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

FORM 10-Q

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

For the quarterly period ended June 30, 2007

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 001-32559

MEDICAL PROPERTIES TRUST, INC.

(Exact Name of Registrant as Specified in Its Charter)

MARYLAND
(State or other jurisdiction
of incorporation or organization)

20-0191742
(I. R. S. Employer
Identification No.)

1000 URBAN CENTER DRIVE, SUITE 501
BIRMINGHAM, AL
(Address of principal executive offices)

35242
(Zip Code)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (205) 969-3755

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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of August 9, 2007, the registrant had 49,578,062 shares of common stock, par value \$.001, outstanding.

MEDICAL PROPERTIES TRUST, INC.
QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

MEDICAL PROPERTIES TRUST, INC. AND SUBSIDIARIES
Condensed Consolidated Balance Sheets

	June 30, 2007 (Unaudited)	December 31, 2006
Assets		
Real estate assets		
Land, buildings and improvements, and intangible lease assets	\$ 482,279,348	\$ 437,367,722
Construction in progress	362,243	57,432,264
Mortgage loans	210,000,000	105,000,000
Real estate held for sale	—	63,324,381
Gross investment in real estate assets	692,641,591	663,124,367
Accumulated depreciation and amortization	(15,407,604)	(12,056,422)
Net investment in real estate assets	677,233,987	651,067,945
Cash and cash equivalents	8,588,912	4,102,873
Interest and rent receivable	9,338,364	11,893,513
Straight-line rent receivable	16,726,141	12,686,976
Other loans	72,494,574	45,172,830
Other assets of discontinued operations	5,254,170	6,890,919
Other assets	13,170,964	12,941,689
Total Assets	\$ 802,807,112	\$ 744,756,745
Liabilities and Stockholders' Equity		
Liabilities		
Debt	\$ 279,851,471	\$ 304,961,898
Debt — real estate held for sale	—	43,165,650
Accounts payable and accrued expenses	19,834,289	30,386,858
Deferred revenue	18,526,442	14,615,609
Lease deposits and other obligations to tenants	8,247,801	6,853,759
Total liabilities	326,460,003	399,983,774
Minority interests	74,982	1,051,835
Stockholders' equity		
Preferred stock, \$0.001 par value. Authorized 10,000,000 shares; no shares outstanding	—	—
Common stock, \$0.001 par value. Authorized 100,000,000 shares; issued and outstanding - 48,985,954 shares at June 30, 2007, and 39,585,510 shares at December 31, 2006	48,986	39,586
Additional paid in capital	494,295,184	356,678,018
Distributions in excess of net income	(18,072,043)	(12,996,468)
Total stockholders' equity	476,272,127	343,721,136
Total Liabilities and Stockholders' Equity	\$ 802,807,112	\$ 744,756,745

See accompanying notes to condensed consolidated financial statements.

MEDICAL PROPERTIES TRUST, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Income
(Unaudited)

	<u>For the Three Months Ended June 30,</u>		<u>For the Six Months Ended June 30,</u>	
	<u>2007</u>	<u>2006</u>	<u>2007</u>	<u>2006</u>
Revenues				
Rent billed	\$ 11,486,993	\$ 7,558,318	\$ 23,303,496	\$ 14,825,537
Straight-line rent	3,305,702	998,303	3,989,652	1,996,610
Interest and fee income	9,798,596	2,353,193	15,356,491	4,845,339
Total revenues	<u>24,591,291</u>	<u>10,909,814</u>	<u>42,649,639</u>	<u>21,667,486</u>
Expenses				
Real estate depreciation and amortization	2,791,074	1,434,791	5,330,939	2,869,353
General and administrative	3,021,472	2,838,447	7,659,152	5,354,618
Total operating expenses	<u>5,812,546</u>	<u>4,273,238</u>	<u>12,990,091</u>	<u>8,223,971</u>
Operating income	18,778,745	6,636,576	29,659,548	13,443,515
Other income (expense)				
Interest income	99,506	321,786	277,719	574,065
Interest expense	(5,381,638)	—	(10,394,872)	—
Net other (expense) income	<u>(5,282,132)</u>	<u>321,786</u>	<u>(10,117,153)</u>	<u>574,065</u>
Income from continuing operations	<u>13,496,613</u>	<u>6,958,362</u>	<u>19,542,395</u>	<u>14,017,580</u>
Income (loss) from discontinued operations	(1,985,031)	956,709	2,173,139	1,875,101
Net income	<u>\$ 11,511,582</u>	<u>\$ 7,915,071</u>	<u>\$ 21,715,534</u>	<u>\$ 15,892,681</u>
Net income per common share — basic				
Income from continuing operations	\$ 0.27	\$ 0.18	\$ 0.42	\$ 0.35
Income (loss) from discontinued operations	(0.04)	0.02	0.05	0.05
Net income	<u>\$ 0.23</u>	<u>\$ 0.20</u>	<u>\$ 0.47</u>	<u>\$ 0.40</u>
Weighted average shares outstanding — basic	<u>49,040,141</u>	<u>39,519,695</u>	<u>45,948,878</u>	<u>39,480,684</u>
Net income per share — diluted				
Income from continuing operations	\$ 0.27	\$ 0.18	\$ 0.42	\$ 0.35
Income (loss) from discontinued operations	(0.04)	0.02	0.05	0.05
Net income	<u>\$ 0.23</u>	<u>\$ 0.20</u>	<u>\$ 0.47</u>	<u>\$ 0.40</u>
Weighted average shares outstanding — diluted	<u>49,293,328</u>	<u>39,757,723</u>	<u>46,155,705</u>	<u>39,633,158</u>

See accompanying notes to condensed consolidated financial statements.

MEDICAL PROPERTIES TRUST, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	For the Six Months Ended June 30,	
	2007	2006
Operating activities		
Net income	\$ 21,715,534	\$ 15,892,681
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	5,576,423	3,629,981
Straight-line rent revenue	(3,989,652)	(2,560,868)
Share-based compensation	1,586,653	1,583,025
Gain on sale of real estate	(4,061,626)	—
Increase (decrease) in accounts payable and accrued liabilities	(13,082,545)	4,174,397
Other adjustments	(115,245)	(2,224,708)
Net cash provided by operating activities	7,629,542	20,494,508
Investing activities		
Real estate acquired	(28,401,269)	(9,475,775)
Principal received on loans receivable	48,629,745	—
Proceeds from sale of real estate	68,203,802	—
Investment in loans receivable	(123,283,327)	(1,410,000)
Construction in progress and other	(10,447,925)	(52,252,403)
Net cash used for investing activities	(45,298,974)	(63,138,178)
Financing activities		
Additions to debt	123,200,000	29,968,658
Payments of debt	(191,862,008)	(29,000,000)
Distributions paid	(25,509,266)	(15,605,995)
Sale of common stock	135,809,396	—
Other financing activities	517,349	(1,211)
Net cash provided by (used for) financing activities	42,155,471	(14,638,548)
Increase (decrease) in cash and cash equivalents for period	4,486,039	(57,282,218)
Cash and cash equivalents at beginning of period	4,102,873	59,115,832
Cash and cash equivalents at end of period	\$ 8,588,912	\$ 1,833,614
Interest paid, including capitalized interest of \$1,335,413 in 2007 and \$2,582,531 in 2006	\$ 9,494,105	\$ 3,262,813
Supplemental schedule of non-cash investing activities		
Construction in progress transferred to land and building	66,202,763	—
Interest and other receivables recorded as deferred revenue	3,027,433	3,501,836
Interest and other receivables transferred to loans receivable	4,621,677	—
Other non-cash investing activities	749,940	232,500
Supplemental schedule of non-cash financing activities:		
Distributions declared, unpaid	\$ 13,343,278	\$ 10,047,552
Other non-cash financing activities	30,679	237,042

See accompanying notes to condensed consolidated financial statements.

MEDICAL PROPERTIES TRUST, INC. AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements (Unaudited)

1. Organization

Medical Properties Trust, Inc., a Maryland corporation (the Company), was formed on August 27, 2003 under the General Corporation Law of Maryland for the purpose of engaging in the business of investing in and owning commercial real estate. The Company's operating partnership subsidiary, MPT Operating Partnership, L.P. (the Operating Partnership) through which it conducts all of its operations, was formed in September 2003. Through another wholly owned subsidiary, Medical Properties Trust, LLC, the Company is the sole general partner of the Operating Partnership. The Company presently owns directly all of the limited partnership interests in the Operating Partnership.

The Company's primary business strategy is to acquire and develop real estate and improvements, primarily for long term lease to providers of healthcare services such as operators of general acute care hospitals, inpatient physical rehabilitation hospitals, long-term acute care hospitals, surgery centers, centers for treatment of specific conditions such as cardiac, pulmonary, cancer, and neurological hospitals, and other healthcare-oriented facilities. The Company manages its business as a single business segment as defined in Statement of Financial Accounting Standards (SFAS) No. 131, *Disclosures about Segments of an Enterprise and Related Information*.

From the time of the Company's initial capitalization in April 2004 through completion of the follow-on offering in the first quarter of 2007, the Company has sold approximately 48.0 million shares of common stock and realized net proceeds of approximately \$494.5 million. The Company has also issued \$125.0 million in fixed rate term notes and \$138.0 million in fixed rate exchangeable notes. At August 1, 2007, the Company has in place \$192.0 million of secured revolving credit facilities with a total available borrowing base of approximately \$115.4 million.

2. Summary of Significant Accounting Policies

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Principles of Consolidation: Property holding entities and other subsidiaries of which the Company owns 100% of the equity or has a controlling financial interest evidenced by ownership of a majority voting interest are consolidated. All inter-company balances and transactions are eliminated. For entities in which the Company owns less than 100% of the equity interest, the Company consolidates the property if it has the direct or indirect ability to make decisions about the entities' activities based upon the terms of the respective entities' ownership agreements. For entities in which the Company owns less than 100% and does not have the direct or indirect ability to make decisions but does exert significant influence over the entities' activities, the Company records its ownership in the entity using the equity method of accounting.

The Company periodically evaluates all of its transactions and investments to determine if they represent variable interests in a variable interest entity as defined by Financial Accounting Standards Board (FASB) Interpretation No. 46 (revised December 2003) (FIN 46-R), *Consolidation of Variable Interest Entities*, an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*. If the Company determines that it has a variable interest in a variable interest entity, the Company determines if it is the primary beneficiary of the variable interest entity. The Company consolidates each variable interest entity in which the Company, by virtue of its transactions with or investments in the entity, is considered to be the primary beneficiary. The Company re-evaluates its status as primary beneficiary when a variable interest entity or potential variable interest entity has a material change in its variable interests.

Unaudited Interim Condensed Consolidated Financial Statements: The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information, including rules and regulations of the Securities and Exchange

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Commission. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three month and six month periods ended June 30, 2007, are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2006 Annual Report on Form 10-K filed with the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended.

New Accounting Pronouncements: In June 2006, the FASB issued Interpretation No. 48 *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* (FIN No. 48). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with SFAS No. 109 *Accounting for Income Taxes* and prescribes a recognition threshold and measurement attribute of tax positions taken or expected to be taken on a tax return. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company adopted FIN No. 48 on January 1, 2007. No amounts were recorded for unrecognized tax benefits or related interest expense and penalties as a result of the implementation of FIN No. 48. The taxable periods ending December 31, 2004 through December 31, 2006 remain open to examination by the Internal Revenue Service and the tax authorities of significant jurisdictions in which the Company does business.

On July 25, 2007, the FASB authorized a FASB Staff Position (the "proposed FSP") that, if issued, would affect the accounting for our exchangeable notes. If issued in the form expected, the proposed FSP would require that the initial debt proceeds from the sale of our exchangeable notes be allocated between a liability component and an equity component. The resulting debt discount would be amortized over the period the debt is expected to be outstanding as additional interest expense. The proposed FSP is expected to be effective for fiscal years beginning after December 15, 2007, and require retroactive application. The Company is currently evaluating the effect of this proposed FSP.

Reclassifications: Certain reclassifications have been made to the consolidated financial statements to conform to the 2007 consolidated financial statement presentation. These reclassifications have no impact on stockholders' equity or net income.

3. Real Estate and Lending Activities

In May, 2007, the Company received full payment on its mortgage loan on the facility in Odessa, Texas and received a prepayment fee of approximately \$2.3 million.

In May, 2007, the Company acquired a general acute care hospital located in San Diego, CA at a cost of \$22.8 million and entered into an operating lease with the operator. The lease has a 15 year fixed term and contains annual rent escalations at the general increase in the consumer price index. In addition, the Company made loans totaling \$25.0 million collateralized by interests in real property. This loan requires the payment of interest only during the 15 year term with principal due in full at maturity. The loan may be prepaid under certain specified conditions.

