable and other assets, net	2,942	1,085
<b>Total Assets</b>	<b>\$ 210,857</b>	<b>\$ 199,749</b>
<b>Liabilities and Shareholders' Equity:</b>		
<b>Liabilities:</b>		
Line of credit borrowings	\$ 25,800	\$ 16,800
Mortgage note payable, non-recourse to us	7,041	3,717
Mortgage and construction loans payable of consolidated LLCs, non-recourse to us	16,851	16,100
Accrued interest	106	125
Accrued expenses and other liabilities	2,462	1,874
Tenant reserves, escrows, deposits and prepaid rents	716	741
<b>Total Liabilities</b>	<b>52,976</b>	<b>39,357</b>
Minority interests	86	87
<b>Shareholders' Equity:</b>		
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: 2008 - 11,848,545; 2007 - 11,841,938	118	118
Capital in excess of par value	188,840	188,638
Cumulative net income	331,223	327,065
Cumulative dividends	(362,386)	(355,516)
<b>Total Shareholders' Equity</b>	<b>157,795</b>	<b>160,305</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 210,857</b>	<b>\$ 199,749</b>

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****UNIVERSAL HEALTH REALTY INCOME TRUST****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(amounts in thousands)

(unaudited)

	<b>Three months ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 4,158	\$ 5,811
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,406	1,291
Gain on sale of real property by a limited liability company ( LLC )		(252)
Replacement property recovered from UHS Chalmette		(789)
Changes in assets and liabilities:		
Rent receivable	162	123
Accrued expenses and other liabilities	27	(39)
Tenant reserves, escrows, deposits and prepaid rents	(25)	35
Accrued interest	(19)	(6)
Other, net	163	113
<b>Net cash provided by operating activities</b>	<b>5,872</b>	<b>6,287</b>
<b>Cash Flows from Investing Activities:</b>		
Investments in LLCs	(1,671)	(478)
Repayments of advances made to LLCs	13	1,215
Advances made to LLCs	(1,600)	(1,211)
Cash distributions in excess of income from LLCs	652	353
Cash distribution from sale of real property by a LLC		1,096
Cash distributions of refinancing proceeds from LLCs	1,220	
Advances made to third-party partners	(2,000)	
Acquisition of real property	(4,802)	
Additions to real estate investments	(1,018)	(424)
<b>Net cash (used in)/provided by investing activities</b>	<b>(9,206)</b>	<b>551</b>
<b>Cash Flows from Financing Activities:</b>		
Net borrowings on line of credit	9,000	400
Advances from third-party partner	282	
Financing costs paid		(527)
Repayments of mortgage notes payable of consolidated LLCs	(53)	(48)
Borrowings of construction loans payable of consolidated LLC	804	
Repayment of mortgage note payable	(35)	(32)
Dividends paid	(6,870)	(6,722)
Issuance of shares of beneficial interest	164	121
<b>Net cash provided by/(used in) financing activities</b>	<b>3,292</b>	<b>(6,808)</b>
<b>(Decrease)/increase in cash and cash equivalents</b>	<b>(42)</b>	<b>30</b>
Cash and cash equivalents, beginning of period	1,131	798



Edgar Filing: UNIVERSAL HEALTH REALTY INCOME TRUST - Form 10-Q

<b>Cash and cash equivalents, end of period</b>	\$ 1,089	\$ 828
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Interest paid	\$ 533	\$ 448
<b>Supplemental disclosures of non-cash transactions:</b>		
Replacement property recovered from UHS Chalmette	\$	\$ 789

See accompanying notes to condensed consolidated financial statements.

**Table of Contents**

**UNIVERSAL HEALTH REALTY INCOME TRUST**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**March 31, 2008**

(unaudited)

**(1) General**

This Report on Form 10-Q is for the Quarterly Period ended March 31, 2008. In this Quarterly Report, we, us, our and the Trust refer to Universal Health Realty Income Trust.

You should carefully review all of the information contained in this Quarterly Report, and should particularly consider any risk factors that we set forth in this Quarterly Report and in other reports or documents that we file from time to time with the Securities and Exchange Commission (the SEC). In this Quarterly Report, we state our beliefs of future events and of our future financial performance. In some cases, you can identify those so-called forward-looking statements by words such as may, will, should, could, would, predicts, potential, continue, expect, future, intends, plans, believes, estimates, appears, projects and similar expressions, as well as statements in future tense. You should be aware that those statements are only our predictions. Actual events or results may differ materially. In evaluating those statements, you should specifically consider various factors, including the risks outlined in Item 2 of Part I, Management's Discussion and Analysis of Financial Condition and Results of Operations, under Forward Looking Statements and Certain Risk Factors and Item 1A of Part II, Risk Factors. Those factors may cause our actual results to differ materially from any of our forward-looking statements.

In this Quarterly Report on Form 10-Q, the term revenues does not include the revenues of the unconsolidated limited liability companies in which we have various non-controlling equity interests ranging from 33% to 99%. We currently account for our share of the income/loss from these investments by the equity method (see Note 5). As of March 31, 2008, we had investments or commitments in twenty-seven limited liability companies (LLCs), twenty-five of which are or will be accounted for by the equity method and two that are currently consolidated in our financial statements.

The financial statements included herein have been prepared by us, without audit, pursuant to the rules and regulations of the SEC and reflect all normal and recurring adjustments which, in our opinion, are necessary to fairly present results for the interim periods. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although we believe that the accompanying disclosures are adequate to make the information presented not misleading. It is suggested that these financial statements be read in conjunction with the financial statements, accounting policies and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2007. Certain prior year amounts have been reclassified to conform with current year financial statement presentation.

