

NATIONAL HEALTHCARE CORP  
Form 10-Q  
November 08, 2010

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

FORM 10-Q

S QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2010

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 13489

(Exact name of registrant as specified in its Charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

52 2057472  
(I.R.S. Employer  
Identification No.)

100 E. Vine Street  
Murfreesboro, TN

37130  
(Address of principal executive offices)  
(Zip Code)

(615) 890 2020  
Registrant=s telephone number, including area code

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such period that the registrant was required to submit and post such files).

Yes  No

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

Large Accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a  
smaller reporting company)

Smaller reporting company

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

13,575,772 shares of common stock of the registrant were outstanding as of November 1, 2010.

**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements.****NATIONAL HEALTHCARE CORPORATION****Interim Condensed Consolidated Statements of Income***(Unaudited)**(in thousands, except share and per share amounts)*

|                                    | Three Months Ended |            | Nine Months Ended |            |
|------------------------------------|--------------------|------------|-------------------|------------|
|                                    | September 30       |            | September 30      |            |
|                                    | 2010               | 2009       | 2010              | 2009       |
| <b>REVENUES:</b>                   |                    |            |                   |            |
| Net patient revenues               | \$ 165,344         | \$ 154,546 | \$ 486,153        | \$ 463,462 |
| Other revenues                     | 11,920             | 12,840     | 38,783            | 36,260     |
| Net revenues                       | 177,264            | 167,386    | 524,936           | 499,722    |
| <b>COSTS AND EXPENSES:</b>         |                    |            |                   |            |
| Salaries, wages and benefits       | 98,531             | 91,834     | 292,287           | 274,435    |
| Other operating                    | 49,296             | 47,199     | 146,657           | 142,588    |
| Rent                               | 8,231              | 8,032      | 24,579            | 24,064     |
| Depreciation and amortization      | 6,800              | 6,335      | 19,890            | 18,865     |
| Interest                           | 136                | 159        | 396               | 554        |
| Total costs and expenses           | 162,994            | 153,559    | 483,809           | 460,506    |
| Income Before Non-Operating Income | 14,270             | 13,827     | 41,127            | 39,216     |
| Non-Operating Income               | 5,424              | 4,244      | 14,958            | 12,613     |
| Income Before Income Taxes         | 19,694             | 18,071     | 56,085            | 51,829     |
| Income Tax Provision               | (4,611)            | (5,727)    | (18,745)          | (18,934)   |

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|                                             |            |            |            |            |
|---------------------------------------------|------------|------------|------------|------------|
| Net Income                                  | 15,083     | 12,344     | 37,340     | 32,895     |
| Dividends to preferred stockholders         | (2,169)    | (2,169)    | (6,505)    | (6,505)    |
| Net income available to common stockholders | \$ 12,914  | \$ 10,175  | \$ 30,835  | \$ 26,390  |
| Earnings Per Common Share:                  |            |            |            |            |
| Basic                                       | \$ .95     | \$ .74     | \$ 2.25    | \$ 1.95    |
| Diluted                                     | \$ .95     | \$ .74     | \$ 2.25    | \$ 1.95    |
| Weighted Average Common Shares Outstanding: |            |            |            |            |
| Basic                                       | 13,649,174 | 13,675,162 | 13,705,477 | 13,522,351 |
| Diluted                                     | 13,650,916 | 13,685,572 | 13,707,590 | 13,540,066 |

*The accompanying notes to interim condensed consolidated financial statements are an integral part of these consolidated statements.*

**NATIONAL HEALTHCARE CORPORATION****Interim Condensed Consolidated Balance Sheets***(in thousands)*

|                                                                                                   | September 30,<br>2010 | December 31,<br>2009 |
|---------------------------------------------------------------------------------------------------|-----------------------|----------------------|
|                                                                                                   | <i>(unaudited)</i>    |                      |
| <b>Assets</b>                                                                                     |                       |                      |
| Current Assets:                                                                                   |                       |                      |
| Cash and cash equivalents                                                                         | \$ 28,868             | \$ 39,022            |
| Restricted cash and cash equivalents                                                              | 53,014                | 96,934               |
| Marketable securities                                                                             | 83,349                | 71,280               |
| Restricted marketable securities                                                                  | 72,268                | 19,350               |
| Accounts receivable, less allowance for doubtful<br>accounts of \$4,561 and \$3,502, respectively | 64,169                | 62,129               |
| Inventories                                                                                       | 7,700                 | 7,393                |
| Prepaid expenses and other assets                                                                 | 1,531                 | 1,074                |
| Federal income tax receivable                                                                     | -                     | 3,470                |
| Total current assets                                                                              | 310,899               | 300,652              |
| Property and Equipment:                                                                           |                       |                      |
| Property and equipment, at cost                                                                   | 622,398               | 608,753              |
| Accumulated depreciation and amortization                                                         | (196,701)             | (181,177)            |
| Net property and equipment                                                                        | 425,697               | 427,576              |
| Other Assets:                                                                                     |                       |                      |
| Deposits                                                                                          | 339                   | 323                  |
| Goodwill                                                                                          | 20,320                | 5,978                |
| Notes receivable                                                                                  | 25,779                | 26,805               |
| Deferred income taxes                                                                             | 14,184                | 15,555               |
| Investments in limited liability companies and other                                              | 13,110                | 11,643               |
| Total other assets                                                                                | 73,732                | 60,304               |
| Total assets                                                                                      | \$ 810,328            | \$ 788,532           |

*The accompanying notes to interim condensed consolidated financial statements are an integral part of these consolidated statements.*

*The interim condensed consolidated balance sheet at December 31, 2009 is taken from the audited consolidated financial statements at that date.*

**NATIONAL HEALTHCARE CORPORATION****Interim Condensed Consolidated Balance Sheets***(in thousands, except share and per share amounts)*

|                                                                                                                                                                                                                  | September 30,<br>2010 | December<br>31,<br>2009 |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|-------------------------|
|                                                                                                                                                                                                                  | <i>(unaudited)</i>    |                         |
| <b>Liabilities and Stockholders Equity</b>                                                                                                                                                                       |                       |                         |
| Current Liabilities:                                                                                                                                                                                             |                       |                         |
| Trade accounts payable                                                                                                                                                                                           | \$ 10,079             | \$ 10,909               |
| Accrued payroll                                                                                                                                                                                                  | 39,537                | 46,149                  |
| Amounts due to third party payors                                                                                                                                                                                | 20,558                | 18,617                  |
| Accrued risk reserves                                                                                                                                                                                            | 109,162               | 107,456                 |
| Deferred income taxes                                                                                                                                                                                            | 13,638                | 8,427                   |
| Other current liabilities                                                                                                                                                                                        | 13,425                | 15,117                  |
| Dividends payable                                                                                                                                                                                                | 5,983                 | 5,729                   |
| Accrued interest                                                                                                                                                                                                 | 12                    | 81                      |
| Total current liabilities                                                                                                                                                                                        | 212,394               | 212,485                 |
| Long-Term Debt                                                                                                                                                                                                   | 10,000                | 10,000                  |
| Other Noncurrent Liabilities                                                                                                                                                                                     | 20,881                | 22,633                  |
| Deferred Lease Credits                                                                                                                                                                                           | 1,515                 | 2,423                   |
| Deferred Revenue                                                                                                                                                                                                 | 15,549                | 15,212                  |
| Commitments, Contingencies and Guarantees                                                                                                                                                                        |                       |                         |
| Stockholders Equity:                                                                                                                                                                                             |                       |                         |
| Series A Convertible Preferred Stock; \$.01 par value;<br>25,000,000 shares authorized; 10,840,614 and<br>10,841,062 shares, respectively, issued and<br>outstanding; stated at liquidation of \$15.75 per share | 170,548               | 170,555                 |
| Common stock, \$.01 par value; 30,000,000 shares<br>authorized; 13,595,772 and 13,717,701 shares,<br>respectively, issued and outstanding                                                                        | 136                   | 137                     |
| Capital in excess of par value                                                                                                                                                                                   | 126,337               | 130,867                 |

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|                                                         |                                           |         |         |            |
|---------------------------------------------------------|-------------------------------------------|---------|---------|------------|
| Retained earnings                                       |                                           | 216,739 |         | 197,140    |
| Unrealized gains on marketable securities, net of taxes |                                           | 36,229  |         | 27,080     |
|                                                         | Total stockholders equity                 |         | 549,989 | 525,779    |
|                                                         | Total liabilities and stockholders equity | \$      | 810,328 | \$ 788,532 |

*The accompanying notes to interim condensed consolidated financial statements are an integral part of these consolidated statements.*

*The interim condensed consolidated balance sheet at December 31, 2009 is taken from the audited consolidated financial statements at that date.*