For the three months ended June 30, 2007 and 2006, revenue from Vibra Healthcare, LLC accounted for 28.8% and 63.8%, respectively, of total revenue. For the six months ended June 30, 2007 and 2006, revenue from Vibra Healthcare, LLC accounted for 32.1% and 64.0% of total revenue. For the three months ended June 30, 2007 and 2006, revenue from affiliates of Prime Healthcare Services, Inc. accounted for 27.0% and 18.6%, respectively, of total revenue. For the six months ended June 30, 2007 and 2006, revenue from affiliates of Prime Healthcare Services, Inc. accounted for 23.8% and 18.7%, respectively, of total revenue.

4. Debt

The following is a summary of debt:

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	As of June 30, 2007		As of December 31, 2006	
	Balance	Interest Rate	Balance	Interest Rate
Revolving credit facility	\$ 20,515,897	7.670%	\$ 45,996,359	7.800%
Senior unsecured notes — fixed rate through July and October, 2011, due July and October, 2016	125,000,000	7.333% - 7.871%	125,000,000	7.333% - 7.871%
Exchangeable senior notes due November, 2011	134,335,574	6.125%	133,965,539	6.125%
	<u>\$ 279,851,471</u>		<u>\$ 304,961,898</u>	

As of June 30, 2007, principal payments due for our senior unsecured and exchangeable notes were as follows:

2007	\$ —
2008	—
2009	—
2010	—
2011	134,335,574
Thereafter	125,000,000
Total	<u>\$ 259,335,574</u>

In July, 2007, the Company signed a Credit Agreement for a \$42.0 million secured revolving credit facility. The agreement has a five year term and has an interest rate of the 30-day LIBOR plus a spread of 150 basis points. The agreement also requires the payment of certain fees and that the Company comply with certain financial covenants common to similar credit arrangements. The credit facility is secured by real estate with a book value of \$62.3 million at June 30, 2007. The Company may borrow up to 65% of the real estate cost, subject to the appraised value. This agreement requires the payment of interest only during its term. The maximum committed amount is reduced \$800,000 per year beginning in Year 3.

5. Common Stock

In the six months ended June 30, 2007, the Company completed the sale of 12,217,900 shares of common stock at a price of \$15.60 per share, less underwriting commissions. Of the 12 million shares sold, the underwriters borrowed from third parties and sold 3,000,000 shares of Company common stock in connection with forward sale agreements between the Company and affiliates of the underwriters (the “forward purchasers”). The Company expects to settle the forward sale agreements and receive proceeds, subject to certain adjustments, from the sale of those shares only upon one or more future physical settlements of the forward sale agreements on a date or dates specified by the Company by February 28, 2008. The Company may elect to settle the forward sale agreements in cash, in which case the Company may not receive any proceeds and may owe cash to the forward purchasers. Cash settlement is based on the difference between the then current forward price and the current market price of the total shares remaining to be settled under the forward sale agreements.

6. Stock Awards

The Company has adopted the Second Amended and Restated Medical Properties Trust, Inc. 2004 Equity Incentive Plan (the Equity Incentive Plan) which authorizes the issuance of options to purchase shares of common stock, restricted stock awards, restricted stock units, deferred stock units, stock appreciation rights, performance units and other stock-based awards, including profits interest in the operating partnership. The Equity Incentive Plan is administered by the Compensation Committee of the Board of Directors. At June 30, 2007, the Company had 6,216,215 shares of common stock available for awards under the Equity Incentive Plan, which includes the addition of 2,750,000 shares approved by the Company’s shareholders in May, 2007.

In the six month period ended June 30, 2007, the Compensation Committee of the Board of Directors awarded 134,000 shares of restricted stock to management and other employees of the Company. The awards vest over a five year period based on service criteria. In May, 2007, the Compensation Committee awarded 28,750 shares of restricted stock to Company directors. These restricted shares vest over three years. The Company recorded non-cash expense for share based compensation of approximately \$792,000 and \$1,587,000 in the three and six month periods ended June 30, 2007, respectively, compared to approximately \$977,000 and \$1,583,000 in the same periods in 2006, respectively.

7. Discontinued Operations

In 2006, the Company terminated leases for a hospital and medical office building (“MOB”) complex and re-possessed the real estate. In January, 2007, the Company sold the hospital and MOB complex for a sales price of approximately \$71.7 million and recorded a gain of approximately \$4.1 million, which is reported in results from discontinued operations. During the period from the lease termination to the date of sale, the hospital was leased to and operated by a third party operator under contract to the hospital. The Company has substantially funded through loans the working capital requirements of the operator pending the operator’s collection of patient receivables from Medicare and other third party payors. The accompanying financial statements include provisions to reduce such loans to their estimated net realizable value, including a \$1.5 million provision recorded during the quarter ended June 30, 2007.

The following table presents the results of discontinued operations for the three and six months ended June 30, 2007 and 2006:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2006	2006
Revenues	\$ —	\$ 2,254,557	\$ 386,527	\$ 4,189,152
Net (loss) profit	(1,985,031)	956,709	2,173,139	1,875,101
(Loss) earnings per share — basic and diluted	\$ (0.04)	\$ 0.02	\$ 0.05	\$ 0.05

8. Earnings Per Share

The following is a reconciliation of the weighted average shares used in net income per common share to the weighted average shares used in net income per common share — assuming dilution for the three and six months ended June 30, 2007 and 2006, respectively:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
Weighted average number of shares issued and outstanding	48,983,790	39,471,096	45,899,407	39,437,959
Vested deferred stock units	56,351	48,599	49,471	42,725
Weighted average shares — basic	49,040,141	39,519,695	45,948,878	39,480,684
Common stock options and unvested restricted stock	253,187	238,028	206,827	152,474
Weighted average shares — diluted	49,293,328	39,757,723	46,155,705	39,633,158

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

The following discussion and analysis of the consolidated financial condition and consolidated results of operations should be read together with the consolidated financial statements of Medical Properties Trust, Inc. and notes thereto contained in this Form 10-Q and the financial statements and notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2006.

Forward-Looking Statements.

This report on Form 10-Q contains certain “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results or future performance, achievements or transactions or events to be materially different from those expressed or implied by such forward-looking statements, including, but not limited to, the risks described in our Annual Report on Form 10-K for the year ended December 31, 2006, filed with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, as amended. Such factors include, among others, the following:

- National and local economic, business, real estate and other market conditions;
- The competitive environment in which the Company operates;
- The execution of the Company’s business plan;
- Financing risks;
- Acquisition and development risks;
- Potential environmental and other liabilities;
- Other factors affecting real estate industry generally or the healthcare real estate industry in particular;
- Our ability to attain and maintain our status as a REIT for federal and state income tax purposes;
- Our ability to attract and retain qualified personnel; and,
- Federal and state healthcare regulatory requirements.

Overview

We were incorporated under Maryland law on August 27, 2003 primarily for the purpose of investing in and owning net-leased healthcare facilities across the United States. We have operated as a real estate investment trust (“REIT”) since April 6, 2004, and accordingly, elected REIT status upon the filing in September 2005 of our calendar year 2004 federal income tax return. We acquire and develop healthcare facilities and lease the facilities to healthcare operating companies under long-term net leases. We also make mortgage loans to healthcare operators secured by their real estate assets. We also selectively make loans to certain of our operators through our taxable REIT subsidiary, the proceeds of which are used for acquisitions and working capital.

At June 30, 2007, we owned 22 operating healthcare facilities and held five mortgage loans secured by interests in real property. We had one acquisition loan outstanding, the proceeds of which our tenant used for the acquisition of six hospital operating companies. The 22 facilities we owned and the facilities on which we had made mortgage loans were in ten states, had a carrying cost of approximately \$692.3 million and comprised approximately 86.2% of our total assets. Our acquisition and other loans of approximately \$72.5 million represented approximately 9.0% of our total assets. We do not expect such loan assets at any time to exceed 20% of our total assets.

At August 1, 2007, we had 22 employees. Over the next 12 months, we expect to add four to six additional employees as we acquire new properties and manage our existing properties and loans.

Key Factors that May Affect Our Operations

Our revenues are derived from rents we earn pursuant to the lease agreements with our tenants and from interest income from loans to our tenants and other facility owners. Our tenants operate in the healthcare industry, generally providing medical, surgical and rehabilitative care to patients. The capacity of our tenants to pay our rents and interest is dependent upon their ability to conduct their operations at profitable levels. We believe that the business environment of the industry segments in which our tenants operate is generally positive for efficient operators. However, our tenants' operations are subject to economic, regulatory and market conditions that may affect their profitability. Accordingly, we monitor certain key factors, changes to which we believe may provide early indications of conditions that may affect the level of risk in our lease and loan portfolio.

Key factors that we consider in underwriting prospective tenants and in monitoring the performance of existing tenants include the following:

- the historical and prospective operating margins (measured by a tenant's earnings before interest, taxes, depreciation, amortization and facility rent) of each tenant and at each facility;
- the ratio of our tenants' operating earnings both to facility rent and to facility rent plus other fixed costs, including debt costs;
- trends in the source of our tenants' revenue, including the relative mix of Medicare, Medicaid/MediCal, managed care, commercial insurance, and private pay patients; and
- the effect of evolving healthcare regulations on our tenants' profitability.

Certain business factors, in addition to those described above that directly affect our tenants, will likely materially influence our future results of operations. These factors include:

- trends in the cost and availability of capital, including market interest rates, that our prospective tenants may use for their real estate assets instead of financing their real estate assets through lease structures;
- unforeseen changes in healthcare regulations that may limit the opportunities for physicians to participate in the ownership of healthcare providers and healthcare real estate;
- reductions in reimbursements from Medicare, state healthcare programs, and commercial insurance providers that may reduce our tenants' profitability and our lease rates, and;
- competition from other financing sources.

CRITICAL ACCOUNTING POLICIES

In order to prepare financial statements in conformity with accounting principles generally accepted in the United States, we must make estimates about certain types of transactions and account balances. We believe that our estimates of the amount and timing of lease revenues, credit losses, fair values and periodic depreciation of our real estate assets, stock compensation expense, and the effects of any derivative and hedging activities will have significant effects on our financial statements. Each of these items involves estimates that require us to make subjective judgments. We rely on our experience, collect historical data and current market data, and develop relevant assumptions to arrive at what we believe to be reasonable estimates. Under different conditions or assumptions, materially different amounts could be reported related to the accounting policies described below. In addition, application of these accounting policies involves the exercise of judgment on the use of assumptions as to future uncertainties and, as a result, actual results could materially differ from these estimates. Our accounting estimates include the following:

Revenue Recognition. Our revenues, which are comprised largely of rental income, include rents that each tenant pays in accordance with the terms of its respective lease reported on a straight-line basis over the initial term of the lease. Since some of our leases provide for rental increases at specified intervals, straight-line basis accounting requires us to record as an asset, and include in revenues, straight-line rent that we will only receive if the tenant makes all rent payments required through the expiration of the term of the lease.

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Accordingly, our management determines, in its judgment, to what extent the straight-line rent receivable applicable to each specific tenant is collectible. We review each tenant's straight-line rent receivable on a quarterly basis and take into consideration the tenant's payment history, the financial condition of the tenant, business conditions in the industry in which the tenant operates, and economic conditions in the area in which the facility is located. In the event that the collectibility of straight-line rent with respect to any given tenant is in doubt, we are required to record an increase in our allowance for uncollectible accounts or record a direct write-off of the specific rent receivable, which would have an adverse effect on our net income for the year in which the reserve is increased or the direct write-off is recorded and would decrease our total assets and stockholders' equity. At that time, we stop accruing additional straight-line rent income.

Our development projects normally allow for us to earn what we term "construction period rent". Construction period rent accrues to us during the construction period based on the funds which we invest in the facility. During the construction period, the unfinished facility does not generate any earnings for the lessee/operator which can be used to pay us for our funds used to build the facility. In such cases, the lessee/operator pays the accumulated construction period rent over the term of the lease beginning when the lessee/operator takes physical possession of the facility. We record the accrued construction period rent as deferred revenue during the construction period, and recognize earned revenue as the construction period rent is paid to us by the lessee/operator. We make loans to our tenants and from time to time may make construction or mortgage loans to facility owners or other parties. We recognize interest income on loans as earned based upon the principal amount outstanding. These loans are generally secured by interests in real estate, receivables, the equity interests of a tenant, or corporate and individual guarantees and are usually cross-defaulted with their leases and/or other loans. As with straight-line rent receivables, our management must also periodically evaluate loans to determine what amounts may not be collectible. Accordingly, a provision for losses on loans receivable is recorded when it becomes probable that the loan will not be collected in full. The provision is an amount which reduces the loan to its estimated net receivable value based on a determination of the eventual amounts to be collected either from the debtor or from the collateral, if any. At that time, we discontinue recording interest income on the loan to the tenant.

Investments in Real Estate. We record investments in real estate at cost, and we capitalize improvements and replacements when they extend the useful life or improve the efficiency of the asset. While our tenants are generally responsible for all operating costs at a facility, to the extent that we incur costs of repairs and maintenance, we expense those costs as incurred. We compute depreciation using the straight-line method over the estimated useful life of 40 years for buildings and improvements, three to seven years for equipment and fixtures, and the shorter of the useful life or the remaining lease term for tenant improvements and leasehold interests.