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

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

The combined revenues generated from the leases on the UHS hospital facilities accounted for approximately 58% and 56% of our total revenue for the three months ended March 31, 2008 and 2007, respectively. Including 100% of the revenues generated at the unconsolidated LLCs in which we have various non-controlling equity interests ranging from 33% to 99%, the leases on the UHS hospital facilities accounted for approximately 21% and 24% of the combined consolidated and unconsolidated revenue for the three months ended March 31, 2008 and 2007, respectively. In addition, seven MOBs (plus two additional MOBs currently under construction) owned by LLCs in which we hold various non-controlling equity interests, include or will include tenants which are subsidiaries of UHS.

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



---

**Table of Contents**

the leases at the lease terms described below by providing notice to us at least 90 days prior to the termination of the then current term. In addition, UHS has rights of first refusal to: (i) purchase the respective leased facilities during and for 180 days after the lease terms at the same price, terms and conditions of any third-party offer, or; (ii) renew the lease on the respective leased facility at the end of, and for 180 days after, the lease term at the same terms and conditions pursuant to any third-party offer. UHS also has the right to purchase the respective leased facilities at the end of the lease terms or any renewal terms at the appraised fair market value. In addition, during 2006, as part of the overall asset exchange and substitution proposal relating to Chalmette Medical Center ( Chalmette ), as discussed below, as well as the early five year lease renewals on Southwest Healthcare System-Inland Valley Campus ( Inland Valley ), Wellington Regional Medical Center ( Wellington ), McAllen Medical Center ( McAllen ) and The Bridgeway ( Bridgeway ), we agreed to amend the Master Lease to include a change of control provision. The change of control provision grants UHS the right, upon one month's notice should a change of control of the Trust occur, to purchase any or all of the four leased hospital properties at their appraised fair market value.

We are committed to invest up to \$6.3 million in equity, of which \$143,000 has been funded as of March 31, 2008, in exchange for a 95% non-controlling equity interest in a limited liability company that will develop, construct, own and operate the Palmdale Medical Plaza, located in Palmdale, California, on the campus of a UHS hospital that is also currently under construction. This medical office building ( MOB ) will be 75% master leased by UHS of Palmdale, Inc., a subsidiary of UHS, on a triple net basis. The master lease for each suite will be cancelled at such time that the suite is leased for a minimum term of five years, to another tenant acceptable to the LLC and UHS of Palmdale. Based upon the executed leases and letter of intent commitments in place as of March 31, 2008, the master lease threshold of 75% is not expected to be met by the completion and opening of the building. The LLC has a \$9.9 million construction loan commitment from a third-party, which is non-recourse to us. At March 31, 2008, \$8.2 million of third-party debt has been borrowed against this \$9.9 million construction loan commitment. This building, tenants of which will include subsidiaries of UHS, is scheduled to be completed and opened during the second quarter of 2008. This LLC, which is deemed to be a variable interest entity, is consolidated in our financial statements as of March 31, 2008 since we are the primary beneficiary.

We are committed to invest up to \$6.4 million in debt or equity, of which \$95,000 has been funded as of March 31, 2008, in exchange for a 95% non-controlling equity interest in a LLC that will develop, construct, own and operate the Summerlin Medical Office Building III, located in Las Vegas, Nevada, on the campus of a UHS hospital. The LLC has a third-party construction loan commitment of \$14.4 million, of which \$2.2 million has been borrowed as of March 31, 2008. This building, tenants of which will include subsidiaries of UHS, is scheduled to be completed and opened during the fourth quarter of 2008.

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

During the third quarter of 2006, we completed the asset exchange and substitution pursuant to the Asset Exchange and Substitution Agreement ( Agreement ) with UHS whereby we agreed to terminate the lease between us and Chalmette and to transfer the real property assets and all rights attendant thereto (including insurance proceeds) of Chalmette to UHS in exchange and substitution for newly constructed real property assets owned by UHS ( Capital Additions ) at Wellington, Bridgeway and Inland Valley, in satisfaction of the obligations under the Chalmette lease. The Capital Additions consist of properties which were recently constructed on, or adjacent to, facilities already owned by us as well as a recently constructed Capital Addition at Inland Valley which was completed and opened during the third quarter of 2007. Pursuant to section 1033(a)(1) of the Internal Revenue Code of 1986, as amended (the IRC ), we recognized no gain for federal income tax purposes based upon the terms of the transaction as agreed upon in the Agreement.

The total cost of the Capital Addition at Inland Valley amounted to \$11.7 million, which exceeded the \$11.0 million threshold included in the Agreement. Pursuant to the terms of the Agreement, the \$760,000 of cost in excess of the \$11.0

**Table of Contents**

million threshold has been paid to UHS in cash and UHS will pay incremental rent on the \$760,000 excess cost at a rate of 6.75%.

The table below details the renewal options and terms for each of the four UHS hospital facilities:

Hospital Name	Type of Facility	Annual Minimum Rent	End of Lease Term	Renewal Term (years)
McAllen Medical Center	Acute Care	\$ 5,485,000	December, 2011	20(a)
Wellington Regional Medical Center	Acute Care	\$ 3,030,000	December, 2011	20(b)
Southwest Healthcare System, Inland Valley Campus	Acute Care	\$ 2,648,000	December, 2011	20(b)
The Bridgeway	Behavioral Health	\$ 930,000	December, 2014	10(c)

- (a) UHS has four 5-year renewal options at existing lease rates (through 2031).
- (b) UHS has two 5-year renewal options at existing lease rates (through 2021) and two 5-year renewal options at fair market value lease rates (2022 through 2031).
- (c) UHS has two 5-year renewal options at fair market value lease rates (2015 through 2024).