## NATIONAL HEALTHCARE CORPORATION

## Interim Condensed Consolidated Statements of Cash Flows

*(Unaudited)*

|                                                                                   | Nine Months Ended     |           |
|-----------------------------------------------------------------------------------|-----------------------|-----------|
|                                                                                   | September 30          |           |
|                                                                                   | 2010                  | 2009      |
|                                                                                   | <i>(in thousands)</i> |           |
| <b>Cash Flows From Operating Activities:</b>                                      |                       |           |
| Net income                                                                        | \$ 37,340             | \$ 32,895 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                       |           |
| Depreciation and amortization                                                     | 19,890                | 18,865    |
| Provision for doubtful accounts receivable                                        | 1,059                 | 332       |
| Equity in earnings of unconsolidated investments                                  | (6,899)               | (6,593)   |
| Distributions from unconsolidated investments                                     | 5,455                 | 5,285     |
| Gains on sale of restricted marketable securities                                 | (702)                 |           |
| Deferred income taxes                                                             | 913                   | (5,056)   |
| Share-based compensation                                                          | 205                   | 1,116     |
| Changes in operating assets and liabilities:                                      |                       |           |
| Restricted cash and cash equivalents                                              | (4,098)               | 7,215     |
| Accounts receivable                                                               | (3,099)               | 5,574     |
| Income tax receivable                                                             | 3,470                 |           |
| Inventories                                                                       | (307)                 | 258       |
| Prepaid expenses and other assets                                                 | (457)                 | (470)     |
| Trade accounts payable                                                            | (830)                 | (2,028)   |
| Accrued payroll                                                                   | (6,612)               | (13,757)  |
| Amounts due to third party payors                                                 | 1,941                 | 2,065     |
| Accrued interest                                                                  | (69)                  | (5)       |
| Other current liabilities and accrued risk reserves                               | 14                    | 3,906     |
| Entrance fee deposits                                                             | (519)                 | (400)     |
| Other noncurrent liabilities                                                      | (1,752)               | 3,651     |
| Deferred income                                                                   | 856                   | 1,665     |
| Net cash provided by operating activities                                         | 45,799                | 54,518    |
| <b>Cash Flows From Investing Activities:</b>                                      |                       |           |
| Additions to and acquisitions of property and equipment                           | (33,261)              | (32,070)  |

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|                                                             |           |           |
|-------------------------------------------------------------|-----------|-----------|
| Investments in notes receivable                             |           | (8,327)   |
| Collections of notes receivable                             | 1,026     | 4,697     |
| Decrease in restricted cash and cash equivalents            | 48,018    |           |
| Purchase of restricted marketable securities                | (85,484)  |           |
| Sale of restricted marketable securities                    | 36,017    |           |
| Changes in cash fund in liquidation                         |           | 6,065     |
| Net cash used in investing activities                       | (33,684)  | (29,635)  |
| <b>Cash Flows From Financing Activities:</b>                |           |           |
| Payments on debt                                            |           | (2)       |
| Tax benefit from share-based compensation                   | 189       | 3,602     |
| Dividends paid to preferred stockholders                    | (6,505)   | (6,505)   |
| Dividends paid to common stockholders                       | (10,982)  | (9,950)   |
| Issuance of common shares                                   | 1,012     | 14,179    |
| Repurchase of common shares                                 | (5,944)   |           |
| Decrease in deposits                                        | (16)      | 343       |
| Other                                                       | (23)      | (464)     |
| Net cash (used in) provided by financing activities         | (22,269)  | 1,203     |
| <b>Net (Decrease) Increase in Cash and Cash Equivalents</b> | (10,154)  | 26,086    |
| <b>Cash and Cash Equivalents, Beginning of Period</b>       | 39,022    | 49,033    |
| <b>Cash and Cash Equivalents, End of Period</b>             | \$ 28,868 | \$ 75,119 |

*The accompanying notes to interim condensed consolidated financial statements are an integral part of these consolidated statements.*

## NATIONAL HEALTHCARE CORPORATION

## Interim Condensed Consolidated Statements of Stockholders Equity

*(in thousands, except share and per share amounts)**(unaudited)*

|                                                                          | Preferred Stock |            | Common Stock |        | Capital<br>in                | Unrealized           |                                      | Total<br>Stockholders<br>Equity |
|--------------------------------------------------------------------------|-----------------|------------|--------------|--------|------------------------------|----------------------|--------------------------------------|---------------------------------|
|                                                                          | Shares          | Amount     | Shares       | Amount | Excess<br>of<br>Par<br>Value | Retained<br>Earnings | Gains on<br>Marketable<br>Securities |                                 |
| Balance at<br>December<br>31, 2008                                       | 10,841,062      | \$ 170,555 | 13,031,696   | \$ 130 | \$ 113,580                   | \$ 179,710           | \$ 16,842                            | \$ 480,817                      |
| Net<br>income                                                            |                 |            |              |        |                              | 32,895               |                                      | 32,895                          |
| Unrealized<br>gains<br>on<br>securities<br>(net of<br>tax of<br>\$2,828) |                 |            |              |        |                              |                      | 4,238                                | 4,238                           |
| Total<br>comprehensive<br>income                                         |                 |            |              |        |                              |                      |                                      | 37,133                          |
| Share-based<br>compensation                                              |                 |            |              |        | 1,116                        |                      |                                      | 1,116                           |
| Tax<br>benefit<br>from<br>exercise<br>of<br>stock<br>options             |                 |            |              |        | 1,585                        |                      |                                      | 1,585                           |
| Shares<br>sold -<br>options<br>exercised                                 |                 |            | 651,091      |        | 14,172                       |                      |                                      | 14,179                          |
| Dividends<br>declared<br>to                                              |                 |            |              |        |                              | (6,505)              |                                      | (6,505)                         |

|                                                                                                                                            |            |            |            |    |     |            |            |          |          |            |
|--------------------------------------------------------------------------------------------------------------------------------------------|------------|------------|------------|----|-----|------------|------------|----------|----------|------------|
| preferred<br>stockholders<br>(\$0.60<br>per<br>share)<br>Dividends<br>declared<br>to<br>common<br>stockholders<br>(\$0.76<br>per<br>share) |            |            |            |    |     |            |            | (10,385) | (10,385) |            |
| Balance at<br>September<br>30, 2009                                                                                                        | 10,841,062 | \$ 170,555 | 13,682,787 | \$ | 137 | \$ 130,453 | \$ 195,715 | \$       | 21,080   | \$ 517,940 |
| Balance at<br>December<br>31, 2009                                                                                                         | 10,841,062 | \$ 170,555 | 13,717,701 | \$ | 137 | \$ 130,867 | \$ 197,140 | \$       | 27,080   | \$ 525,779 |
| Net<br>income                                                                                                                              |            |            |            |    |     |            | 37,340     |          |          | 37,340     |
| Unrealized<br>gains<br>on<br>securities<br>(net of<br>tax of<br>\$5,669)                                                                   |            |            |            |    |     |            |            |          | 9,149    | 9,149      |
| Total<br>comprehensive<br>income                                                                                                           |            |            |            |    |     |            |            |          |          | 46,489     |
| Share-based<br>compensation                                                                                                                |            |            | 30,000     |    |     | 205        |            |          |          | 205        |
| Tax<br>benefit<br>from<br>exercise<br>of<br>stock<br>options                                                                               |            |            |            |    |     |            | 189        |          |          | 189        |
| Shares<br>sold<br>options<br>exercised                                                                                                     |            |            | 30,864     |    | 1   | 1,011      |            |          |          | 1,012      |
| Shares<br>repurchased                                                                                                                      |            |            | (182,900)  |    | (2) | (5,942)    |            |          |          | (5,944)    |
|                                                                                                                                            | (448)      | (7)        | 107        |    |     | 7          |            |          |          |            |

|                                                                                        |            |            |            |        |            |            |           |    |          |
|----------------------------------------------------------------------------------------|------------|------------|------------|--------|------------|------------|-----------|----|----------|
| Shares<br>issued<br>in<br>conversion<br>of<br>preferred<br>stock to<br>common<br>stock |            |            |            |        |            |            |           |    |          |
| Dividends<br>declared<br>to<br>preferred<br>stockholders<br>(\$0.60<br>per<br>share)   |            |            |            |        |            | (6,505)    |           |    | (6,505)  |
| Dividends<br>declared<br>to<br>common<br>stockholders<br>(\$0.82<br>per<br>share)      |            |            |            |        |            | (11,236)   |           |    | (11,236) |
| Balance at<br>September<br>30, 2010                                                    | 10,840,614 | \$ 170,548 | 13,595,772 | \$ 136 | \$ 126,337 | \$ 216,739 | \$ 36,229 | \$ | 549,989  |

*The accompanying notes to interim condensed consolidated financial statements are an integral part of these consolidated statements.*

NATIONAL HEALTHCARE CORPORATION

September 30, 2010

(unaudited)

**Note 1 Consolidated Financial Statements**

The unaudited condensed consolidated financial statements to which these notes are attached include all normal, recurring adjustments which are necessary to fairly present the financial position, results of operations and cash flows of National HealthCare Corporation ("NHC" or the "Company"). We assume that users of these interim financial statements have read or have access to the audited December 31, 2009 consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies, may be determined in that context. Accordingly, footnotes and other disclosures which would substantially duplicate the disclosure contained in our most recent annual report to stockholders have been omitted. This interim financial information is not necessarily indicative of the results that may be expected for a full year for a variety of reasons. Our audited December 31, 2009 consolidated financial statements are available at our web site: [www.nhccare.com](http://www.nhccare.com).