We are required to make subjective assessments as to the useful lives of our facilities for purposes of determining the amount of depreciation expense to record on an annual basis with respect to our investments in real estate improvements. These assessments have a direct impact on our net income because, if we were to shorten the expected useful lives of our investments in real estate improvements, we would depreciate these investments over fewer years, resulting in more depreciation expense and lower net income on an annual basis.

We have adopted Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which establishes a single accounting model for the impairment or disposal of long-lived assets, including discontinued operations. SFAS No. 144 requires that the operations related to facilities that have been sold, or that we intend to sell, be presented as discontinued operations in the statement of operations for all periods presented, and facilities we intend to sell be designated as "held for sale" on our balance sheet.

When circumstances such as adverse market conditions indicate a possible impairment of the value of a facility, we review the recoverability of the facility's carrying value. The review of recoverability is based on our estimate of the future undiscounted cash flows, excluding interest charges, from the facility's use and eventual disposition. Our forecast of these cash flows considers factors such as expected future operating income, market and other applicable trends, and residual value, as well as the effects of leasing demand, competition and other factors. If impairment exists due to the inability to recover the carrying value of a facility, an impairment loss is recorded to the extent that the carrying value exceeds the estimated fair value of the facility. We are required to make subjective assessments as to whether there are impairments in the values of our investments in real estate.

Purchase Price Allocation. We record above-market and below-market in-place lease values, if any, for the facilities we own which are based on the present value (using an interest rate which reflects the risks associated with

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the leases acquired) of the difference between (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) management's estimate of fair market lease rates for the corresponding in-place leases, measured over a period equal to the remaining non-cancelable term of the lease. We amortize any resulting capitalized above-market lease values as a reduction of rental income over the remaining non-cancelable terms of the respective leases. We amortize any resulting capitalized below-market lease values as an increase to rental income over the initial term and any fixed-rate renewal periods in the respective leases. Because our strategy to a large degree involves the origination of long term lease arrangements at market rates at the same time we acquire the property, we do not expect the above-market and below-market in-place lease values to be significant for many of our anticipated transactions.

We measure the aggregate value of other intangible assets to be acquired based on the difference between (i) the property valued with existing leases adjusted to market rental rates and (ii) the property valued as if vacant. Management's estimates of value are made using methods similar to those used by independent appraisers (e.g., discounted cash flow analysis). Factors considered by management in its analysis include an estimate of carrying costs during hypothetical expected lease-up periods considering current market conditions, and costs to execute similar leases. We also consider information obtained about each targeted facility as a result of our pre-acquisition due diligence, marketing, and leasing activities in estimating the fair value of the tangible and intangible assets acquired. In estimating carrying costs, management also includes real estate taxes, insurance and other operating expenses and estimates of lost rentals at market rates during the expected lease-up periods, which we expect to range primarily from three to 18 months, depending on specific local market conditions. Management also estimates costs to execute similar leases including leasing commissions, legal costs, and other related expenses to the extent that such costs are not already incurred in connection with a new lease origination as part of the transaction.

The total amount of other intangible assets to be acquired, if any, is further allocated to in-place lease values and customer relationship intangible values based on management's evaluation of the specific characteristics of each prospective tenant's lease and our overall relationship with that tenant. Characteristics to be considered by management in allocating these values include the nature and extent of our existing business relationships with the tenant, growth prospects for developing new business with the tenant, the tenant's credit quality, and expectations of lease renewals, including those existing under the terms of the lease agreement, among other factors.

We amortize the value of in-place leases to expense over the initial term of the respective leases, which range primarily from 10 to 15 years. The value of customer relationship intangibles is amortized to expense over the initial term and any renewal periods in the respective leases, but in no event will the amortization period for intangible assets exceed the remaining depreciable life of the building. Should a tenant terminate its lease, the unamortized portion of the in-place lease value and customer relationship intangibles would be charged to expense.

Loans and Losses from Rent Receivables and Loans. We record provisions for losses on rent receivables and loans when it becomes probable that the receivable or loan will not be collected in full. The provision is an amount which reduces the rent or loan to its estimated net realizable value based on a determination of the eventual amounts to be collected either from the debtor or from the collateral, if any. The determination of when to record a provision for loss on loans and rent requires us to estimate amounts to be recovered from collateral, the ability of the tenant and/or borrower to repay, the ability of the tenant and/or borrower to improve its operations.

Accounting for Derivative Financial Investments and Hedging Activities. We expect to account for our derivative and hedging activities, if any, using SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 137 and SFAS No. 149, which requires all derivative instruments to be carried at fair value on the balance sheet.

Derivative instruments designated in a hedge relationship to mitigate exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. We expect to formally document all relationships between hedging instruments and hedged items, as well as our risk-management objective and strategy for undertaking each hedge transaction. We plan to review periodically the effectiveness of each hedging transaction, which involves estimating future cash flows. Cash flow hedges, if any, will be accounted for by recording the fair value of the derivative instrument on the balance sheet as either an asset or liability, with a corresponding amount recorded in other comprehensive income within stockholders' equity. Amounts will be reclassified from other comprehensive income to the income statement in the period or periods the hedged forecasted transaction affects earnings. Derivative instruments designated in a hedge relationship to mitigate exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, which we expect to affect the Company primarily in the form of interest rate risk or variability of interest rates, are considered fair value hedges under SFAS No. 133. We are not currently a party to any derivatives contracts designated as cash flow hedges.

In 2006, we entered into derivative contracts as part of our offering of Exchangeable Senior Notes (the "exchangeable notes"). The contracts are generally termed "capped call" or "call spread" contracts. These contracts are financial instruments which are separate from the exchangeable notes themselves, but affect the overall potential number of shares which will be issued by us to satisfy the conversion feature in the exchangeable notes. The

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exchangeable notes can be exchanged into shares of our common stock when our stock price exceeds \$16.54 per share, which is the equivalent of 60.4583 shares per \$1,000 note. The number of shares actually issued upon conversion will be equivalent to the amount by which our stock price exceeds \$16.54 times the 60.4583 conversion rate. The “capped call” transaction allows us to effectively increase that exchange price from \$16.54 to \$18.94. Therefore, our shareholders will not experience dilution of their shares from any settlement or conversion of the exchangeable notes until the price of our stock exceeds \$18.94 per share rather than \$16.54 per share. When evaluating this transaction, we have followed the guidance in Emerging Issues Task Force (EITF) No. 00-19 *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock*. EITF No. 00-19 requires that contracts such as this “capped call” which meet certain conditions must be accounted for as permanent adjustments to equity rather than periodically adjusted to their fair value as assets or liabilities. We have evaluated the terms of these contracts and recorded this “capped call” as a permanent adjustment to stockholders’ equity in 2006.

The exchangeable notes themselves also contain the conversion feature described above. SFAS No. 133 also states that certain “embedded” derivative contracts must follow the guidance of EITF No. 00-19 and be evaluated as though they also were a “freestanding” derivative contract. Embedded derivative contracts such as the conversion feature in the notes should not be treated as a financial instrument separate from the note if it meets certain conditions in EITF No. 00-19. We have evaluated the conversion feature in the exchangeable notes and have determined that it should not be reported separately from the debt.

Variable Interest Entities. In January 2003, the FASB issued Interpretation No. 46 (FIN 46), *Consolidation of Variable Interest Entities*. In December 2003, the FASB issued a revision to FIN 46, which is termed FIN 46(R). FIN 46(R) clarifies the application of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, and provides guidance on the identification of entities for which control is achieved through means other than voting rights, guidance on how to determine which business enterprise should consolidate such an entity, and guidance on when it should do so. This model for consolidation applies to an entity in which either (1) the equity investors (if any) do not have a controlling financial interest or (2) the equity investment at risk is insufficient to finance that entity’s activities without receiving additional subordinated financial support from other parties. An entity meeting either of these two criteria is a variable interest entity, or VIE. A VIE must be consolidated by any entity which is the primary beneficiary of the VIE. If an entity is not the primary beneficiary of the VIE, the VIE is not consolidated. We periodically evaluate the terms of our relationships with our tenants and borrowers to determine whether we are the primary beneficiary and would therefore be required to consolidate any tenants or borrowers that are VIEs. Our evaluations of our transactions indicate that we have loans receivable from two entities which we classify as VIEs. However, because we are not the primary beneficiary of these VIEs, we do not consolidate these entities in our financial statements.

Stock-Based Compensation. Prior to 2006, we used the intrinsic value method to account for the issuance of stock options under our equity incentive plan in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees*. SFAS No. 123(R) became effective for our annual and interim periods beginning January 1, 2006, but had no material effect on the results of our operations. During the three and six month periods ended June 30, 2007, we recorded \$792,000 and \$1,587,000 of expense for share based compensation, related to grants of restricted common stock. In 2006, we also granted performance based restricted share awards. Because these awards will vest based on the Company’s performance, we must evaluate and estimate the probability of achieving those performance targets. Any changes in these estimates and probabilities must be recorded in the period when they are changed. During 2006, we awarded 105,375 shares of restricted stock which are based solely on performance criteria over the next five years. We expect that there may be additional share based awards which will vest based on the performance rather than service criteria.

LIQUIDITY AND CAPITAL RESOURCES

As of August 1, 2007, we have approximately \$7.1 million in cash and cash equivalents.

From the time of our initial capitalization in April 2004 through completion of our 2007 follow-on offering, we have sold approximately 48.0 million shares of common stock and realized net proceeds of approximately \$494.5 million. We have also issued \$125.0 million in fixed rate term notes and \$138.0 million in fixed rate exchangeable notes. At August 1, 2007, we have in place \$192.0 million of secured revolving credit facilities with an available borrowing base of approximately \$115.4 million (with availability on August 1, 2007, of approximately \$85.5 million).

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We have substantially used this equity and debt capital to acquire and develop healthcare real estate, fund mortgage loans and fund other loans to healthcare operators. We believe our present capitalization provides sufficient liquidity and resources to continue executing our business plan for the foreseeable future.

Short-term Liquidity Requirements: We believe that our existing cash and temporary investments, funds available under our existing loan agreements, additional financing arrangements and cash from operations will be sufficient for us to acquire at least \$200 million in additional assets, provide for working capital, and make required distributions to our stockholders through the remainder of 2007. We expect that such additional financing arrangements may include various types of new debt, including long-term, fixed-rate mortgage loans, variable-rate term loans, and construction financing facilities. Generally, we believe we will be able to finance up to approximately 50-60% of the cost of our healthcare facilities; however, there is no assurance that we will be able to obtain or maintain those levels of debt on our portfolio of real estate assets on favorable terms in the future.

Long-term Liquidity Requirements: We believe that cash flow from operating activities subsequent to 2007 will be sufficient to provide adequate working capital and make required distributions to our stockholders in compliance with our requirements as a REIT. However, in order to continue acquisition and development of healthcare facilities after 2007, we will require access to more permanent external capital, including equity capital. If equity capital is not available at a price that we consider appropriate, we may increase our debt, selectively dispose of assets, utilize other forms of capital, if available, or reduce our acquisition activity.

In the first quarter of 2007, we sold 9.2 million shares of common stock and realized net proceeds of \$136.1 million. Concurrently, the underwriters borrowed from third parties and sold 3 million shares of our common stock in connection with forward sale agreements between us and affiliates of the underwriters. We did not receive any proceeds from the sale of shares of our common stock by the forward purchasers. We expect to settle the forward sale agreements and receive proceeds, subject to certain adjustments, from the sale of those shares upon one or more future physical settlements of the forward sale agreements on a date or dates specified by us by February 28, 2008. The forward sale arrangements allow us to take down the proceeds as needed at a pre-determined price, but without immediately diluting our existing shares.

On July 31, 2007, our Board of Directors approved a common share repurchase program for up to 3.0 million shares. If we repurchase some or all of these shares, we may be required to increase our borrowings, reduce our acquisition activities, or otherwise adjust our investing and capital plans. The repurchase program will expire on July 31, 2008.

Results of Operations

Three months Ended June 30, 2007 Compared to Three Months Ended June 30, 2006

Net income for the three months ended June 30, 2007, was \$11,511,582 compared to net income of \$7,915,071 for the three months ended June 30, 2006, a 45.4% increase.