*UHS Legal Proceedings:* We have been advised by UHS that UHS, together with its South Texas Health System affiliates, which operate McAllen Medical Center, were served with a subpoena dated November 21, 2005, issued by the Office of Inspector General of the Department of Health and Human Services (OIG). At that time, the Civil Division of the U.S. Attorney’s office in Houston, Texas indicated that the subpoena was part of an investigation under the False Claims Act regarding compliance with Medicare and Medicaid rules and regulations pertaining to the employment of physicians and the solicitation of patient referrals from physicians from January 1, 1999 to the date of the subpoena, related to the South Texas Health System. UHS has advised us that since January of 2006, documents were produced on a rolling basis pursuant to this subpoena and several additional requests, including an additional March 9, 2007 subpoena. On February 16, 2007, UHS’s South Texas Health System affiliates were served with a search warrant in connection with what UHS has been advised is a related criminal Grand Jury investigation concerning the production of documents. At that time, the government obtained various documents and other property related to the facilities. Follow-up Grand Jury subpoenas for documents and witnesses and other requests were subsequently served on South Texas Health System facilities and certain UHS employees and former employees.

UHS’s legal representatives continue to meet with representatives of the civil and criminal divisions of the United States Attorney’s Office for the Southern District of Texas to discuss the status of these matters. UHS’s representatives have been advised that the government is continuing its investigations. UHS understands that, based on those discussions and its investigations to date, the government is focused on certain arrangements entered into by the South Texas Health System affiliates which, the government believes, may have violated Medicare and Medicaid rules and regulations pertaining to payments to physicians and the solicitation of patient referrals from physicians and other matters relating to payments to various individuals which may have constituted improper or illegal payments. UHS understands that the government is also focusing its investigation to determine whether the South Texas Health System affiliates and certain individuals illegally failed to fully comply with the original OIG subpoena. UHS is investigating these matters, cooperating with the investigations and responding to the matters raised with them. UHS continues to produce documents on a rolling basis to the government based on its requests pursuant to its investigations. UHS expects to continue their discussions with the government to attempt to resolve these matters in a manner satisfactory to UHS and the government. There is no assurance that UHS will be able to do so, and, at this time, UHS is unable to evaluate the extent of any potential financial or other exposure in connection with these matters which are related to the subject of the government’s investigations.

UHS has advised us that it monitors all aspects of its business and that it has developed a comprehensive ethics and compliance program that is designed to meet or exceed applicable federal guidelines and industry standards. Because the law in this area is complex and constantly evolving, governmental investigation or litigation may result in interpretations that are inconsistent with industry practices, including UHS’s. Although UHS believes its policies, procedures and practices comply with governmental regulations, no assurance can be given that UHS will not be subjected to further inquiries or actions, or that UHS will not be faced with sanctions, fines or penalties in connection with the investigation of their South Texas Health System affiliates. Even if UHS were to ultimately prevail, the government’s inquiry and/or action in connection with this matter could have a material adverse effect on UHS’s future operating results and on the future operating results of McAllen Medical Center. While the base rentals are guaranteed by UHS through the end of the existing lease term, should this matter adversely impact the future revenues and/or operating results of McAllen Medical Center, the future bonus rental earned by us on this facility may be materially, adversely impacted. Bonus rental revenue earned by us from McAllen Medical Center amounted to \$1.7 million during 2007 and \$1.9 million during 2006. We can provide no assurance that this matter will not



---

## **Table of Contents**

have a material adverse impact on underlying value of McAllen Medical Center or on the future base rental earned on this facility should the existing lease not be renewed pursuant to its current lease rates after its December, 2011 scheduled expiration of the existing lease term.

*Advisory Agreement:* UHS of Delaware, Inc. (the Advisor), a wholly-owned subsidiary of UHS, serves as Advisor to us under an Advisory Agreement (the Advisory Agreement) dated December 24, 1986. Under the Advisory Agreement, the Advisor is obligated to present an investment program to us, to use its best efforts to obtain investments suitable for such program (although it is not obligated to present any particular investment opportunity to us), to provide administrative services to us and to conduct our day-to-day affairs. In performing its services under the Advisory Agreement, the Advisor may utilize independent professional services, including accounting, legal, tax and other services, for which the Advisor is reimbursed directly by us. The Advisory Agreement expires on December 31 of each year; however, it is renewable by us, subject to a determination by the Trustees who are unaffiliated with UHS (the Independent Trustees), that the Advisor's performance has been satisfactory. The Advisory Agreement may be terminated for any reason upon sixty days written notice by us or the Advisor. The Advisory Agreement has been renewed for 2008. All transactions between us and UHS must be approved by the Independent Trustees.

The Advisory Agreement provides that the Advisor is entitled to receive an annual advisory fee equal to 0.60% of our average invested real estate assets, as derived from our consolidated balance sheet. The advisory fee is payable quarterly, subject to adjustment at year-end based upon our audited financial statements. In addition, the Advisor is entitled to an annual incentive fee equal to 20% of the amount by which cash available for distribution to shareholders for each year, as defined in the Advisory Agreement, exceeds 15% of our equity as shown on our consolidated balance sheet, determined in accordance with generally accepted accounting principles without reduction for return of capital dividends. The Advisory Agreement defines cash available for distribution to shareholders as net cash flow from operations less deductions for, among other things, amounts required to discharge our debt and liabilities and reserves for replacement and capital improvements to our properties and investments. Advisory fees incurred and paid (or payable) to UHS amounted to \$367,000 and \$351,000 for the three months ended March 31, 2008 and 2007, respectively. No incentive fees were paid in either period.

*Officers and Employees:* Our officers are all employees of UHS and although as of March 31, 2008 we had no salaried employees, our officers do receive stock-based compensation from time-to-time.

*Share Ownership:* As of March 31, 2008, UHS owned 6.6% of our outstanding shares of beneficial interest.