*Reclassifications*

The 2009 financial information has been reclassified so the basis of presentation is consistent with that of the 2010 financial information. Specifically, the Company reclassified "non-operating income" out of "other revenues" in the Consolidated Statements of Income.

**Note 2 Other Revenues**

Other revenues are outlined in the table below. Revenues from insurance services include premiums for workers compensation, health insurance, and professional liability insurance policies that our wholly-owned limited purpose insurance subsidiaries have written for certain long-term health care centers to which we provide management or accounting services. Revenues from management and accounting services include management and accounting fees and revenues from other services provided to managed and other long-term health care centers. "Other" revenues include miscellaneous health care related earnings.

Other revenues include the following:

| <i>(in thousands)</i>                      | Three Months Ended<br>September 30 |           | Nine Months Ended<br>September 30 |           |
|--------------------------------------------|------------------------------------|-----------|-----------------------------------|-----------|
|                                            | 2010                               | 2009      | 2010                              | 2009      |
| Insurance services                         | \$ 4,164                           | \$ 4,329  | \$ 12,914                         | \$ 12,941 |
| Management and accounting services<br>fees | 4,306                              | 5,054     | 15,288                            | 12,686    |
| Rental income                              | 3,149                              | 3,161     | 9,346                             | 9,464     |
| Other                                      | 301                                | 296       | 1,235                             | 1,169     |
|                                            | \$ 11,920                          | \$ 12,840 | \$ 38,783                         | \$ 36,260 |

Certain of our affiliates manage five long-term care centers owned by National Health Corporation ("National"). During the nine months ended September 30, 2010 and 2009, we recognized management fees and interest on management fees of \$3,142,000 and \$1,200,000, respectively, from these centers.

The unpaid fees from the five centers owned by National, because the amount collectable could not be reasonably determined when the management services were provided, and because we cannot estimate the timing or amount of expected future collections, will be recognized as revenues only when fixed or determinable and collectibility of these fees can be reasonably assured. Under the terms of our management agreement with National, the payment of these fees to us may be subordinated to other expenditures of the five long-term care centers. We continue to manage these centers so that we may be able to collect our fees in the future and because the incremental savings from discontinuing services to a center may be small compared to the potential benefit. We may receive payment for the

NATIONAL HEALTHCARE CORPORATION

September 30, 2010

(unaudited)

unrecognized management fees in whole or in part in the future only if cash flows from the operating and investing activities of the five centers are sufficient to pay the fees. There can be no assurance that such future improved cash flows will occur.

Certain of our affiliates manage 15 long-term care centers that were previously owned by National Health Investors, Inc. ("NHI"). During the nine months ended September 30, 2010 and 2009, we recognized \$3,321,000 and \$2,248,000, respectively, of management fees and interest from these 15 long-term care centers.

Of the total 15 centers managed, the management fee revenues from seven centers were currently paid and recognized on the accrual method in 2010 and 2009. The fees from the remaining eight centers, because of insufficient historical collections and the lack of expected future collections, are recognized only when realized. Under the terms of the management agreements, the payment of these fees to us may be subordinated to other expenditures of each of the long-term care centers. Our affiliates continue to manage these centers so that we may be able to collect our fees in the future and because the incremental savings from discontinuing services to a center may be small compared to the potential benefit. We may receive payment for the unrecognized management fees in whole or in part in the future only if cash flows from operating and investing activities of the centers are sufficient to pay the fees. There can be no assurance that such future improved cash flows will occur.

**Note 3 - Non-Operating Income**

Non-operating income is outlined in the table below. Non-operating income includes dividends and other realized gains and losses on securities, interest income and equity in earnings of unconsolidated investments. Our most significant equity method investment is a 50% ownership and voting interest in Caris HealthCare L.P., a business that specializes in hospice care services.



| <i>(in thousands)</i>                                                    | Three Months Ended<br>September 30 |          | Nine Months Ended<br>September 30 |           |
|--------------------------------------------------------------------------|------------------------------------|----------|-----------------------------------|-----------|
|                                                                          | 2010                               | 2009     | 2010                              | 2009      |
| Equity in earnings of unconsolidated investments                         | \$ 2,416                           | \$ 2,251 | \$ 6,899                          | \$ 6,593  |
| Dividends and other net realized gains and losses on sales of securities | 1,597                              | 1,061    | 4,060                             | 3,185     |
| Interest income                                                          | 1,411                              | 932      | 3,999                             | 2,835     |
|                                                                          | \$ 5,424                           | \$ 4,244 | \$ 14,958                         | \$ 12,613 |

#### **Note 4 Other Operating Expenses**

Other operating expenses include the costs of care and services that we provide to the residents of our facilities and the costs of maintaining our facilities. Our primary patient care costs include drugs, medical supplies, purchased professional services, food, professional insurance and licensing fees. The primary facility costs include utilities and property insurance.

#### **Note 5 Earnings per Share**

We compute earnings per share using the two-class method. Under the two-class method, earnings per common share are computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period.

## NATIONAL HEALTHCARE CORPORATION

September 30, 2010

(unaudited)

The following table summarizes the earnings and the weighted average number of common shares used in the calculation of basic and diluted earnings per share.

| <i>(in thousands, except for share and per share amounts)</i> | Three Months Ended Sept. 30 |            | Nine Months Ended Sept. 30 |            |
|---------------------------------------------------------------|-----------------------------|------------|----------------------------|------------|
|                                                               | 2010                        | 2009       | 2010                       | 2009       |
| Basic:                                                        |                             |            |                            |            |
| Weighted average common shares outstanding                    | 13,649,174                  | 13,675,162 | 13,705,477                 | 13,522,351 |
| Net income                                                    | \$ 15,083                   | \$ 12,344  | \$ 37,340                  | \$ 32,895  |
| Dividends to preferred stockholders                           | (2,169)                     | (2,169)    | (6,505)                    | (6,505)    |
| Net income available to common stockholders                   | 12,914                      | 10,175     | 30,835                     | 26,390     |
| Earnings per common share, basic                              | \$ .95                      | \$ .74     | \$ 2.25                    | \$ 1.95    |
| Diluted:                                                      |                             |            |                            |            |
| Weighted average common shares outstanding                    | 13,649,174                  | 13,675,162 | 13,705,477                 | 13,522,351 |
| Dilutive effect of stock options                              | -                           | 10,410     | 1,210                      | 17,715     |
| Dilutive effect of restricted stock                           | 1,742                       |            | 903                        |            |
| Assumed average common shares outstanding                     | 13,650,916                  | 13,685,572 | 13,707,590                 | 13,540,066 |
| Net income available to common stockholders                   | \$ 12,914                   | \$ 10,175  | \$ 30,835                  | \$ 26,390  |

|                                                  |    |        |    |        |    |        |    |        |
|--------------------------------------------------|----|--------|----|--------|----|--------|----|--------|
| Net income for diluted earnings per common share |    | 12,914 |    | 10,175 |    | 30,835 |    | 26,390 |
| Earnings per common share, diluted               | \$ | .95    | \$ | .74    | \$ | 2.25   | \$ | 1.95   |

In the above table, 514,642 and 269,245 options to purchase our common stock have been excluded for 2010 and 2009, respectively, and 2,623,862 and 2,623,971 of potential common shares issuable upon the conversion of the preferred stock have been excluded for 2010 and 2009, respectively, due to their anti-dilutive impact.

### Note 6 - Investments in Marketable Securities

Our investments in marketable securities include available for sale securities. Realized gains and losses from securities sales are determined on the specific identification of the securities.