A comparison of revenues for the three month periods ended June 30, 2007 and 2006, is as follows, as adjusted in 2006 for discontinued operations:

	2007	% of Total	2006	% of Total	Year over Year Change
Base rents	\$ 11,356,942	46.2%	\$ 6,902,430	63.2%	64.5%
Straight-line rents	3,305,702	13.4%	998,303	9.2%	231.1%
Percentage rents	130,051	0.5%	655,888	6.0%	(80.2%)
Fee income	2,597,004	10.6%	250,484	2.3%	936.8%
Interest from loans	7,201,592	29.3%	2,102,709	19.3%	242.5%
Total revenue	<u>\$24,591,291</u>	<u>100.0%</u>	<u>\$10,909,814</u>	<u>100.0%</u>	125.4%

Revenue of \$24,591,291 in the three months ended June 30, 2007, was comprised of rents (60.1%) and interest from loans and fee income (39.9%). In the second quarter of 2007, we owned 22 rent producing properties compared to 14 in the second quarter of 2006, which accounted for the increase in base rents. During the second quarter of 2007, we received percentage rents of approximately \$130,000 from Vibra, a \$526,000 decrease from the second quarter of 2006, which is related to revisions and extensions of certain leases and loans with Vibra. Fee income in the three months ended June 30, 2007 compared to the same period in 2006 increased due to a fee of approximately \$2.3 million received from the prepayment of one of our mortgage loans in May, 2007. Interest income from loans in the quarter ended June 30, 2007 compared to the same period in

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2006 increased due to origination of four additional mortgage loans totaling \$185,000,000 in the third quarter of 2006 and the first quarter of 2007. Vibra accounted for 28.8% and 63.8% of our gross revenues during the three months ended June 30, 2007 and 2006, respectively, and affiliates of Prime accounted for 27.0% and 18.6% of total revenue, respectively.

We expect our revenue to continue to increase in future quarters as a result of expected acquisitions and potential new development projects. We also expect that the relative portion of our revenue that is paid by Vibra will continue to decline as a result of continued tenant diversification.

Depreciation and amortization during the second quarter of 2007, was \$2,791,074, compared to \$1,434,791 during the second quarter of 2006, a 94.5% increase. All of this increase is related to an increase in the number of rent producing properties from the second quarter of 2006 to the second quarter 2007. We expect our depreciation and amortization expense to continue to increase commensurate with our acquisition and development activity.

General and administrative expenses in the second quarter of 2007 were relatively flat compared to the same period in 2006, increasing approximately \$183,000, or 6.5%, from 2,838,447 to \$3,021,472. General and administrative expenses include compensation expense related to our Equity Incentive Plan of \$792,000 and \$977,000, in the three months ended June 30, 2007 and 2006, respectively.

Interest expense for the quarter ended June 30, 2007 totaled \$5,381,638. Capitalized interest for the quarters ended June 30, 2007 and 2006, totaled \$368,110 and \$1,453,114, respectively. Interest expense increased due to larger debt balances in 2007 compared to 2006. Capitalized interest decreased due to our final development under construction being placed into service in April, 2007, compared to three developments under construction totaling \$96.9 million at June 30, 2006.

Six months Ended June 30, 2007 Compared to Six Months Ended June 30, 2006

Net income for the six months ended June 30, 2007, was \$21,715,534 compared to net income of \$15,892,681 for the six months ended June 30, 2006, a 36.6% increase.

A comparison of revenues for the six month periods ended June 30, 2007 and 2006, is as follows, as adjusted in 2006 for discontinued operations:

	2007	% of Total	2006	% of Total	Year over Year Change
Base rents	\$23,034,750	54.0%	\$13,528,941	62.4%	70.3%
Straight-line rents	3,989,652	9.4%	1,996,610	9.2%	99.8%
Percentage rents	268,746	0.6%	1,296,596	6.0%	(79.3%)
Fee income	2,681,862	6.3%	305,240	1.4%	778.6%
Interest from loans	12,674,629	29.7%	4,540,099	21.0%	179.2%
Total revenue	<u>\$42,649,639</u>	<u>100.0%</u>	<u>\$21,667,486</u>	<u>100.0%</u>	96.8%

Revenue of \$42,649,639 in the six months ended June 30, 2007, was comprised of rents (64.0%) and interest from loans and fee income (36.0%). In the first two quarters of 2007, we owned 22 rent producing properties compared to 14 in the first two quarters of 2006, which accounted for the increase in base rents. The sale of the Victorville and Chino facilities and the related funding of mortgage loans in the first quarter of 2007 required the reversal of previously recorded non-cash straight-line rent receivable of approximately \$1.25 million. During the first two quarters of 2007, we received percentage rents of approximately \$269,000 from Vibra, a \$1.0 million decrease from the first two quarters of 2006, which is related to revisions and extensions of certain leases and loans with Vibra. Fee income in the six months ended June 30, 2007 compared to the same period in 2006 increased due to a fee of approximately \$2.3 million received from the prepayment of one of our mortgage loans in May, 2007. Interest income from loans in the two quarters ended June 30, 2007 compared to the same period in 2006 increased due to origination of four additional mortgage loans totaling \$185,000,000 in the third quarter of 2006 and the first quarter of 2007. Vibra accounted for 32.1% and 64.0% of our gross revenues during the six months ended June 30, 2007 and 2006, respectively, and affiliates of Prime accounted for 23.8% and 18.7% of total revenue, respectively.

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We expect our revenue to continue to increase in future quarters as a result of expected acquisitions and potential new development projects. We also expect that the relative portion of our revenue that is paid by Vibra will continue to decline as a result of continued tenant diversification.

Depreciation and amortization during the first two quarters of 2007, was \$5,330,939, compared to \$2,869,353 during the first two quarters of 2006, an 85.8% increase. All of this increase is related to an increase in the number of rent producing properties from the first two quarters of 2006 to the first two quarters of 2007. We expect our depreciation and amortization expense to continue to increase commensurate with our acquisition and development activity.

General and administrative expenses in the first two quarters of 2007 and 2006 totaled \$7,659,152, and \$5,354,618, respectively, an increase of 43.0%. Of the increase, approximately \$1.6 million was the result of a non-recurring adjustment in compensation policies during the first quarter of 2007. General and administrative expenses included compensation expense related to our Amended 2004 Equity Incentive Plan of \$1,587,000 and \$1,583,000 for the six months ended June 30, 2007 and 2006, respectively.

Interest expense for the six months ended June 30, 2007, totaled \$10,394,872. Capitalized interest for the six months ended June 30, 2007 and 2006, totaled \$1,335,413 and \$2,582,531, respectively. All interest expense for the six months ended June 30, 2006 was capitalized as cost of development projects. Interest expense increased due to larger debt balances in 2007 compared to 2006. Capitalized interest decreased due to our final development under construction being placed into service in April, 2007, compared to three developments under construction totaling \$96.9 million at June 30, 2006.

Discontinued Operations

In 2006, the Company terminated leases for a hospital and medical office building (“MOB”) complex and re-possessed the real estate. In January, 2007, the Company sold the hospital and MOB complex for a sales price of approximately \$71.7 million and recorded a gain of approximately \$4.1 million, which is reported in results from discontinued operations. During the period from the lease termination to the date of sale, the hospital was leased to and operated by a third party operator under contract to the hospital. The Company has substantially funded through loans the working capital requirements of the operator pending the operator’s collection of patient receivables from Medicare and other third party payors. The accompanying financial statements include provisions to reduce such loans to their net realizable value, including a \$1.5 million provision recorded during the quarter ended June 30, 2007.

Reconciliation of Non-GAAP Financial Measures

Investors and analysts following the real estate industry utilize funds from operations, or FFO, as a supplemental performance measure. While we believe net income available to common stockholders, as defined by generally accepted accounting principles (GAAP), is the most appropriate measure, our management considers FFO an appropriate supplemental measure given its wide use by and relevance to investors and analysts. FFO, reflecting the assumption that real estate asset values rise or fall with market conditions, principally adjusts for the effects of GAAP depreciation and amortization of real estate assets, which assume that the value of real estate diminishes predictably over time.

As defined by the National Association of Real Estate Investment Trusts, or NAREIT, FFO represents net income (loss) (computed in accordance with GAAP), excluding gains (losses) on sales of real estate, plus real estate related depreciation and amortization and after adjustments for unconsolidated partnerships and joint ventures. We compute FFO in accordance with the NAREIT definition. FFO should not be viewed as a substitute measure of the Company’s operating performance since it does not reflect either depreciation and amortization costs or the level of capital expenditures and leasing costs necessary to maintain the operating performance of our properties, which are significant economic costs that could materially impact our results of operations.

The following table presents a reconciliation of FFO to net income for the three months and six months ended June 30, 2007 and 2006:

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The following table presents a reconciliation of FFO to net income for the three months and six months ended June 30, 2007 and 2006:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
Net income	\$ 11,511,582	\$ 7,915,071	\$ 21,715,534	\$ 15,892,681
Depreciation and amortization	2,791,074	1,434,791	5,330,939	2,869,353
Gain on sale of real estate	—	—	(4,061,626)	—
Funds from operations — FFO	14,302,656	9,349,862	22,984,847	18,762,034
Discontinued operations of real estate sold	1,985,031	(956,709)	1,888,487	(1,875,101)
Funds from operations from continuing operations	<u>\$ 16,287,687</u>	<u>\$ 8,393,153</u>	<u>\$ 24,873,334</u>	<u>\$ 16,886,933</u>

Per diluted share amounts:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
Net income	\$ 0.23	\$ 0.20	\$ 0.47	\$ 0.40
Depreciation and amortization	0.06	0.04	0.12	0.07
Gain on sale of real estate	—	—	(0.09)	—
Funds from operations — FFO	0.29	0.24	0.50	0.47
Discontinued operations of real estate sold	0.04	(0.03)	0.04	(0.04)
Funds from operations from continuing operations	<u>\$ 0.33</u>	<u>\$ 0.21</u>	<u>\$ 0.54</u>	<u>\$ 0.43</u>

Distribution Policy

We have elected to be taxed as a REIT commencing with our taxable year that began on April 6, 2004 and ended on December 31, 2004. To qualify as a REIT, we must meet a number of organizational and operational requirements, including a requirement that we distribute at least 90% of our REIT taxable income, excluding net capital gain, to our stockholders.

The table below is a summary of our distributions paid or declared during the two year period ended June 30, 2007:

Declaration Date	Record Date	Date of Distribution	Distribution per Share
May 17, 2007	June 14, 2007	July 12, 2007	\$ 0.27
February 15, 2007	March 29, 2007	April 12, 2007	\$ 0.27
November 16, 2006	December 14, 2006	January 11, 2007	\$ 0.27
August 18, 2006	September 14, 2006	October 12, 2006	\$ 0.26
May 18, 2006	June 15, 2006	July 13, 2006	\$ 0.25
February 16, 2006	March 15, 2006	April 12, 2006	\$ 0.21
November 18, 2005	December 15, 2005	January 19, 2006	\$ 0.18
August 18, 2005	September 15, 2005	September 29, 2005	\$ 0.17
May 19, 2005	June 20, 2005	July 14, 2005	\$ 0.16

We intend to pay to our stockholders, within the time periods prescribed by the Code, all or substantially all of our annual taxable income, including taxable gains from the sale of real estate and recognized gains on the sale of securities. It is our policy to make sufficient cash distributions to stockholders in order for us to maintain our status as a REIT under the Code and to avoid corporate income and excise tax on undistributed income.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Market risk includes risks that arise from changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market sensitive instruments. In pursuing our business plan, we expect that the primary market risk to which we will be exposed is interest rate risk.

In addition to changes in interest rates, the value of our facilities will be subject to fluctuations based on changes in local and regional economic conditions and changes in the ability of our tenants to generate profits, all of which may affect our ability to refinance our debt if necessary. The changes in the value of our facilities would be reflected also by changes in “cap” rates, which is measured by the current base rent divided by the current market value of a facility.

If market rates of interest on our variable rate debt increase by 1%, the increase in annual interest expense on our variable rate debt would decrease future earnings and cash flows by approximately \$299,000 per year. If market rates of interest on our variable rate debt decrease by 1%, the decrease in interest expense on our variable rate debt would increase future earnings and cash flows by approximately \$299,000 per year. This assumes that the amount outstanding under our variable rate debt remains approximately \$29.9 million, the balance at August 1, 2007.

We currently have no assets denominated in a foreign currency, nor do we have any assets located outside of the United States. We also have no exposure to derivative financial instruments.

Our exchangeable notes are exchangeable into 60.3346 shares of our stock for each \$1,000 note. This equates to a conversion price of \$16.57 per share. This conversion price adjusts based on a formula which considers increases to our dividend subsequent to the issuance of the notes in November, 2006. Our dividends declared since the notes we issued have adjusted our conversion price to \$16.54 per share. Future changes to the conversion price will depend on our level of dividends which cannot be predicted at this time. Any adjustments for dividend increases until the notes are settled in 2011 will affect the price of the notes and the number of shares for which they will eventually be settled.

At the time we issued the exchangeable notes, we also entered into a capped call or call spread transaction. The effect of this transaction was to increase the conversion price from \$16.57 to \$18.94. As a result, our shareholders will not experience any dilution until our share price exceeds \$18.94. If our share price exceeds that price, the result would be that we would issue additional shares of common stock. At a price of \$20 per share, we would be required to issue an additional 434,000 shares. At \$25 per share, we would be required to issue an additional two million shares.

Item 4. Controls and Procedures

We have adopted and maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b), under the Securities Exchange Act of 1934, as amended, we have carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the quarter covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be disclosed by the Company in the reports that the Company files with the SEC.