*SEC reporting requirements of UHS:* UHS is subject to the reporting requirements of the SEC and is required to file annual reports containing audited financial information and quarterly reports containing unaudited financial information. Since the leases on the hospital facilities leased to wholly-owned subsidiaries of UHS comprised approximately 58% and 56% of our consolidated revenues for the periods ended March 31, 2008 and 2007, respectively, and since UHS is our Advisor, you are encouraged to obtain the publicly available filings for UHS, Inc. from the SEC's website at [www.sec.gov](http://www.sec.gov). These filings are the sole responsibility of UHS and are not incorporated by reference herein.

### **(3) Dividends**

A dividend of \$.58 per share or \$6.9 million in the aggregate was declared by the Board of Trustees on March 7, 2008 and was paid on March 31, 2008 to shareholders of record as of March 17, 2008.

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

#### *Acquisitions during the first three months of 2008:*

In February, 2008, we purchased Kindred Hospital; Corpus Christi, an unaffiliated long-term acute care hospital located in Corpus Christi, Texas for a total purchase price of \$8.1 million. We paid \$4.8 million in cash and assumed \$3.3 million of third-party mortgage debt that is non-recourse to us. The lease payments on this facility are unconditionally guaranteed by Kindred Healthcare, Inc. until its scheduled expiration in June, 2019. The proforma effect of this acquisition did not have a material impact on our results of operations.

#### *Dispositions during the first three months of 2007:*

During the three months ended March 31, 2007, RioMed Investments, a LLC in which we had an 80% non-controlling equity interest, sold the real property of Rio Rancho Medical Center, located in Gilbert, Arizona. Our share of the net proceeds from this divestiture was \$1.1 million. This transaction resulted in a \$252,000 gain which is included in Equity in income of unconsolidated LLCs on our condensed consolidated statements of income for the three months ended March 31, 2007.

## Edgar Filing: UNIVERSAL HEALTH REALTY INCOME TRUST - Form 10-Q

Additionally, during the first quarter of 2007, we entered into an agreement to sell one of our consolidated medical office buildings. Completion of this sale transaction was completed during the second quarter of 2007. The financial results of this



**Table of Contents**

property are reflected as discontinued operations on our condensed consolidated statements of income for the three months ended March 31, 2007.

**(5) Summarized Financial Information of Equity Affiliates**

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

Pursuant to the provisions of FIN 46R, two LLCs in which we own non-controlling equity ownership interests of 95% and 98% are considered to be variable interest entities and are consolidated in our results of operations since we are the primary beneficiary. The other LLCs in which we hold various non-controlling ownership interests are not variable interest entities and therefore are not subject to the consolidation requirements of FIN 46R.

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

**Table of Contents**

As of March 31, 2008, we had investments or commitments in twenty-seven LLCs, twenty-five of which are accounted for by the equity method and two that are consolidated into the results of operations. The following tables represent summarized financial and other information related to the LLCs which were accounted for under the equity method:

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

- (a.) The membership interests of this entity are held by a master LLC in which we hold a 90% non-controlling ownership interest.
- (b.) Tenants of these medical office buildings include subsidiaries of UHS.
- (c.) We have committed to invest a total of \$8.0 million in equity, of which \$5.2 million has been funded as of March 31, 2008, in exchange for a 75% non-controlling interest in a LLC that owns the Saint Mary s Professional Office Building located in Reno, Nevada. As of March 31, 2008, the LLC has a \$28.0 million mortgage from a third party, which is non-recourse to us. This medical office building opened in March of 2005.
- (d.) We have committed to invest a total of up to \$5.2 million in equity and/or debt financing in exchange for a 95% non-controlling interest in a LLC that owns and operates the Sierra San Antonio Medical Plaza located in Fontana, California. As of March 31, 2008, we have invested \$2.9 million in equity and \$2.1 million in debt financing (\$485,000 of which was repaid during the first quarter of 2007) in connection with this project. The LLC has a \$5.9 million total construction loan commitment from a third party, which is non-recourse to us. This project was completed and opened during the first quarter of 2006.
- (e.) We have committed to invest a total of up to \$12.3 million in debt and/or equity financing (of which \$10.7 million has been funded as of March 31, 2008), in exchange for a 95% non-controlling interest in a LLC that owns and operates the Spring Valley Hospital Medical Office Building II, located in Las Vegas, Nevada on the campus of a UHS facility. This building, tenants of which include subsidiaries of UHS, opened during the second quarter of 2007.
- (f.) We have committed to invest a total of up to \$3.5 million in equity, of which \$2.0 million has been funded as of March 31, 2008, in exchange for a 95% non-controlling interest in a LLC that owns the Phoenix Children s East Valley Care Center, a single tenant medical office building, located in Gilbert, Arizona. The LLC has a \$7.2 million total construction loan commitment from a third-party, which is non-recourse to us. This project was completed and opened during the fourth quarter of 2007.
- (g.) We have committed to invest up to \$6.6 million in equity and/or debt financing (\$1.0 million of has been funded as of March 31, 2008) in exchange for a 95% non-controlling interest in a LLC that owns the Centennial Hills Medical Office Building I, located in Las Vegas, Nevada on the campus of a UHS hospital. The LLC has a \$15.7 million



**Table of Contents**

- construction loan commitment from a third-party, which is non-recourse to us. This building, tenants of which include subsidiaries of UHS, was completed and opened during the fourth quarter of 2007.
- (h.) We have committed to invest up to \$6.0 million in equity and/or debt financing, \$4.0 million of which was funded as of March 31, 2008, in exchange for a 95% non-controlling interest in a LLC that owns the Canyon Springs Medical Plaza in Gilbert, Arizona. The LLC has a \$17.4 million mortgage from a third-party, which is non-recourse to us. This building was opened during the fourth quarter of 2007.
- (i.) We have committed to invest up to \$6.8 million (\$250,000 in equity, none of which has been funded as of March 31, 2008, and \$6.6 million in equity and/or debt financing, \$197,000 of which has been funded as of March 31, 2008) in exchange for a 95% non-controlling interest in a LLC that will develop, construct, own and operate the Deer Valley Medical Office Building III in Phoenix, Arizona. The LLC has a \$13.6 million construction loan commitment with a third-party, which is non-recourse to us. This project is scheduled to be completed and opened during the second quarter of 2009.
- (j.) We have committed to invest up to \$6.4 million in debt and/or equity, of which \$95,000 has been funded as of March 31, 2008, in exchange for a 95% non-controlling interest in a LLC that will develop, construct, own and operate the Summerlin Medical Office Building III, located in Las Vegas, Nevada. The LLC has a \$14.4 million construction loan commitment with a third-party, which is non-recourse to us. This project is scheduled to be completed and opened during the fourth quarter of 2008.