Marketable securities and restricted marketable securities consist of the following:

|                                                 | September 30, 2010 |            | December 31, 2009 |           |
|-------------------------------------------------|--------------------|------------|-------------------|-----------|
|                                                 | Amortized          | Fair       | Amortized         | Fair      |
| <i>(in thousands)</i>                           | Cost               | Value      | Cost              | Value     |
| Investments available for sale:                 |                    |            |                   |           |
| Marketable equity securities                    | \$ 29,604          | \$ 83,349  | \$ 29,604         | \$ 71,280 |
| Restricted investments available for sale:      |                    |            |                   |           |
| Corporate debt securities                       | 27,792             | 29,014     | 3,159             | 3,125     |
| Commercial mortgage-backed securities           | 26,338             | 27,153     | 7,422             | 7,392     |
| U.S. Treasury securities                        | 8,201              | 8,435      | 8,918             | 8,833     |
| U.S. government sponsored enterprise securities | 3,385              | 3,534      |                   |           |
| State and municipal securities                  | 3,953              | 4,132      |                   |           |
|                                                 | \$ 99,273          | \$ 155,617 | \$ 49,103         | \$ 90,630 |



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Included in the available for sale marketable equity securities are the following:

(in thousands, except share amounts)

|                  | September 30, 2010 |           |            | December 31, 2009 |           |            |
|------------------|--------------------|-----------|------------|-------------------|-----------|------------|
|                  | Shares             | Cost      | Fair Value | Shares            | Cost      | Fair Value |
| NHI Common Stock | 1,630,642          | \$ 24,734 | \$ 71,846  | 1,630,642         | \$ 24,734 | \$ 60,317  |

The amortized cost and estimated fair value of debt securities classified as available for sale, by contractual maturity, are as follows:

| (in thousands) | September 30, 2010 |            | December 31, 2009 |            |
|----------------|--------------------|------------|-------------------|------------|
|                | Cost               | Fair Value | Cost              | Fair Value |
| Maturities:    |                    |            |                   |            |
| Within 1 year  | \$ 3,151           | \$ 3,168   | \$ 1,475          | \$ 1,493   |
| 1 to 5 years   | 47,092             | 48,684     | 13,105            | 12,984     |
| 6 to 10 years  | 15,538             | 16,492     | 4,919             | 4,873      |
| Over 10 years  | 3,888              | 3,924      |                   |            |
|                | \$ 69,669          | \$ 72,268  | \$ 19,499         | \$ 19,350  |

Gross unrealized gains related to available for sale securities are \$56,364,000 and \$41,676,000 as of September 30, 2010 and December 31, 2009, respectively. Gross unrealized losses related to available for sale securities were \$20,000 and \$149,000 as of September 30, 2010 and December 31, 2009, respectively.

Proceeds from the sale of investments in marketable securities during the nine months ended September 30, 2010 and September 30, 2009 were \$36,017,000 and \$-0-, respectively. Gross investment gains of \$702,000 were realized on these sales during the nine months ended September 30, 2010.

#### **Note 7 - Fair Value Measurements**

The carrying amounts of cash and cash equivalents, restricted cash and cash equivalents, accounts receivable, and accounts payable approximate fair value due to their short-term nature. The estimated fair value of notes receivable approximates the carrying value based principally on their underlying interest rates and terms, maturities, collateral and credit status of the receivables. Our long-term debt approximates fair value due to variable interest rates. At September 30, 2010 and December 31, 2009, there were no material differences between the carrying amounts and fair values of NHC's financial instruments.

The accounting standard for fair value measurements provides a framework for measuring fair value and requires expanded disclosures regarding fair value measurements. Fair value is defined as the price that would be received for an asset or the exit price that would be paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants on the measurement date. This accounting standard establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs, where available. The following summarizes the three levels of inputs that may be used to measure fair value:

*Level 1* The valuation is based on quoted prices in active markets for identical instruments.

*Level 2* The valuation is based on observable inputs such as quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

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*Level 3* The valuation is based on unobservable inputs that are supported by minimal or no market activity and that are significant to the fair value of the instrument. Level 3 valuations are typically performed using pricing models, discounted cash flow methodologies, or similar techniques that incorporate management's own estimates of assumptions that market participants would use in pricing the instrument, or valuations that require significant management judgment or estimation.

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The Company determines fair value for marketable securities with Level 1 inputs through quoted market prices. The Company determines fair value for marketable securities with Level 2 inputs through broker or dealer quotations or alternative pricing sources with reasonable levels of price transparency. Our Level 2 marketable securities have been initially valued at the transaction price and subsequently valued, at the end of each month, typically utilizing third party pricing services or other market observable data. The pricing services utilize industry standard valuation models, including both income and market based approaches and observable market inputs to determine value. These observable market inputs include reportable trades, benchmark yields, credit spreads, broker/dealer quotes, bids, offers, and other industry and economic events. We did not have any significant transfers of assets between Level 1 and Level 2 of the fair value measurement hierarchy during the nine months ended September 30, 2010.

The following table summarizes fair value measurements by level at September 30, 2010 and December 31, 2009 for assets and liabilities measured at fair value on a recurring basis (*in thousands*):

| September 30, 2010 | Fair<br>Value | Fair Value Measurements Using                                    |                                                           |                                                    |
|--------------------|---------------|------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
|                    |               | Quoted Prices<br>in Active<br>Markets<br>For Identical<br>Assets | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |

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(Level 1)

|                                                 |    |         |    |         |    |           |
|-------------------------------------------------|----|---------|----|---------|----|-----------|
| Cash and cash equivalents                       | \$ | 28,868  | \$ | 28,868  | \$ | \$        |
| Restricted cash and cash equivalents            |    | 53,014  |    | 53,014  |    |           |
| Marketable equity securities                    |    | 83,349  |    | 83,349  |    |           |
| Corporate debt securities                       |    | 29,014  |    |         |    | 29,014    |
| Commercial mortgage-backed securities           |    | 27,153  |    |         |    | 27,153    |
| U.S. Treasury securities                        |    | 8,435   |    | 8,435   |    |           |
| U.S. government sponsored enterprise securities |    | 3,534   |    |         |    | 3,534     |
| State and municipal securities                  |    | 4,132   |    |         |    | 4,132     |
| Total financial assets                          | \$ | 237,499 | \$ | 173,666 | \$ | 63,833 \$ |



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|                                          | Fair       | Fair Value Measurements Using         |                                              |                                       |
|------------------------------------------|------------|---------------------------------------|----------------------------------------------|---------------------------------------|
|                                          |            | Quoted Prices<br>in Active<br>Markets | Significant<br>Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs |
| December 31, 2009                        | Value      | For Identical<br>Assets<br>(Level 1)  | (Level 2)                                    | (Level 3)                             |
| Cash and cash equivalents                | \$ 39,022  | \$ 39,022                             | \$                                           | \$                                    |
| Restricted cash and cash<br>equivalents  | 96,934     | 96,934                                |                                              |                                       |
| Marketable equity securities             | 71,280     | 71,280                                |                                              |                                       |
| Corporate debt securities                | 3,125      | 3,125                                 |                                              |                                       |
| Commercial mortgage-backed<br>securities | 7,392      |                                       | 7,392                                        |                                       |
| U.S. Treasury securities                 | 8,833      | 8,833                                 |                                              |                                       |
| Total financial assets                   | \$ 226,586 | \$ 219,194                            | \$ 7,392                                     | \$                                    |

**Note 8 - Long-Term Debt and Commitments***Long-Term Debt*

Long-term debt consists of the following:

| <i>(dollars in thousands)</i>                                                                      | Weighted           |            |                  |                  |
|----------------------------------------------------------------------------------------------------|--------------------|------------|------------------|------------------|
|                                                                                                    | Average            |            |                  |                  |
|                                                                                                    | Interest Rate      | Maturities | Long-Term Debt   |                  |
|                                                                                                    |                    |            | 9/30/10          | 12/31/09         |
| Revolving Credit Facility, interest payable monthly                                                | Variable,<br>1.26% | 2011       | \$               | \$               |
| Unsecured term note payable to National, interest payable quarterly, principal payable at maturity | Variable,<br>2.8%  | 2018       | 10,000<br>10,000 | 10,000<br>10,000 |
| Less current portion                                                                               |                    |            | \$ 10,000        | \$ 10,000        |

**Note 9 - \$75,000,000 Revolving Credit Facility**

Effective October 26, 2010, we extended the maturity of our Credit Agreement (the "Credit Agreement") with Bank of America, N.A., as lender (the "Lender"). The Credit Agreement provides for a \$75,000,000 revolving credit facility (the "Credit Facility"), of which up to \$5,000,000 may be utilized for letters of credit.

Borrowings bear interest at either (i) the Eurodollar rate plus 1.00% or (ii) the prime rate. Letter of credit fees are equal to 1.00% times the maximum amount available to be drawn under outstanding letters of credit. The rates and fees are unchanged from those in effect prior to the extension.

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Commitment fees are payable on the daily unused portion of the Credit Facility at a rate of twenty (20) basis points per annum. NHC is permitted to prepay the loans outstanding under the Credit Facility at any time, without penalty.

The Credit Facility matures on October 25, 2011. Between 90 and 120 days prior to the maturity date, NHC may request the extension of the maturity date. If the Lender elects to consent to such extension, subject to certain conditions, the maturity date will be extended to the date which is 364 days after the then maturity date.

NHC's obligations under the Credit Agreement are guaranteed by certain NHC subsidiaries and are secured by pledges by NHC and the guarantors of (i) 100% of the equity interests of domestic subsidiaries and (ii) up to 65% of the voting equity interests and 100% of the non-voting equity interests of foreign subsidiaries, in each case, held by NHC or the guarantors.