There has been no change in our internal control over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION**Item 1. Legal Proceedings**

Not applicable.

Item 1.A. Risk Factors

There have been no material changes to the Risk Factors as presented in our Annual Report on Form 10-K for the year ended December 31, 2006 as filed with the Commission on March 16, 2007.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) Not applicable.

(b) Not applicable.

(c) Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders

Our annual meeting of stockholders was held on May 17, 2007.

Proxies for the annual meeting were solicited pursuant to Regulation 14A under the Exchange Act. There were no solicitations in opposition to management's nominees for the board of directors or other proposals listed in our proxy statement. All nominees listed in the proxy statement were elected and all proposals listed in the proxy statement were approved.

The election of eight directors for the ensuing year was voted upon at the annual meeting. The number of votes cast for and withheld for each nominee for director is set forth below:

<u>Nominee:</u>	<u>For:</u>	<u>Withheld:</u>
Edward K. Aldag, Jr.	38,964,383	703,866
Virginia A. Clarke	39,262,223	406,026
G. Steven Dawson	39,222,309	445,940
R. Steven Hamner	38,698,143	970,106
Robert E. Holmes, Ph.D.	39,098,159	570,090
Sherry A. Kellett	39,256,628	411,621
William G. McKenzie	38,878,733	789,516
L. Glenn Orr, Jr.	39,233,553	434,696

A proposal to ratify the appointment of KPMG LLP as independent registered public accounting firm for the fiscal year ending December 31, 2007 was voted upon at the Annual Meeting. The number of votes that were cast for and against this proposal and the number of abstentions and broker non-votes are set forth below:

<u>For:</u>	<u>Against:</u>	<u>Abstentions and Broker Non-Votes:</u>
39,363,263	104,708	200,276

A proposal to allow the polls to remain open on a proposal to approve the second Amended and Restated Medical Properties Trust, Inc. 2004 Equity Incentive Plan and adjourn the Annual Meeting to May 30, 2007, was voted on at the Annual Meeting. The number of votes that were cast for and against this proposal and the number of abstentions and broker non-votes are set forth below:

<u>For:</u>	<u>Against:</u>	<u>Abstentions and Broker Non-Votes:</u>
39,668,249	—	—

The Annual Meeting reconvened on May 30, 2007. The proposal to approve the Second Amended and Restated Medical Properties Trust, Inc. 2004 Equity Incentive Plan was voted upon at the adjournment of the Annual Meeting. The number of votes that were cast for and against this proposal and the number of abstentions and broker non-votes are set forth below:

<u>For:</u>	<u>Against:</u>	<u>Abstentions and Broker Non-Votes:</u>
21,477,672	3,655,607	235,322

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Item 5. Other Information.

Not applicable.

Item 6. Exhibits

The following exhibits are filed as a part of this report:

<u>Exhibit Number</u>	<u>Description</u>
23.1	Consent of Independent Registered Public Accounting firm
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350
99.1	Consolidated Financial Statements of Vibra Healthcare, LLC as of March 31, 2007. Since Vibra Healthcare, LLC leases more than 20% of our properties under triple net leases, the financial status of Vibra may be considered relevant to investors. The most recently available financial statements for Vibra are attached as Exhibit 99.1 to this Quarterly Report on Form 10-Q. We have not participated in the preparation of Vibra's financial statements nor do we have the right to dictate the form of any financial statements provided to us by Vibra.
99.2	Consolidated Financial Statements of Prime Healthcare Services, Inc., as of December 31, 2006. Since affiliates of Prime Healthcare Services, Inc. lease more than 20% of our properties under triple net leases, the financial status of Prime may be considered relevant to investors. The most recently available financial statements for Prime are attached as Exhibit 99.2 to this Quarterly Report on Form 10-Q. We have not participated in the preparation of Prime's financial statements nor do we have the right to dictate the form of any financial statements provided to us by Prime.

SIGNATURE

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.

MEDICAL PROPERTIES TRUST, INC.

By: /s/ R. Steven Hamner

R. Steven Hamner

Executive Vice President and Chief Financial Officer

(On behalf of the Registrant and as the Registrant's

Principal Financial and Accounting Officer)

Date: August 9, 2007

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INDEX TO EXHIBITS

<u>Exhibit Number</u>	<u>Description</u>
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32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to Rule 13a-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350
99.1	Consolidated Financial Statements of Vibra Healthcare, LLC as of March 31, 2007
99.2	Consolidated Financial Statements of Prime Healthcare Services, Inc. as of December 31, 2006

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors,
Prime Healthcare Services, Inc. and Subsidiaries

We hereby consent to the incorporation by reference in the registration statements (No. 333-130337 and 333-126574) on Form S-8, (Nos. 333-121883 and 119957) on Form S-11, and (Nos. 333-140433, and 333-141100) on Form S-3 of Medical Properties Trust, Inc. of our report dated June 13, 2007, relating to the consolidated balance sheets of Prime Healthcare Services, Inc. and Subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for the three years then ended which report appears in the June 30, 2007 Quarterly Report on Form 10-Q of Medical Properties Trust, Inc.

/s/ Moss Adams LLP
Irvine, California
August 8, 2007

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO RULE 13a-14(a) UNDER THE SECURITIES EXCHANGE ACT OF 1934**

I, Edward K. Aldag, Jr., certify that:

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

Date: August 9, 2007

/s/ Edward K. Aldag, Jr.

Edward K. Aldag, Jr.
Chairman, President and
Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO RULE 13a-14(a) UNDER THE SECURITIES EXCHANGE ACT OF 1934**

I, R. Steven Hamner, certify that:

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

Date: August 9, 2007

/s/ R. Steven Hamner

R. Steven Hamner
Executive Vice President and
Chief Financial Officer

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO RULE 13a-14(b) UNDER THE SECURITIES EXCHANGE ACT OF 1934 AND 18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with this quarterly report on Form 10-Q of Medical Properties Trust, Inc. (the "Company") for the quarter ended June 30, 2007 (the "Report"), each of the undersigned, Edward K. Aldag, Jr. and R. Steven Hamner, certifies, pursuant to Section 18 U.S.C. Section 1350, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 9, 2007

/s/ Edward K. Aldag, Jr.

Edward K. Aldag, Jr.
Chairman, President and
Chief Executive Officer

/s/ R. Steven Hamner

R. Steven Hamner
Executive Vice President and
Chief Financial Officer

Vibra Healthcare, LLC and Subsidiaries
(Excludes Post Acute Medical, LLC)
Consolidated Balance Sheet
March 31, 2007 and December 31, 2006

Assets

	<u>March 31, 2007</u> (Unaudited)	<u>December 31, 2006</u>
Current assets:		
Cash and cash equivalents	\$ 1,747,047	\$ 3,239,881
Patient accounts receivable, net of allowance for doubtful collections of \$2,085,000 at March 31, 2007 and \$2,407,000 at December 31, 2006	25,188,973	25,791,405
Prepaid insurance	2,857,760	2,775,816
Other current assets	<u>1,576,423</u>	<u>2,139,890</u>
Total current assets	31,370,203	33,946,992
Restricted investment	100,000	100,000
Property and equipment, net	27,732,131	26,117,659
Goodwill	22,629,663	22,629,663
Intangible assets	5,140,000	5,140,000
Deposits	245,380	317,547
Deferred financing and lease costs	<u>1,925,889</u>	<u>1,980,230</u>
Total assets	<u>\$ 89,143,266</u>	<u>\$ 90,232,091</u>

Liabilities, Non-Controlling Interest, and Member's Deficit

Current liabilities:		
Current maturities of long-term debt	\$ 1,667,464	\$ 1,271,993
Current maturities of obligations under capital leases	709,919	692,957
Accounts payable	6,903,713	7,300,783
Accounts payable — affiliates	540,171	538,546
Accrued liabilities	5,951,255	7,429,158
Accrued insurance claims	<u>1,215,856</u>	<u>1,331,694</u>
Total current liabilities	16,988,378	18,565,131
Accrued insurance claims	2,855,000	2,855,000
Deferred rent	9,729,272	8,802,954
Deferred development fees	796,488	783,121
Long-term debt	61,007,018	60,151,182
Obligations under capital leases	<u>21,729,763</u>	<u>20,008,640</u>
Total liabilities	113,105,919	111,166,028
Member's deficit	<u>(23,962,653)</u>	<u>(20,933,937)</u>
Total liabilities, non-controlling interest, and member's deficit	<u>\$ 89,643,837</u>	<u>\$ 90,232,091</u>

Vibra Healthcare, LLC and Subsidiaries
(Excludes Post Acute Medical, LLC)
Consolidated Statement of Operations and Changes in Member's Deficit
For the Three Months Ended March 31, 2007 and 2006
(Unaudited)

	2007	2006
Revenue:		
Net patient service revenue	\$ 37,936,784	\$ 35,789,860
Expenses:		
Cost of services	28,335,517	24,971,636
Rent expense	5,630,605	5,353,640
General and administrative	4,002,862	4,708,166
Interest expense	2,061,175	1,801,748
Management fee — Vibra Management, LLC	799,037	740,124
Depreciation and amortization	661,278	508,183
Bad debt expense	285,077	187,866
Total expenses	41,775,551	38,271,363
Loss from operations	(3,838,767)	(2,481,503)
Non-operating revenue	810,051	599,844
Net loss	(3,028,716)	(1,881,659)
Member's deficit — beginning	(20,933,937)	(10,776,550)
Member's deficit — ending	\$ (23,962,653)	\$ (12,658,209)

Vibra Healthcare, LLC and Subsidiaries
(Excludes Post Acute Medical, LLC)
Consolidated Statement of Cash Flows
For the Three Months Ended March 31, 2007 and 2006
(Unaudited)

	2007	2006
Operating activities:		
Net loss	\$ (3,028,716)	\$ (1,881,659)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	661,278	508,183
Provision for bad debts	285,077	187,866
Changes in operating assets and liabilities, net of effects from acquisition of business:		
Patient accounts receivable including third party settlements	317,356	(4,873,547)
Prepays and other current assets	481,523	84,427
Deposits	72,167	(73,218)
Accounts payable	(395,445)	(381,377)
Accrued liabilities	(1,593,741)	(210,506)
Deferred rent/gain	939,685	581,480
Net cash used in operating activities	<u>(2,260,816)</u>	<u>(6,058,351)</u>
Investing activities:		
Purchases of property and equipment	(251,538)	(161,947)
Net cash used in investing activities	<u>(251,538)</u>	<u>(161,947)</u>
Financing activities:		
Borrowings under revolving credit facility	36,399,937	36,103,365
Repayments of revolving credit facility	(36,812,214)	(30,174,988)
Repayment of capital leases	(198,287)	(145,959)
Borrowings under notes payable	9,501,765	—
Repayment of notes payable	(7,838,181)	(16,625)
Payment of deferred financing costs	(33,500)	—
Net cash provided by financing activities	<u>1,019,520</u>	<u>5,765,793</u>
Net (decrease) increase in cash and cash equivalents	(1,492,834)	(454,505)
Cash and cash equivalents — beginning	3,239,881	3,018,829
Cash and cash equivalents — ending	<u>\$ 1,747,047</u>	<u>\$ 2,564,324</u>
Supplemental cash flow information:		
Cash paid for interest	<u>\$ 2,061,175</u>	<u>\$ 1,801,748</u>
Supplemental disclosure of non-cash investing and financing activities:		
Property and equipment funded by capital lease	<u>\$ 1,936,372</u>	<u>\$ 64,492</u>

EXHIBIT 99.2

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES**

INDEPENDENT AUDITOR'S REPORT

AND

CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2006 AND 2005

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INDEPENDENT AUDITOR'S REPORT

Board of Directors
Prime Healthcare Services, Inc., and Subsidiaries

We have audited the accompanying consolidated balance sheets of Prime Healthcare Services, Inc., and Subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of Prime Healthcare Services, Inc., and Subsidiaries' management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards Public Company Accounting Oversight (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the internal control over financial reporting of Prime Healthcare Services, Inc. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Prime Healthcare Services, Inc., and Subsidiaries, as of December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, Prime Healthcare Services, Inc. adopted FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities* effective January 1, 2005. Prime Healthcare Services, Inc. has accounted for the effect of the adoption as a cumulative effect change in the consolidated statement of income for the year ended December 31, 2005.