Below are the combined statements of income for the LLCs accounted for under the equity method:

	<b>Three Months Ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
Revenues	\$ 11,388	\$ 9,643
Operating expenses	5,235	4,238
Depreciation and amortization	2,251	1,775
Interest, net	3,500	2,643
Net income before gain	402	987
Gain on sale of real property		339
Net income	\$ 402	\$ 1,326
Our share of net income before gain (a.)	\$ 612	\$ 695
Our share of gain on sale of real property		252
Our share of net income	\$ 612	\$ 947

- (a.) Our share of net income for the three months ended March 31, 2008 and 2007, include approximately \$348,000 and \$12,000, respectively, of interest income earned on various advances made to LLCs

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

	<b>March 31, 2008</b>	<b>December 31, 2007</b>
	<i>( in thousands )</i>	
Net property, including CIP	\$ 252,600	\$ 247,514
Other assets	22,516	22,859
Total assets	\$ 275,116	\$ 270,373
Liabilities	\$ 10,241	\$ 10,707
Mortgage notes payable, non-recourse to us	219,007	214,912
Notes payable to us	15,757	14,035

Edgar Filing: UNIVERSAL HEALTH REALTY INCOME TRUST - Form 10-Q

Equity	30,111	30,719
Total liabilities and equity	\$ 275,116	\$ 270,373
Our share of equity and notes receivable from LLCs	\$ 53,416	\$ 52,030

---

**Table of Contents**

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

**(6) Recent Accounting Pronouncements**

**Business Combinations:** In December 2007, the FASB issued SFAS 141 (revised 2007) *Business Combinations* ( SFAS 141R ). SFAS 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. SFAS 141R also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. We do not anticipate that the adoption of SFAS 141R will have a material impact on our results of operations or financial position.

**Noncontrolling Interests in Consolidated Financial Statements:** In December 2007, the FASB issued SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51* . SFAS 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. SFAS 160 requires retroactive adoption of the presentation and disclosure requirements for existing minority interests. All other requirements of SFAS 160 shall be applied prospectively. We do not anticipate that the adoption of SFAS No. 160 will have a material impact on our results of operations or financial position.

**Fair Value Option for Financial Assets and Financial Liabilities:** In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115*, ( SFAS No. 159 ). SFAS No. 159 permits a company to choose to measure many financial instruments and certain other items at fair value at specified election dates. Most of the provisions in SFAS No. 159 are elective; however, it applies to all companies with available-for-sale and trading securities. A company will report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance indicator if the company does not report earnings) at each subsequent reporting date. The fair value option: (a) may be applied instrument by instrument; (b) is irrevocable (unless a new election date occurs), and; (c) is applied only to entire instruments and not to portions of instruments. SFAS No. 159 is effective as of January 1, 2008. We chose not to elect the fair value option for our financial assets and financial liabilities existing at January 1, 2008, and did not elect the fair value option on financial assets and financial liabilities transacted subsequent to that time. Therefore, the adoption of SFAS No. 159 had no impact on our results of operations or financial position.

**Fair Value Measurements:** In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The provisions for SFAS 157 are to be applied prospectively as of the beginning of the fiscal year in which it is initially applied, except in limited circumstances including certain positions in financial instruments that trade in active markets as well as certain financial and hybrid financial instruments initially measured under SFAS No. 133 *Accounting for Derivative Instruments and Hedging Activities* ( SFAS No. 133 ) using the transaction price method. In these circumstances, the transition adjustment is measured as the difference between the carrying amounts and the fair values of those financial instruments at the date SFAS No. 157 is initially applied. In February, 2008, the FASB decided to issue final staff positions that will: (i) partially defer the effective date of SFAS No. 157 for one year for certain non-financial assets and non-financial liabilities, and; (ii) remove certain leasing transactions from the scope of SFAS No. 157. As permitted by FASB Staff Position No. FAS 157-2, *Effective Date of FASB Statement No. 157* , we elected to defer the adoption of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities. The partial adoption of SFAS No. 157 for financial assets and financial liabilities did not have a material impact on our results of operations or financial position.

**Disclosures about Derivative Instruments and Hedging Activities:** In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, an amendment of FASB Statement No. 133 ( SFAS No. 161 ). This statement is intended to improve transparency in financial reporting by requiring enhanced disclosures of an entity's derivative instruments and hedging activities and their effects on the entity's financial position, financial performance, and cash flows. SFAS No. 161 applies to all derivative instruments within the scope of SFAS No. 133 as well as related hedged items, bifurcated derivatives, and nonderivative instruments that are designated and qualify as hedging instruments. Entities with instruments subject to SFAS No. 161 must provide expanded qualitative and quantitative disclosures. SFAS No. 161 is effective prospectively for financial statements issued beginning after November 15,

## Edgar Filing: UNIVERSAL HEALTH REALTY INCOME TRUST - Form 10-Q

2008, with early application permitted. Our adoption of this statement will result in changes related to presentation and disclosure of our interest rate swaps and will not affect our results of operations.