The Credit Agreement contains customary representations and warranties, and covenants, including covenants that restrict, among other things, asset dispositions, mergers and acquisitions, dividends, restricted payments, debt, liens, investments and affiliate transactions. The Credit Agreement contains customary events of default.

The Credit Facility is available for general corporate purposes, including working capital and acquisitions.

**Note 10 Share-Based Compensation**

NHC recognizes share-based compensation for all stock options and restricted stock granted over the requisite service period using the fair value for these grants as estimated at the date of grant either using the Black-Scholes pricing model for stock options or the quoted market price for restricted stock.

*The 2005 and 2010 Share-Based Compensation Plans*

The Compensation Committee of the Board of Directors ( the Committee ) has the authority to select the participants to be granted options; to designate whether the option granted is an incentive stock option ( ISO ), a non qualified option, or a stock appreciation right; to establish the number of shares of common stock that may be issued upon exercise of the option; to establish the vesting provision for any award; and to establish the term any award may be outstanding.

The exercise price of any ISO s granted will not be less than 100% of the fair market value of the shares of common stock on the date granted and the term of an ISO may not be any more than ten years. The exercise price of any non qualified options granted will not be less than 100% of the fair market value of the shares of common stock on the date granted unless so determined by the Committee.

In May 2005, our stockholders approved the 2005 Stock Option, Employee Stock Purchase, Physician Stock Purchase and Stock Appreciation Rights Plan ( the 2005 Plan ) pursuant to which 1,200,000 shares of our common stock were available to grant as share-based payments to key employees, directors, and non-employee consultants. During the second quarter of fiscal 2010, the Company granted and issued 30,000 restricted stock shares in accordance with the 2005 Plan. These particular restricted stock shares vest on a graded five-year schedule. At September 30, 2010, 779,052 shares were available for future grants under the 2005 Plan.

In May 2010, our stockholders approved the 2010 Omnibus Equity Incentive Plan ( the 2010 Plan ) pursuant to which 1,200,000 shares of our common stock were available to grant as share-based payments to key employees, directors, and non-employee consultants. During the second quarter of fiscal 2010, the Company granted stock options to purchase 158,000 shares of our common stock in accordance with the 2010 Plan. These particular stock options become vested and exercisable thirty days prior to the expiration date of the options, which is five years after the date of the grant. At September 30, 2010, 1,042,000 shares were available for future grants under the 2010 Plan.

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Compensation expense is recognized only for the awards that ultimately vest. The compensation expense reported for share-based compensation totaled \$205,000 for the nine months ended September 30, 2010. The expense consisted of \$123,000 for stock options and \$82,000 for restricted stock, as compared to \$1,116,000 for the nine months ended September 30, 2009, consisting of \$1,116,000 for stock options and \$-0- for restricted stock. At September 30, 2010, we had \$1,789,000 of unrecognized compensation cost related to unvested share-based compensation awards, which consisted of \$838,000 for stock options and \$951,000 for restricted stock. This expense will be recognized over the remaining weighted average vesting period, which is approximately 4.5 years for stock options and 2.8 years for restricted stock. Share-based compensation is included in Salaries, wages and benefits in the Consolidated Statements of Income.

The following table summarizes our outstanding stock options for the nine months ended September 30, 2010 and for the year ended December 31, 2009.

|                                           | Number of | Weighted       | Aggregate |
|-------------------------------------------|-----------|----------------|-----------|
|                                           | Shares    | Average        | Intrinsic |
|                                           |           | Exercise Price | Value     |
| Options outstanding at December 31, 2008  | 992,196   | \$ 30.55       |           |
| Options granted                           | 113,914   | 37.37          |           |
| Options exercised                         | (685,805) | 22.44          |           |
| Options cancelled or expired              | (35,000)  | 55.00          |           |
| Options outstanding at December 31, 2009  | 385,305   | 44.78          |           |
| Options granted                           | 181,315   | 35.56          |           |
| Options exercised                         | (30,664)  | 32.75          |           |
| Options cancelled or expired              | (21,314)  | 32.01          |           |
| Options outstanding at September 30, 2010 | 514,642   | \$ 42.78       | \$ -      |
| Options exercisable at September 30, 2010 | 333,327   | \$ 46.70       | \$ -      |

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| Options        |                 | Weighted Average |                       |
|----------------|-----------------|------------------|-----------------------|
| Outstanding    |                 | Weighted Average | Remaining Contractual |
| Sept. 30, 2010 | Exercise Prices | Exercise Price   | Life in Years         |
| 264,022        | 35.37 to 37.70  | 36.23            | 3.9                   |
| 250,620        | 44.25 to 52.50  | 49.67            | 1.6                   |
| 514,642        |                 |                  |                       |

The following table summarizes our restricted stock activity for the nine months ended September 30, 2010.

|                                                  | Number of | Weighted        |
|--------------------------------------------------|-----------|-----------------|
|                                                  | Shares    | Average Grant   |
|                                                  |           | Date Fair Value |
| Unvested restricted shares at December 31, 2009  |           | \$              |
| Award shares granted                             | 30,000    | 34.46           |
| Award shares vested                              |           |                 |
| Unvested restricted shares at September 30, 2010 | 30,000    | \$ 34.46        |

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**Note 11 Accounting for Uncertainty in Income Taxes**

NHC continually evaluates for uncertain tax positions. Uncertain tax positions may arise where tax laws may allow for alternative interpretations or where the timing of recognition of income is subject to judgment. We believe we have made adequate provision for unrecognized tax benefits related to uncertain tax positions. However, because of uncertainty of interpretation by various tax authorities and the possibility that there are issues that have not been recognized by management, we cannot guarantee we have accurately estimated our tax liabilities. We believe that our liabilities reflect the anticipated outcome of known uncertain tax positions in conformity with ASC Topic 740, *Income Taxes*. Our liabilities for unrecognized tax benefits are presented in the consolidated balance sheets within Other Noncurrent Liabilities.

At September 30, 2010, we had \$16,348,000 of unrecognized tax benefits, composed of \$10,885,000 of deferred tax assets, \$-0- of deferred tax liabilities, and \$5,463,000 of permanent differences. Accrued interest and penalties of \$4,533,000 relate to unrecognized tax benefits at September 30, 2010. Unrecognized tax benefits of \$5,463,000, net of federal benefit, at September 30, 2010, attributable to permanent differences, would favorably impact our effective tax rate if recognized. Accrued interest and penalties of \$1,766,000 relate to these permanent differences at September 30, 2010. We do not expect to recognize significant increases or decreases in unrecognized tax benefits within twelve months beginning September 30, 2010, except for the effect of decreases related to the lapse of statute of limitations estimated at \$2,450,000, composed of temporary differences of \$-0-, and permanent tax differences of \$2,450,000. Interest and penalties of \$787,000 relate to these permanent difference changes within 12 months beginning September 30, 2010.

Interest and penalties expense related to U.S. federal and state income tax returns are included within income tax expense.

The Company is no longer subject to U.S. federal and state examinations by tax authorities for years before 2007 (with certain state exceptions). Currently, there are no U.S. federal or state returns under examination.

**Note 12 Guarantees and Contingencies**

*Accrued Risk Reserves*

We are self insured for risks related to health insurance and have wholly-owned limited purpose insurance companies that insure risks related to workers' compensation and general and professional liability insurance claims both for our owned or leased entities and certain of the entities to which we provide management or accounting services. The liability we have recognized for reported claims and estimates for incurred but unreported claims totals \$109,162,000 and \$107,456,000 at September 30, 2010 and December 31, 2009, respectively. This liability is classified as a current liability based on the uncertainty regarding the timing of potential payments. The liability is included in accrued risk reserves in the consolidated balance sheets and is subject to adjustment for actual claims incurred. It is possible that these claims plus unasserted claims could exceed our insurance coverages and our reserves, which could have a material adverse effect on our financial position, results of operations and cash flows.

As a result of the terms of our insurance policies and our use of wholly-owned limited purpose insurance companies, we have retained significant insurance risk with respect to workers' compensation and general and professional liability. We use independent actuaries to estimate our exposures for claims obligations (for both asserted and unasserted claims) related to deductibles and exposures in excess of coverage limits, and we maintain reserves for these obligations. Such estimates are based on many variables including historical and statistical information and other factors.



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*Workers Compensation*

For workers compensation, we utilize a wholly-owned Tennessee domiciled property/casualty insurance company to write coverage for NHC affiliates and for third-party customers. Policies are written for a duration of twelve months and cover only risks related to workers compensation losses. All customers are companies which operate in the long-term care industry. Business is written on a direct basis. Direct business coverage is written for statutory limits and the insurance company's losses in excess of \$1,000,000 per claim are covered by reinsurance.

For these workers compensation insurance operations, the premium revenues reflected in the consolidated financial statements within "Other Revenues" for the nine months ended September 30, 2010 and 2009, respectively, are \$3,827,000 and \$4,037,000. Associated losses and expenses are reflected in the consolidated financial statements as "Other operating costs and expenses".