/s/ Moss Adams LLP

Irvine, California
June 13, 2007

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS**

ASSETS

	DECEMBER 31,	
	2006	2005
CURRENT ASSETS		
Cash and cash equivalents	\$ 13,984,387	\$ 25,550,515
Patient accounts receivable, net of allowance for doubtful accounts of \$4,171,000 in 2006 and \$3,427,000 in 2005	53,397,527	21,144,471
Related party receivables	956,361	596,301
Supplies inventory	2,233,614	1,676,500
Prepaid expenses and other assets	27,921,033	9,991,132
Deposits	1,881,544	2,524,120
Income taxes receivable	18,413	—
Deferred income taxes	—	787,000
	<u>100,392,879</u>	<u>62,270,039</u>
PROPERTY AND EQUIPMENT, net of accumulated depreciation and amortization	<u>31,045,265</u>	<u>14,931,460</u>
GOODWILL	<u>12,316,712</u>	<u>7,646,046</u>
	<u>\$ 143,754,856</u>	<u>\$ 84,847,545</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

	DECEMBER 31,	
	2006	2005
CURRENT LIABILITIES		
Bank overdraft	\$ 1,159,486	\$ —
Accounts payable	17,379,765	4,344,105
Accrued expenses	18,328,683	6,663,254
Medical claims payable	3,959,088	4,708,760
Related party payables	5,669,785	2,275,707
Income taxes payable	147,000	2,201,315
Estimated third-party payor settlements	2,640,190	5,610,607
Other current liabilities	1,219,450	1,309,357
Deferred income taxes	—	1,767,000
Current portion of capital leases	448,440	451,813
Current portion of long-term debt	9,093,668	2,033,145
	<u>60,045,555</u>	<u>31,365,063</u>
LONG-TERM LIABILITIES		
Deferred income taxes	—	1,958,000
Accrued professional liability reserve	2,288,000	2,288,000
Capital leases, net of current portion	695,426	620,339
Long-term debt, net of current portion	14,734,500	8,098,070
	<u>17,717,926</u>	<u>12,964,409</u>
NON CONTROLLING INTEREST	31,299,046	17,746,674
STOCKHOLDERS' EQUITY		
Common stock, .01 par value, 3,000 shares authorized, 100 shares issued and outstanding	1	1
Additional paid in capital	2,999	2,999
Note receivable from stockholder	(9,000,000)	—
Retained earnings	43,689,329	22,768,399
	<u>34,692,329</u>	<u>22,771,399</u>
	<u>\$ 143,754,856</u>	<u>\$ 84,847,545</u>

See accompanying notes.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME**

	YEAR ENDED DECEMBER 31,	
	2006	2005
REVENUE		
Net patient service revenue	\$ 336,335,806	\$ 139,635,409
Premium revenue	26,440,384	28,580,312
Other revenue	5,510,341	1,678,946
	<u>368,286,531</u>	<u>169,894,667</u>
OPERATING EXPENSES		
Compensation and employee benefits	141,878,408	51,493,423
Provision for doubtful accounts	42,161,121	25,731,743
General and administrative	73,949,811	31,773,780
Medical supplies	30,280,374	13,465,691
Professional services	27,203,252	14,045,050
Depreciation and amortization	3,573,601	1,388,162
Medical claims	1,321,107	845,433
(Gain) loss on sale of assets	(9,939)	326,282
	<u>320,357,735</u>	<u>139,069,564</u>
INCOME FROM OPERATIONS	47,928,796	30,825,103
INTEREST EXPENSE, net	(642,039)	(44,599)
GAIN ON EXTINGUISHMENT OF DEBT	104,447	2,845,071
INCOME BEFORE PROVISION FOR INCOME TAXES	47,391,204	33,625,575
INCOME TAX (BENEFIT) PROVISION	(2,682,098)	4,084,838
INCOME BEFORE EXTRAORDINARY GAIN	50,073,302	29,540,737
EXTRAORDINARY GAIN ON ACQUISITION	—	4,402,621
INCOME BEFORE CUMULATIVE EFFECT OF ACCOUNTING CHANGE	50,073,302	33,943,358
CUMULATIVE EFFECT OF ACCOUNTING CHANGE	—	(712,880)
INCOME BEFORE ALLOCATION TO NON-CONTROLLING INTEREST	50,073,302	33,230,478
ALLOCATION OF INCOME TO NON-CONTROLLING INTEREST	(27,052,372)	(27,258,407)
CONTROLLING INTEREST IN NET INCOME	<u>\$ 23,020,930</u>	<u>\$ 5,972,071</u>

See accompanying notes.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**

	<u>Shares</u>	<u>Note Receivable from Stockholder</u>	<u>Common Stock</u>	<u>Additional Paid in Capital</u>	<u>Retained Earnings</u>	<u>Total</u>
BALANCE, December 31, 2004	30	\$ —	\$ 1	\$ 2,999	\$ 16,796,328	\$ 16,799,328
Controlling interest in net income	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>5,972,071</u>	<u>5,972,071</u>
BALANCE, December 31, 2005	30	—	1	2,999	22,768,399	22,771,399
Distributions to stockholders	—	—	—	—	(2,100,000)	(2,100,000)
Notes receivable from shareholder	—	(9,000,000)	—	—	—	(9,000,000)
Controlling interest in net income	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>23,020,930</u>	<u>23,020,930</u>
BALANCE, December 31, 2006	<u>30</u>	<u>\$ (9,000,000)</u>	<u>\$ 1</u>	<u>\$ 2,999</u>	<u>\$ 43,689,329</u>	<u>\$ 34,692,329</u>

See accompanying notes.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS**

	YEAR ENDED DECEMBER 31,	
	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES		
Controlling interest in net income	\$ 23,020,930	\$ 5,972,071
Adjustments to reconcile controlling interest in net income to net cash provided by operating activities:		
Depreciation and amortization	3,573,601	1,388,162
Loss (Gain) on sale of assets	(9,939)	326,282
Provision for doubtful accounts	42,161,121	25,731,743
Extraordinary gain on acquisition	—	(4,402,621)
Gain on extinguishment of debt	(104,447)	(2,845,071)
Deferred income taxes	(2,938,000)	2,460,000
Non controlling interest in net income	27,052,372	27,971,287
Changes in assets and liabilities net of acquisitions:		
Patient accounts receivable	(74,264,177)	(28,180,154)
Supplies inventory	439,965	138,028
Prepaid expenses and other assets	(17,459,183)	(2,915,119)
Deposits	253,068	(1,552,483)
Due to/ from related parties	508,032	(49,417)
Accounts payable	13,035,659	(4,242,153)
Accrued expenses	5,526,967	(3,441,764)
Medical claims payable	(749,672)	(799,641)
Income taxes payable/ receivable	(2,072,728)	(1,559,982)
Estimated third-party payor settlements	(2,970,417)	1,345,613
Other current liabilities	14,540	2,600,314
Accrued professional liability reserve	—	(940,000)
Net cash provided by operating activities	<u>15,017,692</u>	<u>17,005,095</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisition of Veritas	—	(1,050,000)
Cash received from acquisition of Veritas	—	3,946,394
Acquisition of net assets from Sherman Oaks Health System	—	(695,758)
Purchase of property and equipment	(16,866,981)	(5,247,575)
Proceeds from the sale of assets	—	64,600
Amounts advanced for related party receivables	(2,985,048)	(10,942,291)
Amounts received from related party receivables	5,361,034	24,987,500
Net cash (used in) provided by investing activities	<u>(14,490,995)</u>	<u>11,062,870</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Increase/(decrease) in bank overdraft	1,159,486	(395,728)
Proceeds from long-term debt borrowing	5,412,366	9,269,205
Payments on long-term debt	(3,064,677)	(3,404,568)
Distribution to non-controlling interest	(14,500,000)	(9,500,000)
Advances on stockholder notes receivable	(9,000,000)	
Distribution to stockholder	(2,100,000)	—
Proceeds from issuance of common stock in non controlling interest	1,000,000	—
Net borrowing from lines of credit	9,000,000	—
Net cash used in financing activities	<u>(12,092,825)</u>	<u>(4,031,091)</u>
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(11,566,128)	24,036,874
CASH AND CASH EQUIVALENTS, beginning of year	25,550,515	1,513,641
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 13,984,387</u>	<u>\$ 25,550,515</u>

SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid during the year for:

Interest	<u>\$ 1,148,702</u>	<u>\$ 943,729</u>
Income taxes	<u>\$ 1,431,500</u>	<u>\$ 2,525,000</u>

SUPPLEMENTAL DISCLOSURE OF NON CASH INVESTING AND FINANCING ACTIVITIES

Obligations incurred for the acquisition of property and equipment	<u>\$ 2,420,978</u>	<u>\$ 1,884,935</u>
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See accompanying notes.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 1 — Nature of Business

Prime Healthcare Services, Inc. (the “Company” or “PHSI”), formerly Desert Valley Health System, Inc., is a Delaware corporation incorporated on March 27, 2000. The Company is a holding company whose principal activity is the ownership and management of its wholly owned subsidiaries, Desert Valley Hospital, Inc. (“DVH”), Prime Healthcare Services, LLC (“PHS”), Apple Valley Surgery Center Corporation (“AVSCC”), Prime Healthcare Systems II, LLC dba Sherman Oaks Hospital (“PHS2”), Veritas Health Services, Inc. dba Chino Valley Medical Center, Prime Healthcare Huntington Beach, LLC dba Huntington Beach Hospital, Prime Healthcare La Palma, LLC dba La Palma Intercommunity Hospital, Prime Healthcare Anaheim, LLC dba West Anaheim Medical Center, Prime Healthcare Services III, LLC dba Montclair Hospital Medical Center (“PHS3”). DVH operates an 83 bed acute care hospital (“Desert Valley Hospital”) located in Victorville, California. AVSCC operates an ambulatory surgery center located in Apple Valley, California. PHS provides management and consulting services to other healthcare organizations. PHS3 was created during the year ended December 31, 2005 for the purpose of acquiring a hospital (Note 12). Sherman Oaks Hospital is a 153 bed acute care hospital located in Sherman Oaks, California. Veritas Health Services, Inc. (“Veritas”) is a 126 bed acute care hospital located in Chino California. PHSI acquired 100% of the outstanding common stock of Veritas on January 1, 2006 (Note 12). Prime Healthcare Huntington Beach, LLC (“HBH”) was formed during the year ended December 31, 2006 for the purpose of acquiring certain operating assets of VHS of Huntington Beach, Inc. dba Huntington Beach Hospital (Note 12). HBH operates a 131 bed acute care hospital located in Huntington Beach, California. Prime Healthcare La Palma, LLC (“La Palma”) was formed during the year ended December 31, 2006 for the purpose of acquiring certain operating assets of VHS of Orange County, Inc. dba La Palma Intercommunity Hospital (Note 12). La Palma operates a 141 bed acute care hospital located in La Palma, California. Prime Healthcare Anaheim, LLC (“WAMC”) was formed during the year ended December 31, 2006 for the purpose of acquiring certain operating assets of VHS of Anaheim, Inc. dba West Anaheim Medical Center (Note 12). WAMC operates a 219 bed acute care hospital located in Anaheim, California. Prime Healthcare Services III, LLC (“Montclair”) was formed during the year ended December 31, 2006 for the purpose of acquiring certain operating assets of Doctor’s Hospital Medical Center of Montclair, L.P. dba Doctor’s Hospital Medical Center of Montclair (Note 12). Montclair operates a 102 bed acute care hospital located in Montclair, California.

Effective January 1, 2005 the Company adopted Financial Accounting Standards Board (FASB) Financial Interpretation No. 46(R) “*Consolidation of Variable Interest Entities*” (FIN46(R)). The Company determined that it has a variable interest in Desert Valley Medical Group, Inc. (“DVMG”), Chino Valley Medical Group, Inc. (“CVMG”), Sherman Oaks Medical Group Management, Inc. (“SOMGM”), and Prime Management Services, Inc. (“PMSI”). It was also determined that PHSI is the primary beneficiary of these variable interest entities. The adoption of FIN46(R) resulted in a cumulative effect adjustment of \$712,880 which was a reduction in income before allocation to non-controlling interest. See basis of consolidation below. DVMG was incorporated as a California professional corporation in August 1995 and is headquartered in Victorville, California. DVMG has over 60 board-certified primary care and specialty physicians, urgent care/walk-in clinics, on-site imaging, health education and access to pharmacy, and lab services. DVMG is affiliated with DVH, which is adjacent to the main campus of DVMG. CVMG was formed in February 2005 to establish a multi-specialty medical group. As of December 31, 2006 CVMG has not commenced operations. SOMGM was incorporated as a California professional corporation in October 2005 and is located in Sherman Oaks, California. PMSI was incorporated on October 18, 2005 as a California corporation. PMSI provides certain management services to hospitals owned by PHSI.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 1 — Nature of Business (continued)

Following is summarized financial statement information for DVMG as of and for the year ended December 31, 2006:

Balance Sheet Information

Current assets	\$ 3,302,663
Property and equipment, net	753,207
Deposits	222,400
Related party receivables	2,605,740
Total Assets	\$ 6,884,010
Current liabilities	\$ 5,907,142
Long-term liabilities	1,701,481
Stockholder's deficit	(724,613)
Total liabilities and stockholder's deficit	\$ 6,884,010

Income Statement Information

Revenue	\$41,349,404
Operating expenses	37,273,223
Income from operations	4,076,181
Other, net	(11,733)
Income before income taxes	4,064,448
Income taxes	59,000
Net income	\$ 4,005,448

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 2 — Organization and Summary of Significant Accounting Policies

Basis of consolidation - The consolidated financial statements include the accounts of the Company, DVH, PHS, PHS2, PHS3, AVSCC, Veritas, HBH, La Palma and WAMC, after the elimination of all material intercompany transactions and balances. The Company has determined that DVMG, CVMG, SOMGM and PMSI are variable interest entities as defined by FIN 46(R). The equity of the variable interest entities have been reflected as a non-controlling interest as of December 31, 2006 and 2005. On October 1, 2005, DVMG acquired all of the outstanding shares of Veritas Health Services, Inc. dba Chino Valley Medical Center (see Note 12). DVMG's consolidated financial statements as of and for the year ended December 31, 2005 includes the accounts of CVMC from the date of acquisition, October 1, 2005, through December 31, 2005. All inter-company accounts and transactions have been eliminated upon consolidation. The consolidation of these entities does not change any legal ownership, and does not change the assets or the liabilities and equity of PHSI as a stand-alone entity. However, certain creditors of the non-controlling interest entity have recourse to the general credit of the Company.