### **(7) Segment Reporting**

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

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

## **Table of Contents**

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

#### **Overview**

We are a real estate investment trust ( REIT ) that commenced operations in 1986. We invest in healthcare and human service related facilities including acute care hospitals, behavioral healthcare facilities, rehabilitation hospitals, sub-acute facilities, surgery centers, childcare centers and medical office buildings. As of March 31, 2008, we have forty-seven real estate investments or commitments located in fourteen states consisting of:

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

thirty-six medical office buildings, including twenty-seven owned by various LLCs, and;

four pre-school and childcare centers.

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

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

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

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

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

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

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

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



## Edgar Filing: UNIVERSAL HEALTH REALTY INCOME TRUST - Form 10-Q

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

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

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

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

## Table of Contents

of providing, or reduce the demand for, health care; the ability to attract and retain qualified medical personnel, including physicians;

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

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

competition for our operators from other REITs;

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

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

fluctuations in the value of our common stock, and;

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

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

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

## Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the amounts reported in our consolidated financial statements and accompanying notes. We consider our critical accounting policies to be those that require us to make significant judgments and estimates when we prepare our financial statements, including the following:

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

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

## Edgar Filing: UNIVERSAL HEALTH REALTY INCOME TRUST - Form 10-Q

**Investments in Limited Liability Companies ( LLCs ):** Our consolidated financial statements include the consolidated accounts of our controlled investments and those investments that meet the criteria of a variable interest entity where we are the primary beneficiary. In accordance with the American Institute of Certified Public Accountants' Statement of Position 78-9 Accounting for Investments in Real Estate Ventures as amended by FASB Staff Position SOP 78-9-1 *Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5*, Emerging Issues Task Force Issue (EITF) 96-16, *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights* and EITF 04-5 *Determining Whether a General Partner, or the*

**Table of Contents**

*General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights* we account for our unconsolidated investments in LLCs which we do not control using the equity method of accounting. The third-party members in these investments have equal voting rights with regards to issues such as, but not limited to: (i) divestiture of property; (ii) annual budget approval, and; (iii) financing commitments. These investments, which represent 33% to 99% non-controlling ownership interests, are recorded initially at our cost and subsequently adjusted for our net equity in the net income, cash contributions to, and distributions from, the investments. Pursuant to certain agreements, allocations of profits and losses of some of the LLC investments may be allocated disproportionately as compared to ownership interests after specified preferred return rate thresholds have been satisfied.

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51*. This Interpretation, as revised ( FIN 46R ), addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. As a result of our related party relationship with UHS, and certain master lease, lease assurance or lease guarantee arrangements between UHS and various properties owned by two LLCs in which we own non-controlling ownership interests ranging from 95% to 98%, these two LLCs were considered to be variable interest entities and are therefore included in our consolidated financial statements on a consolidated basis since we are the primary beneficiary. One of these consolidated LLCs owns a medical office building that is currently under construction, which is scheduled to be completed and opened during the second quarter of 2008.

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

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

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

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

**Relationship with Universal Health Services, Inc. ( UHS )** UHS is our principal tenant and through UHS of Delaware, Inc., a wholly owned subsidiary of UHS, serves as our advisor (the Advisor ) under an Advisory Agreement dated December 24, 1986 between the Advisor and us (the Advisory Agreement ). Our officers are all employees of UHS and although as of March 31, 2008 we had no salaried employees, our officers do receive stock-based compensation from time-to-time.

Under the Advisory Agreement, the Advisor is obligated to present an investment program to us, to use its best efforts to obtain investments suitable for such program (although it is not obligated to present any particular investment opportunity to us), to provide administrative services to us and to conduct our day-to-day affairs. In performing its services under the Advisory Agreement, the Advisor may utilize independent professional services, including accounting, legal, tax and other services, for which the Advisor is reimbursed directly by us. The Advisory Agreement expires on December 31 of each year; however, it is renewable by us, subject to a determination by the Independent Trustees who are unaffiliated with UHS, that the Advisor's performance has been satisfactory. The Advisory Agreement may be terminated for any reason upon sixty days written notice by us or the Advisor. The Advisory Agreement has been renewed for 2008. All transactions between us and UHS must be approved by the Independent Trustees. The Advisor is entitled to certain advisory fees for its services. See Relationship with Universal Health Services, Inc. in Note 2 to the consolidated financial statements for additional information on the Advisory Agreement and related fees.

The combined revenues generated from the leases on the UHS hospital facilities accounted for approximately 58% and 56% of our total revenue for the three months ended March 31, 2008 and 2007, respectively. Including 100% of the revenues generated at the unconsolidated LLCs in which we have various non-controlling equity interests ranging from 33% to 99%, the leases on the UHS hospital facilities accounted for approximately 21% and 24% of the combined consolidated and unconsolidated revenue for the three months ended March 31, 2008 and 2007, respectively. The leases to the hospital facilities of UHS are guaranteed by UHS and cross-defaulted with one another.

**Table of Contents**

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

**Results of Operations**

For the quarters ended March 31, 2008 and 2007, net income was \$4.2 million, or \$0.35 per diluted share, as compared to \$5.8 million, or \$0.49 per diluted share, during the comparable prior year quarter. The decrease in net income of \$1.6 million, or \$0.14 per diluted share, during the first quarter of 2008, as compared to the comparable quarter of 2007, was primarily attributable to:

an unfavorable change of \$789,000, or \$0.07 per diluted share, resulting from the gain recognized during the first quarter of 2007 in connection with the previously disclosed Chalmette Medical Center ( Chalmette ) asset exchange and substitution transaction;

**Table of Contents**

an unfavorable change of \$252,000, or \$0.02 per diluted share, resulting from the gain recorded during the first quarter of 2007 in connection with the sale of real property by a LLC in which we had an 80% non-controlling equity interest;

an unfavorable change of \$437,000, or \$0.04 per diluted share, resulting from increased depreciation expense, as compared to the first quarter of 2007, recorded by certain of our unconsolidated LLCs, primarily resulting from newly constructed medical office buildings which were opened throughout 2007, and;

other combined net unfavorable changes of \$175,000, or \$0.01 per diluted share, including the additional interest expense, as discussed below.