*General and Professional Liability Lawsuits and Insurance*

Across the nation, the entire long term care industry has experienced significant amounts of personal injury/wrongful death claims and awards based on alleged negligence by nursing facilities and their employees in providing care to residents. As of September 30, 2010, we and/or our managed centers are currently defendants in 29 such claims covering the years 2002 through September 30, 2010.

Due to either the unavailability and/or prohibitive cost of quoted professional liability insurance coverage in 2002, we elected to pay the premiums into a wholly-owned licensed captive insurance company, incorporated in the Cayman Islands, for the purpose of managing our losses related to these risks. Thus, for the years 2002-2010, insurance coverage for incidents occurring at all providers owned or leased, and most providers managed by us, is provided through this wholly-owned insurance company. Current policies are written for a duration of twelve months.

Our insurance coverage for all years includes both primary and excess policies. In 2002, deductibles were eliminated and first dollar coverage was provided through the wholly-owned insurance company, while the excess coverage was provided by a third party insurer.

For 2003-2010, both primary professional liability insurance coverage and excess coverage is provided through our wholly-owned liability insurance company in the amount of \$1 million per incident, \$3 million per location with an aggregate primary policy limit. The limit was \$17.0 million for the years 2010 and 2009, and \$16.0 million for 2008. There is a \$9.0 million annual excess aggregate applicable to years 2010, 2009 and 2008.

For these professional liability insurance operations, the premium revenues reflected in the consolidated financial statements within "Other revenues" for the nine months ended September 30, 2010 and 2009, respectively, are \$3,331,000 and \$3,485,000. Associated losses and expenses including those for self-insurance are included in the consolidated financial statements as "Other operating costs and expenses".

#### *Other Matters*

On July 24, 2009, the Company received a civil investigative demand from the Tennessee Attorney General's Office, requesting production of documents related to NHC's business relationships with non-profit entities. The Company has responded to the demand and will comply as required with the terms of the demand.

#### **Note 13 Acquisition of South Carolina Homecare Business**

Effective May 1, 2010, we purchased for \$14,850,000 in cash certain assets and assumed certain liabilities of three homecare programs located in South Carolina. The three homecare programs are licensed in five South Carolina

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counties. We accounted for the acquisition in accordance with ASC Topic 805, *Business Combinations*. ASC Topic 805 states the purchase price should be allocated based upon the fair value of the identifiable assets acquired and liabilities assumed with the excess of the fair value of the consideration provided over the fair value of the identifiable assets and liabilities recorded as goodwill. As a result of the acquisition, we recorded \$14,342,000 as goodwill, all of which is expected to be fully deductible as amortized for income tax purposes. The operating results of the three homecare programs have been included in the consolidated financial statements since May 1, 2010, the acquisition date. The unaudited pro forma results are not disclosed due to the results being immaterial to the consolidated financial statements.

**Note 14 New Accounting Pronouncements**

In July 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. This update requires increased disclosures about the credit quality of financing receivables and allowances for credit losses, including disclosure about credit quality indicators, past due information and modifications of finance receivables. The guidance is generally effective for reporting periods ending after December 15, 2010. We are currently assessing the effects of this update and will provide the required disclosure in the 2010 Annual Report.

In February 2010, the FASB issued ASU No. 2010-09, *Amendments to Certain Recognition and Disclosure Requirements*. This update removes the requirement for an SEC filer to disclose the date through which subsequent events have been evaluated and became effective immediately. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-06, *Improving Disclosures about Fair Value Measurements*. This update requires the disclosure of transfers between the observable input categories and activity in the unobservable input category for fair value measurements. The guidance also requires disclosures about the inputs and valuation techniques used to measure fair value and became effective for our interim and annual reporting periods beginning January 1, 2010. The adoption of this guidance is reflected in Note 7 Fair Value Measurements.

In September 2009, the FASB issued ASU No. 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (VIEs). This guidance replaces the quantitative-based risks and rewards calculation for determining which enterprise might have a controlling financial interest in a VIE. The new, more qualitative evaluation focuses on who has the power to direct the significant economic activities of the VIE and also who has the obligation to absorb losses or rights to receive benefits from the VIE. It also requires an ongoing reassessment of whether an enterprise is the primary beneficiary of a VIE and calls for certain expanded disclosures about an enterprise's involvement with variable interest entities. This update was effective for our interim and annual reporting periods beginning January 1, 2010. The adoption did not have a material impact on the Company's consolidated financial statements.

## **Item 2.**

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

#### Overview

National HealthCare Corporation ( NHC or the Company ) is a leading provider of long-term health care services. We operate or manage, through certain affiliates, 77 long-term health care centers with 9,742 beds in 10 states and provide other services in one additional state. These operations are provided by separately funded and maintained subsidiaries. We provide long-term health care services to patients in a variety of settings including long-term nursing centers, managed care specialty units, sub-acute care units, Alzheimer's care units, hospice programs, homecare programs, assisted living centers and independent living centers. In addition, we provide management and accounting services and lease properties to owners of long-term health care centers.

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Summary of Goals and Areas of Focus

*Earnings* To monitor our earnings, we have developed budgets and management reports to monitor labor, census, and the composition of revenues. Inflationary increases in our costs may cause net earnings from patient services to decline.

*Development and Growth* In January 2009, we purchased five hospice locations in South Carolina and also opened a Greenville, South Carolina hospice location. In January 2010, we opened a new 120-bed skilled care and dementia center in Bluffton, South Carolina. In March 2010, we opened a new 45-unit assisted living community in Mauldin, South Carolina. In May 2010, we purchased three homecare programs located in South Carolina. These three homecare locations are licensed in five South Carolina counties. We have also initiated construction of a new 75-unit assisted living community in Parklane, South Carolina, and a 46-unit addition to our existing Franklin, Tennessee assisted living community.

We have Certificates of Need for a 92-bed healthcare center in Hendersonville, Tennessee, a 90-bed healthcare center in Tullahoma, Tennessee, and a 150-bed healthcare center in Nashville, Tennessee. These projects are in preparation for future development. During 2010, we may apply for Certificates of Need for additional beds in select markets and new construction opportunities for skilled nursing and assisted living facilities. NHC will also continue to seek prudent acquisition opportunities in each of our lines of business.

*Accrued Risk Reserves* Our accrued professional liability reserves, workers' compensation reserves and health insurance reserves totaled \$109,162,000 at September 30, 2010 and are a primary area of management focus. We have set aside restricted cash and cash equivalents and marketable securities to fund substantially all of our professional liability and workers' compensation liabilities.

As to exposure for professional liability claims, we have developed for our centers performance certification criteria to measure and bring focus to the patient care issues most likely to produce professional liability exposure, including in house acquired pressure ulcers, significant weight loss and numbers of falls. These programs for certification, which we regularly modify and improve, have produced measurable improvements in reducing these incidents. Our experience is that achieving goals in these patient care areas improves both patient and employee satisfaction.

#### Application of Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us 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 and cause our reported net income to vary significantly from period to period.

Our critical accounting policies that are both important to the portrayal of our financial condition and results and require our most difficult, subjective or complex judgments are as follows:

*Revenue Recognition Third Party Payors* Approximately 64% (2009), 63% (2008), and 65% (2007) of our net revenues are derived from Medicare, Medicaid, and other government programs. Amounts earned under these programs are subject to review by the Medicare and Medicaid intermediaries. In our opinion, adequate provision has been made for any adjustments that may result from these reviews. Any differences between our estimates of settlements and final determinations are reflected in operations in the year finalized. At September 30, 2010, we have made

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provisions for amounts due third party payors of approximately \$20,558,000. Revenues and results of operations in the nine months ended September 30, 2010 and 2009 were not materially impacted by changes in estimates of settlements and final determinations.

*Revenue Recognition Private Pay* For private pay patients in skilled nursing or assisted living facilities, we bill room and board in advance for the current month with payment being due upon receipt of the statement in the month the services are performed. Charges for ancillary, pharmacy, therapy and other services to private patients are billed in the month following the performance of services. All billings are recognized as revenue when the services are performed.

*Accrued Risk Reserves* We are principally self-insured for risks related to employee health insurance, workers compensation and professional and general liability claims. The accrued risk reserves include a liability for reported claims and estimates for incurred but unreported claims. Our policy with respect to a significant portion of our workers compensation and professional and general liability claims is to use an actuary to support the estimates recorded for incurred but unreported claims. Our health insurance reserve is based on our known claims incurred and an estimate of incurred but unreported claims determined by our analysis of historical claims paid. We reassess our accrued risk reserves on a quarterly basis.

Professional liability remains an area of particular concern to us. The entire long term care industry has seen personal injury/wrongful death claims based on alleged negligence by nursing homes and their employees in providing care to residents. As of September 30, 2010, we and/or our managed centers are defendants in 29 such claims inclusive of years 2002 through 2010. It remains possible that these pending matters plus potential unasserted claims could exceed our reserves, which would have a material adverse effect on our financial position, results of operations and cash flows. It is also possible that future events could cause us to make significant adjustments or revisions to these reserve estimates and cause our reported net income to vary significantly from period to period.