Net patient service revenue - Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. In some cases, reimbursement is based on formulas which cannot be determined until cost reports are filed and audited or otherwise settled by the various programs. Normal estimation differences between final settlements and amounts accrued in previous years are reflected in net patient service revenue.

Premium revenue and medical claims expense - The Company has agreements with various Health Maintenance Organizations ("HMO") to provide medical services to enrollees. Under these agreements, the Company receives monthly capitation revenue based on the number of each HMO's enrollees, regardless of services actually performed by the Company. Premium revenue under HMO contracts is recognized during the period in which the Company is obligated to provide services. Certain of the HMO contracts also contain shared-risk provisions whereby the Company can earn additional incentive revenue or incur penalties based upon the utilization of inpatient hospital services by assigned HMO enrollees. The Company records shared-risk revenue and expenses based upon inpatient utilization on an estimated basis. Differences between estimated shared-risk revenue or expenses and actual amounts are recorded upon final settlement with each HMO. Amounts due to unaffiliated health care providers for out of network claims are recognized as incurred. The amounts recorded are based upon projections of historical developments. Such projections are adjusted and estimates changed when developments of claims information warrant. Estimation differences are reflected in medical claims expenses.

Supplies inventory - Supplies inventory is stated at cost, determined by the average cost method, which is not in excess of market.

Property and equipment - Property and equipment is stated at cost. Depreciation and amortization is computed using the straight-line method over the estimated useful lives of the assets, which range from 3 to 15 years. Amortization of leasehold improvements is computed over the lessor of the lease term and the estimated useful lives of the assets and is included in depreciation and amortization expense.

Use of estimates - The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Income taxes - As of and for the year ended December 31, 2005, income taxes were accounted for under the asset and liability method for deferred income taxes for PHSI, DVH, AVSCC and Veritas. Under this method, deferred income tax assets and liabilities result from temporary differences in the financial reporting bases and the income tax reporting bases of assets and liabilities. When it appears more likely than not that deferred taxes will not be realized, a valuation allowance is recorded to reduce the deferred tax asset to its estimated realizable value. The Company files consolidated income tax returns with its subsidiaries.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 2 — Organization and Summary of Significant Accounting Policies (continued)

Effective January 1, 2006 PHSI, DVH, AVSCC and Veritas, filed an election to convert corporate status from Sub chapter C corporations to Sub Chapter S of the Internal Revenue Code and state law. In addition, DVH, AVSCC, Veritas and PMSI are qualified Q subs of PHSI and are included in the PHSI consolidated income tax return for the year ended December 31, 2006. In lieu of corporate income taxes, the stockholders of PHSI will be taxed on their proportionate share of PHSI's net income as defined by the Internal Revenue Code. HBH, La Palma, WAMC, and Montclair are single member LLCs. Their taxable income and loss will be included in the PHSI consolidated income tax return for the year ended December 31, 2006. However, PHSI is subject to various state and franchise taxes. PHSI may disburse funds necessary to satisfy the stockholders' estimated income tax liabilities.

DVMG, PMSI and SOMGM have elected to be taxed under the provision of subchapter S of the Internal Revenue Code and state law. Under these provisions, the entities do not pay corporate income taxes on their taxable income. However, the entities are subject to California franchise taxes. In addition, the stockholders' of the entities are liable for individual federal and state income taxes on taxable income. The Company may disburse funds necessary to satisfy the stockholders' estimated tax liability.

Cash and cash equivalents - The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Goodwill - Management evaluates goodwill, at a minimum, on an annual basis and whenever events and changes in circumstances suggest that the carrying amount may not be recoverable. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit. The fair values of the reporting units are estimated using a combination of the income or discounted cash flow approach and market approach, which uses comparable data. If the carrying amount of the reporting unit exceeds fair value, goodwill is considered impaired and a second step is performed to measure the amount of impairment loss, if any.

For the year ended December 31, 2006, the management of the Company determined that an impairment did not exist. However, if estimates or the related assumptions change in the future, the Company may be required to record impairment charges to reduce the carrying amount of this asset.

Fair value of financial instruments - The Company's consolidated balance sheets include the following financial instruments: cash and cash equivalents, patient accounts receivable, notes receivable, accounts payable and accrued liabilities, and long-term liabilities. The Company considers the carrying amounts of current assets and liabilities in the consolidated balance sheets to approximate the fair value of these financial instruments and their expected realization. The carrying amount of notes receivable and long-term debt approximated their fair value, based on current market rates of instruments of the same risks and maturities.

Note 3 — Concentration of Credit Risk

Financial instruments which potentially subject the Company to significant concentrations of credit risk consist primarily of cash. The Company maintains cash in bank deposit accounts at high credit quality financial institutions. The balances at times, may exceed the \$100,000 federally insured limit.

Patient accounts receivable at December 31, 2006 and 2005 are comprised of the following: government programs, primarily Medicare 31% and 27%, respectively, Medi-Cal 25% and 21%, respectively, Healthcare maintenance and preferred provider organizations (managed care programs) 16% and 2%, respectively, and private pay and commercial insurance patients 28% and 50%, respectively. Management believes there are no credit risks associated with receivables from government programs. Receivables from managed care programs and others are from various payors who are subject to differing economic conditions and do not represent concentrated risks to the Company. Management continually monitors and adjusts the reserves associated with receivables, and does not require collateral. Losses due to bad debts have been within management's estimates.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 4 — Property and Equipment

Property and equipment consist of the following at December 31:

	<u>2006</u>	<u>2005</u>
Equipment	\$ 40,844,735	\$ 27,583,264
Leasehold improvements	4,726,087	2,526,609
Automobiles	3,273,016	1,426,209
Construction in progress (estimated cost to complete at December 31, 2006 is approximately \$16,475,000)	<u>2,663,488</u>	<u>477,641</u>
	51,507,326	32,013,723
Accumulated depreciation and amortization	<u>(20,462,061)</u>	<u>(17,082,263)</u>
	<u>\$ 31,045,265</u>	<u>\$ 14,931,460</u>

Gross property and equipment includes \$1,906,347 of equipment under capital lease arrangements as of December 31, 2006. Related accumulated amortization totaled approximately \$587,980 as of December 31, 2006.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 5 — Long-Term Debt

Long-term debt consists of the following as of December 31:

	<u>2006</u>	<u>2005</u>
Line of credit with City National Bank, secured by accounts receivable, interest payable monthly at an annual rate of prime (8.25% at December 31, 2006), due March 1, 2007.	\$ 6,000,000	\$ —
Term loans with GE Commercial Finance, secured by various equipment, payable in monthly installments ranging from approximately \$7,000 to \$140,000 including interest at fixed interests rate ranging from 6.63% to 7.44% per annum, maturing in 2010.	6,111,616	5,664,448
Term loan with City National Bank, secured by equipment, interest payable monthly at an annual rate of prime (8.25% at December 31, 2006), principal payable in monthly payments of \$116,667, maturing on August 1, 2011.	6,493,450	4,295,312
Bank note payable, secured by certain real estate, bearing interest at 5.75% per annum, payable in monthly payments of \$1,258, maturing in August 2024.	160,457	171,455
Line of credit with Merrill Lynch, secured by accounts receivables, interest payable monthly at an annual rate of LIBOR plus 3% (8.38% at December 31, 2006), maturing in September 2008.	3,000,000	—
Note payable with City National Bank, secured by equipment, bearing interest at LIBOR plus 1.5% per annum (6.88% at December 31, 2006), principal payable in monthly payment of \$34,377 starting September 1, 2007, maturing September 1, 2012.	<u>2,062,645</u>	<u>—</u>
	23,828,168	10,131,215
Less current portion	<u>(9,093,668)</u>	<u>(2,033,145)</u>
	<u>\$ 14,734,500</u>	<u>\$ 8,098,070</u>

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 5 — Long-Term Debt (continued)

Aggregate annual principal maturities of long-term debt for the five years subsequent to December 31, 2006 are as follows:

<u>Years ending December 31,</u>	
2007	\$ 9,093,668
2008	6,517,261
2009	3,639,390
2010	2,825,989
2011	1,312,986
Thereafter	<u>438,874</u>
	<u>\$23,828,168</u>

During 2005, Veritas secured a line of credit in the amount of \$5,000,000. The amounts drawn on this line of credit were \$3,000,000 and \$0 as of December 31, 2006 and 2005, respectively. Interest on the outstanding borrowings is payable monthly at LIBOR plus 3%. The interest rate was 8.38% as of December 31, 2006. The line is secured by accounts receivable of Veritas. Under the terms of the agreement, Veritas is required to maintain certain financial and non financial covenants. Management believes Veritas was in compliance with loan covenants as of December 31, 2006.

In March 2005, DVH and DVMG secured a line of credit in the amount of \$7,000,000. The amounts drawn on this line of credit by DVH were \$6,000,000 and \$0 at December 31, 2006 and 2005, respectively. Interest on the outstanding borrowings is payable monthly at the lender's prime rate plus 3%. The interest rate was 8.25% as of December 31, 2006. The line is secured by accounts receivable of DVH. Under the terms of the agreement, the Company is required to maintain certain financial and non financial covenants. Management believes the Company was in compliance with the covenants as of December 31, 2006.

Note 6 — Professional Liability and Workers Compensation Insurance

The Company has entered into an agreement with Desert Valley Insurance, LTD. ("DVIL") and ACE Insurance Company to provide workers' compensation insurance coverage for the Company. DVIL is affiliated with the Company through common ownership. Under the terms of the agreement DVIL is obligated to insure each workers' compensation claim up to a maximum of \$500,000 per claim. Losses in excess of \$500,000 per claim are insured by ACE Insurance Company.

The Company also entered into an agreement with DVIL to provide commercial malpractice liability insurance on a claims made basis. Under the policy with DVIL the Company is covered up to a \$10,000,000 general aggregate limit with no amount deductible.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 6 — Professional Liability and Workers Compensation Insurance (continued)

Accounting principles generally accepted in the United States of America require that a health care facility disclose the estimated costs of malpractice claims in the period of the incident of malpractice, if it is reasonably possible that liabilities may be incurred and losses can be reasonably estimated. The Company recognized an estimated liability based upon its claims experience to cover the Company's potential exposure to incurred but unreported claims. The claim reserve is based on the best data available to the Company; however, the estimate is subject to a significant degree of inherent variability. Such an estimate is continually monitored and reviewed, and as the reserve is adjusted, the difference is reflected in current operations. While the ultimate amount of professional liability is dependent on future developments, management is of the opinion that the associated liabilities recognized in the accompanying consolidated financial statements is adequate to cover such claims. Management is aware of no potential professional liability claims whose settlement, if any, would have a material adverse effect on the Company's consolidated financial position.

The Company has evaluated whether they are required to consolidate DVIL in accordance with FIN 46(R) as of December 31, 2006, and have determined that DVIL is not required to be consolidated.

Note 7 — Leases

During the period June 1, 2004 through February 28, 2005, the Company leased the Desert Valley Hospital facility under a month to month arrangement. Effective February 28, 2005, the Company entered into a new lease for this facility which expires on February 28, 2020. The new lease provides for monthly rent payments of approximately \$240,000, which is adjusted annually based on the consumer price index.

The Company leases certain equipment under various non-cancelable operating and capital lease arrangements. The leases expire on various dates through 2011. Capital leases bear interest at rates ranging from 6.0% — 9.4%.

On November 30, 2005, Veritas entered into a non-cancelable operating lease for its hospital facility which expires November 30, 2020. Veritas has an option to extend the term of the lease for three additional periods of five years each. The lease provides for a monthly base rent of \$175,000, which is adjusted annually based on the greater of 2% or the consumer price index.

On December 30, 2005, PHS2 entered into a non-cancelable operating lease for its hospital facility which expires December 30, 2020. PHS2 has an option to extend the term of the lease for three additional periods of five years each. The lease provides for a monthly base rent of \$175,000, which is adjusted annually based on the greater of 2% or the consumer price index.