Included in our other operating expenses are expenses related to the consolidated medical office buildings, which totaled \$852,000 and \$782,000 for the three month periods ended March 31, 2008 and 2007, respectively. A portion of the expenses associated with our consolidated medical office buildings is passed on directly to the tenants. Tenant reimbursements for operating expenses are accrued as revenue in the same period the related expenses are incurred and are included as tenant reimbursement revenue in our condensed consolidated statements of income.

Interest expense, net of interest income, increased \$163,000 during the three months ended March 31, 2008, as compared to the comparable prior year quarter. The \$163,000 increase in interest expense for the three month period ending March 31, 2008, as compared to the prior year period, is due primarily to an increase in our average outstanding borrowings, partially offset by a decrease in our average cost of funds.

During the three months ended March 31, 2008 and 2007, we recorded equity in income of unconsolidated LLCs of \$612,000 and \$947,000, respectively. The \$335,000 decrease during the three month period of 2008, as compared to the comparable 2007 period, was primarily due to a \$252,000 gain recorded on the sale of real property by a LLC during the first three months of 2007.

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

Below is a reconciliation of our reported net income to FFO for the three month periods ended March 31, 2008 and 2007 (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2008</b>	<b>2007</b>
Net income	\$ 4,158	\$ 5,811
Plus: Depreciation and amortization expense:		
Consolidated investments	1,388	1,244
Unconsolidated affiliates	1,787	1,350
Discontinued operations		31
Less: Gain on LLC's sale of real property		(252)
Gain on asset exchange and substitution agreement with UHS - Chalmette		(789)
Funds from operations (FFO)	\$ 7,333	\$ 7,395

---

**Table of Contents**

**Liquidity and Capital Resources**

**Net cash provided by operating activities**

Net cash provided by operating activities was \$5.9 million and \$6.3 million for the three month periods ended March 31, 2008 and 2007, respectively.

The \$415,000 net decrease was attributable to:

an unfavorable change of \$497,000 due to a decrease in net income plus or minus the adjustments to reconcile net income to net cash provided by operating activities (depreciation and amortization, gain on sale of property by a LLC and replacement property recovered from UHS-Chalmette). This decrease was primarily due to: (i) an increase of \$163,000 in interest expense, resulting primarily from increased borrowings; (ii) an increase of \$437,000 in depreciation and amortization expense recorded by certain unconsolidated LLCs, primarily resulting from newly constructed MOB's which were opened throughout 2007, and; (iii) \$103,000 of other favorable changes, and;

\$82,000 of other net favorable changes.

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

Net cash (used in) provided by investing activities was (\$9.2 million) during the three months ended March 31, 2008 as compared to \$551,000 during the three months ended March 31, 2007.

During the three month period ended March 31, 2008, we funded \$1.7 million of equity investments, funded \$1.6 million of advances to LLCs, spent \$1.0 million on capital additions, spent \$4.8 million on the acquisition of real property and advanced \$2.0 million to our third-party partners, as discussed below. Also during the three month period ended March 31, 2008, we received: (i) \$1.2 million related to debt refinancing by LLCs, and; (ii) \$652,000 of cash distributions in excess of income from our unconsolidated LLCs.

During the first quarter of 2008, we advanced \$2.0 million to our third-party partners in a certain LLC in connection with a \$4.0 million loan commitment. This loan is a non-amortizing loan with interest paid on a quarterly basis. The interest rate on this loan will be: (i) 4.25% plus LIBOR, or; (ii) if information to determine LIBOR is not available, three hundred seventy-five basis points over then existing borrowing cost. The loan has a stated maturity date of 2012, although it may be prepaid without penalty and is secured by various forms of collateral, including personal guarantees from each of the partners to the loan, as well as their ownership interest in the LLC.

During the three month period ended March 31, 2007, we funded equity investments of \$478,000, funded \$1.2 million of advances to LLCs and spent \$424,000 on capital additions to certain of our real estate investments. Also during the three month period ended March 31, 2007, we received: (i) \$1.2 million from LLCs for repayment of advances; (ii) \$1.1 million of cash proceeds related to the sale of real property by a LLC, and; (iii) \$353,000 of cash distributions in excess of income from our unconsolidated LLCs.

**Net cash provided by (used in) financing activities**

Net cash provided by (used in) financing activities was \$3.3 million during the three months ended March 31, 2008 and (\$6.8 million) during the three months ended March 31, 2007.

During the three month period ended March 31, 2008, we had net debt borrowings of \$9.0 million on our revolving line of credit, had net borrowings of \$804,000 under a construction loan of a consolidated LLC that is non-recourse to us, had net advances of \$282,000 from our third-party partner, paid \$6.9 million of dividends, paid \$88,000 on mortgage notes payable that are non-recourse to us and generated \$164,000 of cash from the issuance of shares of beneficial interest.

During the three month period ended March 31, 2007, we had net debt borrowings of \$400,000 on our revolving line of credit, paid \$527,000 in financing fees related to our new revolving credit agreement, paid \$6.7 million of dividends, paid \$80,000 on mortgage notes payable that are non-recourse to us and generated \$121,000 of cash from the issuance of shares of beneficial interest.

## Edgar Filing: UNIVERSAL HEALTH REALTY INCOME TRUST - Form 10-Q

A dividend of \$0.58 per share was paid on was paid on March 31, 2008 to shareholders of record as of March 17, 2008.