We maintain insurance coverage for incidents occurring at all providers owned or leased by us, and most providers managed by us. The coverages include both primary policies and excess policies. In all years, settlements, if any, in excess of available insurance policy limits and our own reserves would be expensed by us.

*Revenue Recognition Subordination of Fees and Uncertain Collections* We provide management services to certain long term care facilities and to others we provide accounting and financial services. We generally charge 6% of net revenues for our management services and a predetermined fixed rate per bed for the accounting and financial services. Our policy is to recognize revenues associated with both management services and accounting and financial services on an accrual basis as the services are provided. However, under the terms of our management contracts, payments for our management services are subject to subordination to other expenditures of the long-term care center being managed. Furthermore, there are certain of the third parties with whom we have contracted to provide services and which we have determined, based on insufficient historical collections and the lack of expected future collections, that collection is not reasonably assured and our policy is to recognize income only in the period in which the amounts are realized. We recognize the expenses related to the provision of those services in the period in which they are incurred. We may receive payment for the unpaid and unrecognized management fees in whole or in part in the future only if cash flows from the operating and investing activities of the centers are sufficient to pay the fees. There can be no assurance that such future cash flows will occur. The realization of such previously unrecognized revenue could cause our reported net income to vary significantly from period to period.

We agree to subordinate our fees to the other expenses of a managed center because we believe we know how to improve the quality of patient services and finances of a long-term care center and because subordinating our fees demonstrates to the owner and employees of the managed center how confident we are of the impact we can have in making the center operations successful. We may continue to provide services to certain managed centers despite not being fully paid currently so that we may be able to collect unpaid fees in the future from improved operating results and because the incremental savings from discontinuing services to a center may be small compared to the potential benefit. Also, we may benefit from providing other ancillary services to the managed center.



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Our accounts receivable from private paying patients and our notes receivable are subject to credit losses. We have attempted to reserve for expected accounts receivable credit losses based on our past experience with similar accounts receivable and believe our reserves to be adequate.

We continually monitor and evaluate the carrying amount of our notes receivable in accordance with ASC Topic 310, *Receivables*. It is possible, however, that the accuracy of our estimation process could be materially impacted as the composition of the receivables changes over time. We continually review and refine our estimation process to make it as reactive to these changes as possible. However, we cannot guarantee that we will be able to accurately estimate credit losses on these balances. It is possible that future events could cause us to make significant adjustments or revisions to these estimates and cause our reported net income to vary significantly from period to period.

*Potential Recognition of Deferred Income* - During 1988, we sold the assets of eight long-term health care centers to National Health Corporation ( National ), our administrative general partner at the time of the sale. The resulting profit of \$15,745,000 was deferred. \$10,000,000 of the deferred gain and related deferred income taxes of \$4,000,000 were recognized as income in December 2007 with the collection of the \$10,000,000 note from National. \$3,745,000 of the deferred gain has been amortized into income on a straight-line basis over the 20-year management contract period. Additional deferred income of \$2,000,000 will be recognized when the Company no longer has an obligation to advance a \$2,000,000 working capital loan which obligation has been extended until January 20, 2018 with the extension of the management agreement with National to that date.

*Guarantees* At September 30, 2010, no agreements to guarantee debt of other parties are outstanding.

*Uncertain Tax Positions* NHC continually evaluates for uncertain tax positions. These uncertain positions may arise where tax laws may allow for alternative interpretations or where the timing of recognition of income is subject to judgment. We believe we have adequate provisions for our uncertain tax positions including related penalties and interest. However, because of uncertainty of interpretation by various tax authorities and the possibility that there are issues that have not been recognized by management, we cannot guarantee we have accurately estimated our tax liabilities.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles, with no need for management's judgment in their application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result. See our December 31, 2009 consolidated financial statements and notes thereto which contain accounting policies and other disclosures required by generally accepted accounting principles.

#### Government Program Financial Changes

Cost containment will continue to be a priority for Federal and State governments for health care services, including the types of services we provide. Government reimbursement programs such as Medicare and Medicaid prescribe, by law, the billing methods and amounts that health care providers may charge and be reimbursed to care for patients covered by these programs. Congress has passed a number of laws that have effected major changes in the Medicare and Medicaid programs. The Balanced Budget Act of 1997 sought to achieve a balanced federal budget by, among other things, reducing federal spending on Medicare and Medicaid to various providers. The Balanced Budget Act of 1997 defined the Medicare Prospective Payment System ("PPS") and this System has subsequently been refined in 1999, 2000, 2005, 2006 and 2010.

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*Recent developments*

In March 2010, President Obama signed into law the Patient Protection and Affordable Care Act ("PPACA") and the Health Care and Education Reconciliation Act of 2010 ("HCERA"), which represents significant changes to the current U.S. health care system (collectively the "Acts"). The Acts affect aging services providers, our partners (employees) and our patients and residents in a multitude of ways. We are evaluating the provisions of the Acts and do not expect material effects on our results of operations, liquidity and cash flows in 2010. We anticipate many of the provisions of the Acts may be subject to further clarification and modification through the rule-making process. It is uncertain at this time the effect the modifications will have on our future results of operations or cash flows.

*Medicare*

On July 16, 2010, CMS issued its final rule regarding PPS rates for skilled nursing facilities for the 2011 fiscal year, which commences on October 1, 2010. This rule provides for an inflationary increase of 2.3% which is reduced by a negative .6 percentage point forecast error adjustment, generating a net market basket increase of 1.7%. The PPS rates had a net market basket decrease of 1.1% in 2009 and a net market basket increase of 3.4% in 2008.

The final CMS ruling also addressed the postponement of the new Resource Utilization Group ( RUG ) IV system and the development of a new Hybrid RUG III system ( HR-III ). The HR-III system will not be ready for implementation on the effective date of October 1, 2010. Consequently, CMS will make payments under the RUG-IV system on an interim basis, beginning with service dates of October 1, 2010 until the HR-III system is implemented. Payments would then be adjusted retroactively from the date of the HR-III implementation to October 1, 2010. RUG-IV will be fully implemented in the next fiscal year beginning October 1, 2011.

CMS has stated the transition from RUG-III to HR-III will be on a budget neutral basis. Based on this assertion, we believe the impact of HR-III will be budget neutral plus a market basket increase of 1.7%. The effect of these rate changes on our revenues is dependent upon our total census and the mix of our patients at the PPS pay rates.

For the first nine months of 2010, our average Medicare per diem rate increased 0.2% compared to the same period in 2009. No assurances can be given as to whether Congress will increase or decrease reimbursement in the future, the timing of any action or the form of relief, if any, that may be enacted.

Effective October 1, 2010, hospice agencies will receive Medicare payments which represent a 1.8% increase. The effect on NHC revenues is dependent upon our number of hospice patents after this effective date.

Effective January 1, 2011, home health agencies will receive Medicare payments which represent a 4.8% decrease. We estimate the effect of the revenue decrease for NHC homecare programs to be approximately \$3,400,000, or \$850,000 per quarter.

### *Medicaid*

Tennessee annual Medicaid rate increases were implemented effective July 1, 2010. Tennessee Medicaid fully funded the ceiling rate increases for all skilled and intermediate providers. We estimate the resulting increase in revenue from this payment source is approximately \$592,000 per quarter.

Due to state budgetary allocations in South Carolina, some South Carolina centers' annual Medicaid rates will decrease effective October 1, 2010. We estimate the resulting decrease in revenue for NHC will be approximately \$10,750 per quarter.

For the first nine months of 2010, our average Medicaid per diem overall increased by 3.5% compared to the same period in 2009. We face challenges with respect to states' Medicaid payments because many states currently do not

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cover the total costs incurred in providing care to those patients. States will continue to control Medicaid expenditures but also look for adequate funding sources, including provider assessments. In February 2006, Congress enacted the Deficit Reduction Act, or DRA, which included several provisions designed to reduce or slow the rate of increase in Medicaid spending. These provisions include, among others, provisions strengthening the Medicaid asset transfer restrictions for persons seeking to qualify for Medicaid long-term care coverage, which could, due to the timing of the penalty period, increase facilities' exposure to uncompensated care. Other provisions could increase state funding for home and community-based services, potentially having an impact on funding for nursing facilities. There is no assurance that the funding for our services will increase or decrease in the future.

Results of Operations

*Three Months Ended September 30, 2010 Compared to Three Months Ended September 30, 2009.*

Results for the three month period ended September 30, 2010 include a 5.9% increase in net revenues and a 9.0% increase in income before taxes compared to the same period in 2009.

Included in the operating results for the three month period ended September 30, 2010 that are not included in the operating results for the same period a year ago are the operations of one skilled nursing facility, one assisted living community, and three homecare programs. If the operations of these newly constructed or acquired facilities are excluded, results for the three month period ended September 30, 2010 include a 3.8% increase in net revenues and a 12.4% increase in income before taxes compared to the same period in 2009.