On July 31, 2006 Montclair entered into a non-cancelable operating lease for its hospital facility which expires July 31, 2021. Montclair has an option to extend the term of the lease for three additional periods of five years each. The lease provides for a monthly base rent of \$162,500, which is adjusted annually based on the greater of 2% or consumer price index.

On November 8, 2006 HBH, La Palma and WAMC entered into non-cancelable operating leases for their hospital facilities which expire November 8, 2021. These leases have an option to extend the term of the lease for three additional periods of five years each. The lease provides for a monthly base rent ranging from \$98,900 to \$197,900, which is adjusted annually based on the greater of 2% or consumer price index.

Lease expense consisting primarily of building rent, and equipment leases, amounted to approximately \$19,063,000 and \$10,692,000 for the years ended December 31, 2006 and 2005 respectively.

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 7 — Leases (continued)

Future minimum lease payments under non-cancelable operating leases (with initial or remaining lease terms in excess of one year) and future minimum capital lease payments as of December 31, 2006 are:

Years ending December 31,	Capital Leases	Operating Lease Commitments
2007	\$ 514,655	\$ 21,790,431
2008	342,156	20,335,114
2009	223,251	19,582,257
2010	161,131	17,594,824
2011	36,069	16,226,331
Thereafter	<u>—</u>	<u>151,745,046</u>
Total minimum lease payments	1,277,262	<u>\$ 247,274,002</u>
Less amounts representing interest	<u>(133,396)</u>	
	1,143,866	
Less current portion	<u>(448,440)</u>	
	<u>\$ 695,426</u>	

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 8 — Related Party Transactions

The Company leases certain office buildings and parking facilities from a related party. The leases are for five year terms. Rent expense incurred under these leases was \$985,025 and \$694,985 for the years ended December 31, 2006 and 2005, respectively.

The Company purchases medical supplies from a related party within the normal course of business. For the years ended December 31, 2006 and 2005, medical supplies purchased from the related party totaled \$309,035 and \$357,576, respectively.

Notes receivable from related parties as of December 31:

	<u>2006</u>	<u>2005</u>
Notes receivable from Action Collection, unsecured, non interest bearing, due on demand.	\$ 3,561	\$ 18,697
Notes receivable from an officer of the Company, unsecured, bearing interest at 6% as of December 31, 2006, due on demand.	—	62,911
Short term unsecured advances to employees, non interest bearing, due on demand	272,169	504,253
Receivable from DVIL, related to expenses incurred in excess of deductibles.	433,080	—
Notes receivable from related party, unsecured, non interest bearing, payable on demand.	241,612	—
Various	<u>5,939</u>	<u>10,440</u>
	<u>\$ 956,361</u>	<u>\$ 596,301</u>

**PRIME HEALTHCARE SERVICES, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 8 — Related Party Transactions (continued)

Notes payable from related parties as of December 31:

	<u>2006</u>	<u>2005</u>
Notes payable to Sherman Oaks Health System related to acquisition (Note 12) , unsecured, non interest bearing, payable on demand.	\$ 94,374	\$ 287,576
Notes payable to related party, unsecured, non interest bearing, payable on demand.	5,133,463	1,988,131
Payable to DVIL, related to the financing of insurance premiums.	273,535	—
Notes payable to Action Collection, unsecured, non interest bearing, due on demand.	<u>168,413</u>	<u>—</u>
	<u>\$ 5,669,785</u>	<u>\$ 2,275,707</u>

The Company uses the services of Action Collection, a related party collection agency to collect delinquent patient accounts receivable. For the years ended December 31, 2006 and 2005, agency fees paid to the related party totaled \$2,009,581 and \$2,018,355, respectively.

The Company entered into agreements with DVIL to provide workers' compensation insurance coverage and commercial malpractice liability insurance on a claims made basis (see Note 6). Insurance premiums paid to DVIL totaled \$33,421,594 and \$9,624,650 for the years ended December 31, 2006 and 2005, respectively. The Company gets reimbursement from DVIL for workers' compensation insurance deductibles paid on behalf of DVIL.

The Company leases certain office buildings and parking facilities from a related party. The leases are for five year terms. Rent expense incurred under these leases was approximately \$175,000 for the years ended December 31, 2006 and 2005.

The Company purchases medical supplies from a related party within the normal course of business. For the years ended December 31, 2006 and 2005, medical supplies purchased from the related party totaled approximately \$309,035 and \$357,576 respectively.

During 2006, the Company advanced \$9,000,000 to an officer/stockholder. The advances are unsecured, due on demand and bear interest at 6% per annum. For financial reporting purposes the advances are being reflected as a reduction in stockholders' equity.

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Note 9 — Retirement Savings Plan

The Company has a defined contribution pension plan covering substantially all of its employees. The Company's contribution to the plan is at the Company's discretion but limited to the maximum amount deductible for federal income tax purposes under the applicable Internal Revenue Code. During the years ended December 31, 2006 and 2005, the Company made contributions of \$513,746 and \$0, respectively, to the plan.

Note 10 — Contingencies

The Company is aware of certain asserted and unasserted legal claims. While the outcome cannot be determined at this time, it is management's opinion that the liability, if any, from these actions will not have a material adverse effect on the Company's financial position.

The health care industry is subject to numerous laws and regulations of federal, state, and local governments. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time. These laws and regulations include, but are not limited to, accreditation, licensure, and government health care program participation requirements, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Recently, government activity has increased with respect to investigations and allegations concerning possible violations of fraud and abuse statutes and regulations by health care providers. Violations of these laws and regulations could result in exclusion from government health care program participation, together with the imposition of significant fines and penalties, as well as significant repayment for past reimbursement for patient services received. While the Company is subject to similar regulatory review, there are no reviews currently underway and management believes that the outcome of any potential regulatory review will not have a material adverse effect on the Company's financial position.

Management believes that the Company is in compliance with government law and regulations related to fraud and abuse and other applicable areas. While no material regulatory inquiries have been made, compliance with such laws and regulations can be subject to future governmental review and interpretation, as well as regulatory actions unknown or unasserted at this time.

Note 11 — Legislation

The Health Insurance Portability and Accountability Act (HIPAA) was enacted on August 21, 1996, to assure health insurance portability, reduce health care fraud and abuse, guarantee security and privacy of health information and enforce standards for health information. Organizations were required to be in compliance with certain HIPAA privacy provisions beginning April 2003. Organizations are subject to significant fines and penalties if found not to be compliant with the provisions outlined in the regulations. Management believes that the Company is in compliance with HIPAA.

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Note 12 — Acquisitions

On October 1, 2005 DVMG acquired 100% of the outstanding common stock of Veritas. The acquisition of Veritas expands and compliments the operations of the Company. The purchase price of \$1,050,000 was paid in cash to the Veritas shareholders. The operating results of Veritas are included in the DVMG consolidated results from the date of acquisition through December 31, 2005. At January 1, 2006 PHSI acquired 100% of the outstanding common stock at Veritas from DVMG. The purchase price of \$1,050,000 was paid in cash to DVMG.

The acquisition of Veritas has been accounted for using the purchase method in accordance with Statement of Financial Accounting Standards (“SFAS”) No. 141, *Business Combinations*. The following table presents the allocation of the aggregate purchase price of Veritas:

	Allocation at <u>October 1, 2005</u>
Cash	\$ 3,946,394
Patient accounts receivable	10,500,000
Prepays and other current assets	5,385,839
Supplies inventory	876,212
Accounts payable and accrued expenses	(7,214,190)
Income taxes payable	(3,600,652)
Third party settlements	(2,658,868)
Pre-petition liabilities	(1,554,114)
Accrued professional liability reserve	(228,000)
Extraordinary gain on acquisition	<u>(4,402,621)</u>
Purchase price	<u>\$ 1,050,000</u>

Extra ordinary gain on acquisition of \$4,402,621 represents the excess of the fair value of the net assets acquired over the purchase price.

On December 30, 2005 PHS2 entered into an asset purchase agreement “the agreement” with Sherman Oaks Health System. Pursuant to the agreement PHS2 acquired the operating assets and certain capital lease obligations from Sherman Oaks Health System. The purchase price of \$695,758 was paid in cash to Sherman Oaks Health System. The acquisition of the operating assets and assumption of the liabilities of Sherman Oaks Health System expands and compliments the operations of the Company.

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Note 12 — Acquisitions (continued)

The acquisition has been accounted for using the purchase method in accordance with SFAS No. 141. The following table presents the allocation of the aggregate purchase price:

	Allocation at <u>December 30, 2005</u>
Prepays and other current assets	\$ 49,538
Supplies inventory	423,378
Major moveable equipment	846,675
Capital lease obligations	<u>(623,833)</u>
	<u>\$ 695,758</u>

On October 1, 2006 HBH entered into an asset purchase agreement with VHS of Huntington Beach, Inc. Pursuant to the agreement HBH acquired the operating assets and certain current liabilities from VHS of Huntington Beach, Inc. The purchase price of \$2,048,705 was paid through the assumption of liabilities. The acquisition of the operating assets and assumption of certain current liabilities of VHS of Huntington Beach, Inc. expands and complements the operations of the Company.

The acquisition has been accounted for using the purchase method in accordance with SFAS No. 141. The following table presents the allocation of the aggregate purchase price:

Prepays and other current assets	\$ 300,861
Supplies inventory	395,162
Goodwill	1,352,681
Accrued liabilities	<u>(2,048,704)</u>
	<u>\$ —</u>

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Note 12 — Acquisitions (continued)

On October 1, 2006 La Palma entered into an asset purchase agreement with VHS of Orange County, Inc. Pursuant to the agreement La Palma acquired the operating assets and certain current liabilities from VHS of Orange County, Inc. The purchase price of \$1,527,251 was paid through the assumption of liabilities. The acquisition of the operating assets and assumption of certain current liabilities VHS of Orange County, Inc. expands and compliments the operations of the Company.

The acquisition has been accounted for using the purchase method in accordance with SFAS No. 141. The following table presents the allocation of the aggregate purchase price:

	Allocation at October 1, 2006
Prepays and other current assets	\$ 24,698
Supplies inventory	290,752
Goodwill	1,211,801
Accrued liabilities	<u>(1,527,251)</u>
	<u>\$ —</u>

On October 1, 2006 WAMC entered into an asset purchase agreement with VHS of Anaheim, Inc. Pursuant to the agreement WAMC acquired the operating assets and certain current liabilities from VHS of Anaheim, Inc. The purchase price of \$2,667,653 was paid through the assumption of liabilities. The acquisition of the operating assets and assumption of certain current liabilities VHS of Anaheim, Inc. expands and compliments the operations of the Company.

The acquisition has been accounted for using the purchase method in accordance with SFAS No. 141. The following table presents the allocation of the aggregate purchase price:

Prepays and other current assets	\$ 145,159
Supplies inventory	416,311
Goodwill	2,106,183
Accrued liabilities	<u>(2,667,653)</u>
	<u>\$ —</u>

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Note 13 — Income taxes

Temporary differences that result in deferred tax assets and liabilities at December 31, are as follows:

	2006	2005
Deferred tax assets, current		
Accounts receivable	\$ —	\$ 533,000
Accrued vacation and other accrued liabilities	—	158,000
State taxes	—	96,000
	<u>—</u>	<u>787,000</u>
Deferred tax liabilities, current		
Prepaid expenses	<u>\$ —</u>	<u>\$ 1,767,000</u>
Deferred tax liabilities, non-current		
Fixed assets	<u>\$ —</u>	<u>\$ 1,958,000</u>

The components of the provision (benefit) for income taxes for the year ended December 31, are as follows:

Current		
Federal	\$ —	\$ 979,950
State	64,521	644,888
	<u>64,521</u>	<u>1,624,838</u>
Deferred expense		
Federal	\$(2,497,300)	\$2,091,000
State	(440,700)	369,000
	<u>(2,938,000)</u>	<u>2,460,000</u>
	<u>\$ (2,873,479)</u>	<u>\$ 4,084,838</u>

The income tax benefit for the year ended December 31, 2006 is the result of the Company's change in corporate status from Subchapter C to Subchapter S of the Internal Revenue Code (see Note 1).

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Note 14 — Proceedings Under Chapter 11

On June 30, 2005 the bankruptcy court approved Veritas's plan of reorganization from Chapter 11 bankruptcy. Pursuant to the plan Veritas will make payments in full to all creditors with approved pre-petition claims and consummate the plan through its continued operations.

The accounts of Veritas included pre-petition liabilities of \$1,219,450 and \$1,309,357 as of December 31, 2006 and 2005. Pre-petition liabilities include claims that are expected to be settled as part of the plan of reorganization. Pre-petition liabilities consist primarily of trade accounts payable to unsecured creditors.

Gain on extinguishment of debt of \$104,447 and \$2,845,071 for the year ended December 31, 2006 and 2005, respectively, represents pre-petition claims that have been discharged by the bankruptcy court or reductions in pre-petition claims resulting from settlement agreements between Veritas and the creditors.