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



**Table of Contents****Credit facilities and mortgage debt**

In January 2007, we entered into an unsecured \$100 million revolving credit agreement (the Agreement) which expires on January 19, 2012. We have a one-time option, which can be exercised at any time, subject to bank approval, to increase the amount by \$50 million for a total commitment of \$150 million. The Agreement provides for interest at our option, at the Eurodollar rate plus .75% to 1.125% or the prime rate plus zero to .125%. A fee of .15% to .225% is paid on the unused portion of the commitment. The margins over the Eurodollar rate, prime rate and the commitment fee are based upon our debt to total capital ratio as defined by the Agreement. As of March 31, 2008, the applicable margin over the Eurodollar rate was .75% and over the prime rate was zero. The commitment fee was 0.15%.

At March 31, 2008, we had \$25.8 million of outstanding borrowings and \$25.2 million of letters of credit outstanding against the Agreement. There are no compensating balance requirements. The Agreement contains a provision whereby the commitments will be reduced by 50% of the proceeds generated from any new equity offering. At March 31, 2008, we had \$48.9 million of available borrowing capacity under this agreement.

Covenants relating to the revolving credit facility require the maintenance of a minimum tangible net worth and specified financial ratios, limit our ability to incur additional debt, limit the aggregate amount of mortgage receivables and limit our ability to increase dividends in excess of 95% of cash available for distribution, unless additional distributions are required to comply with the applicable section of the Internal Revenue Code and related regulations governing real estate investment trusts. We are in compliance with all of the covenants at March 31, 2008. The carrying value of this instrument approximates fair value.

We have three mortgages and one construction loan, which are non-recourse to us, included in our consolidated balance sheet as of March 31, 2008 with a combined outstanding balance of \$23.9 million. Two of the mortgages carry an interest rate of 8.3% and have maturity dates in 2010. The third mortgage carries an interest rate of 6.5% and has a maturity date in 2019. The construction loan carries an interest rate as of March 31, 2008, of LIBOR plus 2.6% or 5.2%. The mortgages are secured by the real property of the buildings as well as property leases and rents. The following table summarizes these outstanding loans at March 31, 2008 (amounts in thousands):

Facility Name / Secured by	Outstanding Balance (in thousands)	Interest Rate	Maturity Date
Medical Center of Western Connecticut	\$ 3,682	8.3 %	2010
Summerlin Hospital MOB II	8,635	8.3 %	2010
Palmdale Construction Loan	8,217	5.2 %	2008
Kindred Corpus Christi	3,358	6.5 %	2019
Total	\$ 23,892		

**Off Balance Sheet Arrangements**

As of March 31, 2008, we are party to certain off balance sheet arrangements consisting of standby letters of credit and equity and debt financing commitments. Our outstanding letters of credit at March 31, 2008 totaled \$25.2 million consisting of: (i) \$1.1 million related to Sierra Medical Properties; (ii) \$900,000 related to Arlington Medical Properties; (iii) \$6.0 million related to Centennial Hills Medical Properties; (iv) \$3.9 million related to Palmdale Medical Properties; (v) \$2.0 million related to Deerval Parking; (vi) \$5.9 million related to Deerval Properties II; (vii) \$5.5 million related to the Banbury Medical Properties. The \$1.1 million letter of credit for Sierra Medical Properties is related to our construction commitment to Sierra Medical Properties, of which \$4.5 million has been funded as of March 31, 2008. The \$901,000 letter of credit for Arlington Medical Properties is related to our construction commitment to Arlington Medical Properties, of which a net of \$5.2 million has been funded as of March 31, 2008. The \$6.0 million letter of credit for Centennial Medical Properties is related to our construction commitment to Centennial Medical Properties of which \$1 million has been funded as of March 31, 2008. The \$3.9 million letter of credit for Palmdale Medical Properties is related to our construction commitment to the Palmdale Medical Plaza of which \$143,000 has been funded as of March 31, 2008. The \$7.9 million letter of credit for Deerval Properties II is related to our construction commitment to Deerval Properties II and related entity, of which \$271,000 has been funded as of March 31, 2008. The \$5.5 million letter of credit for Banbury Medical Properties is related to our construction commitment to Banbury Medical Properties of which \$95,000 has been funded as of March 31, 2008.

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

There have been no material changes in the quantitative and qualitative disclosures during the first three months of 2008. Reference is made to Item 7A in the Annual Report on Form 10-K for the year ended December 31, 2007.

**Table of Contents**

**Item 4. Controls and Procedures**

As of March 31, 2008, under the supervision and with the participation of our management, including the Trust's Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), we performed an evaluation of the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended (the 1934 Act ). Based on this evaluation, the CEO and CFO have concluded that our disclosure controls and procedures are effective to ensure that material information is recorded, processed, summarized and reported by management on a timely basis in order to comply with our disclosure obligations under the 1934 Act and the SEC rules thereunder.

There have been no changes in our internal control over financial reporting or in other factors during the first quarter of 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents**

**PART II. OTHER INFORMATION**

**UNIVERSAL HEALTH REALTY INCOME TRUST**

**Item 1A. Risk Factors**

There have been no material changes in our risk factors from those set forth in our Annual Report on Form 10-K dated December 31, 2007.

**Item 6. Exhibits**

- 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934, as amended.
- 31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) under the Securities Exchange Act of 1934, as amended.
- 32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**Table of Contents**

**Signatures**

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

Date: May 8, 2008

UNIVERSAL HEALTH REALTY INCOME TRUST  
(Registrant)

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

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

**Table of Contents**

**EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15(d)-14(a) under the Securities Exchange Act of 1934 as amended.
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15(d)-14(a) under the Securities Exchange Act of 1934 as amended.
32.1	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.