Net patient revenues increased \$10,798,000 or 7.0% compared to the same period last year. Medicare per diem rates increased 1.3% compared to the quarter a year ago. Medicaid and private pay per diem rates increased 4.6% and 4.2%, respectively, compared to the quarter a year ago. In combination with our Medicare per diem rates increasing, our Medicare patient days increased 5.5%, which increased Medicare revenues 6.8% compared to the quarter a year ago. Homecare operations also increased net patient revenues in the amount of \$1,884,000 compared to the quarter a

year ago.

The total census at owned and leased centers for the quarter averaged 92.1% (92.6% if operations owned less than one year are removed) compared to an average of 92.0% (92.4% if operations owned less than a year are removed) for the same quarter a year ago.

Other revenues decreased \$920,000 or 7.2% in the three-month 2010 period to \$11,920,000 from \$12,840,000 in the 2009 three-month period. The decrease in other revenues is primarily due from a decrease in management and accounting services fees of \$748,000, of which \$306,000 of the decrease was from National facilities.

Non-operating income increased \$1,180,000, or 27.8%, to \$5,424,000 in the three-month 2010 period in comparison to the three-month 2009 period. The increase is primarily due to an increase in interest income related to the increased invested amounts in restricted marketable securities (\$479,000) and dividend income related to marketable securities (\$536,000).

Total costs and expenses for the 2010 third quarter compared to the 2009 third quarter increased \$9,435,000 or 6.1% to \$162,994,000 from \$153,559,000. Salaries, wages and benefits, the largest operating costs of this service company, increased \$6,697,000 or 7.3% to \$98,531,000 from \$91,834,000. Other operating expenses increased \$2,097,000 or 4.4% to \$49,296,000 for the 2010 period compared to \$47,199,000 for the 2009 period. Rent expense increased \$199,000 or 2.5% to \$8,231,000 compared to \$8,032,000 for the 2009 period. Depreciation and amortization increased \$465,000 or 7.3% to \$6,800,000 from \$6,335,000. Interest costs decreased \$23,000 to \$136,000.

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Increases in salaries, wages and benefits are due to the increased staffing from the opening of our new 120-bed skilled care and dementia center in Bluffton, South Carolina and our new 45-unit assisted living community in Mauldin, South Carolina (\$1,060,000), the acquisition and staffing of three new homecare locations in South Carolina (\$1,139,000), increased costs for therapist services (\$1,008,000), an increased provision for workers compensation claims (\$1,190,000), and inflationary increases. The increase in other operating expenses was also due to the opening of the two new facilities and three new homecare locations mentioned above (\$1,496,000). Depreciation expense increased primarily due to the two new facilities being placed into service during the first quarter of 2010.

The income tax provision for the three months ended September 30, 2010 is \$4,611,000 (an effective income tax rate of 23.4%). The income tax provision and effective tax rate for the three months ended September 30, 2010 were unfavorably impacted by adjustments to unrecognized tax benefits resulting in an increase in the provision of \$651,000 or 3.3% of income before taxes. The income tax provision and effective tax rate for 2010 were favorably impacted by statute of limitations expirations resulting in a benefit to the provision of \$3,721,000 composed of \$2,502,000 tax and \$1,219,000 of interest and penalties on permanent differences, or 18.9% of income before taxes in 2010. The income tax provision for the three months ended September 30, 2009 was \$5,727,000 (an effective tax rate of 31.7%). The income tax provision and effective tax rate for the three months ended September 30, 2009 were favorably impacted by statute of limitation expirations and adjustments to unrecognized tax benefits resulting in a benefit to the provision of \$1,553,000 composed of \$941,000 tax and \$612,000 of interest and penalties on permanent differences, or 8.6% of income before taxes in 2009.

*Nine Months Ended September 30, 2010 Compared to Nine Months Ended September 30, 2009.*

Results for the nine-month period ended September 30, 2010 include a 5.1% increase in net revenues and an 8.2% increase in income before taxes compared to the same period in 2009.

Included in the operating results for the nine-month period ended September 30, 2010 that are not included in the operating results of the same period a year ago are the operations of one skilled nursing facility, one assisted living community, and three homecare programs. If the operations of these newly constructed or acquired facilities are excluded, results for the nine month period ended September 30, 2010 include a 3.9% increase in net revenues and a 13.7% increase in income before taxes compared to the same period in 2009.

Net patient revenues increased \$22,691,000 or 4.9% compared to the same period last year. Medicare per diem rates increased 0.2% compared to the nine months a year ago. Medicaid and private pay per diem rates increased 3.5% and 3.8%, respectively, compared to the nine months a year ago. In combination with our Medicare per diem rates increasing, our Medicare patient days increased 5.4%, which increased Medicare revenues 5.5% compared to the nine months a year ago. Homecare operations also increased net patient revenues in the amount of \$4,973,000 compared to the nine months a year ago.

The total census at owned and leased centers for the nine months averaged 92.0% (92.6% if operations owned less than one year are removed) compared to an average of 92.0% (92.3% if operations owned less than one year are removed) for the same period a year ago.

Other revenues increased \$2,523,000 or 7.0% in the nine-month 2010 period to \$38,783,000 from \$36,260,000 in the 2009 nine-month period. The increase in other revenues is primarily due from an increase in management and accounting services fees of \$2,602,000, of which \$1,942,000 of the increase was paid from National.

Non-operating income increased \$2,345,000, or 18.6%, to \$14,958,000 in the nine-month 2010 period in comparison to the nine-month 2009 period. The increase is primarily due to an increase in interest income related to the increased invested amounts in restricted marketable securities (\$1,164,000) and dividend income related to marketable securities (\$875,000).



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Total costs and expenses for the 2010 nine-month period compared to the 2009 nine-month period increased \$23,303,000 or 5.1% to \$483,809,000 from \$460,506,000. Salaries, wages and benefits, the largest operating costs of this service company, increased \$17,852,000 or 6.5% to \$292,287,000 from \$274,435,000. Other operating expenses increased \$4,069,000 or 2.9% to \$146,657,000 for the 2010 period compared to \$142,588,000 for the 2009 period. Rent expense increased \$515,000 or 2.1% to \$24,579,000 compared to \$24,064,000 for the 2009 period. Depreciation and amortization increased \$1,025,000 or 5.4% to \$19,890,000 from \$18,865,000. Interest costs decreased \$158,000 to \$396,000.

Increases in salaries, wages and benefits are due to the increased staffing from the opening of our new 120-bed skilled care and dementia center in Bluffton, South Carolina and our new 45-unit assisted living community in Mauldin, South Carolina (\$2,406,000), the acquisition and staffing of three new homecare locations in South Carolina (\$1,890,000), increased costs for therapist services (\$2,952,000), an increased provision for workers compensation claims (\$3,350,000), and inflationary increases. The increase in other operating expenses was also due to the opening of the two new facilities and three new homecare locations mentioned above (\$3,387,000). Depreciation expense increased primarily due to the two new facilities being placed into service during the nine-month period of 2010.

The income tax provision for the nine months ended September 30, 2010 is \$18,745,000 (an effective tax rate of 33.4%). The income tax provision and effective tax rate for the nine months ended September 30, 2010 were unfavorably impacted by adjustments to unrecognized tax benefits resulting in an increase in the provision of \$786,000 or 1.4% of income before taxes. The income tax provision and effective tax rate for 2010 were favorably impacted by statute of limitations expirations resulting in a benefit to the provision of \$3,721,000 composed of \$2,502,000 tax and \$1,219,000 of interest and penalties on permanent differences, or 6.6% of income before taxes in 2010. The income tax provision for the nine months ended September 30, 2009 was \$18,934,000 (an effective tax rate of 36.5%). The income tax provision and effective tax rate for the nine months ended 2009 were favorably impacted by statute of limitation expirations and adjustments to unrecognized tax benefits resulting in a benefit to the provision of \$1,553,000 composed of \$941,000 tax and \$612,000 of interest and penalties on permanent differences, or 3.0% of income before taxes in 2009.

Liquidity, Capital Resources, and Financial Condition

*Sources and Uses of Funds* - Our primary sources of cash include revenues from the healthcare and senior living facilities we operate, insurance services, management services and accounting services. Our primary uses of cash include salaries, wages and other operating costs of our home office and the facilities we operate, the cost of additions to and acquisitions of real property, rent expenses, and dividend distributions. These sources and uses of cash are reflected in our Consolidated Statements of Cash Flows and are discussed in further detail below. The following is a summary of our sources and uses of cash flows (*dollars in thousands*):

|                                                   | Nine Months Ended    |           | Nine Month Change |            |
|---------------------------------------------------|----------------------|-----------|-------------------|------------|
|                                                   | September 30<br>2010 | 2009      | \$                | %          |
| Cash and cash equivalents at beginning of period  | \$ 39,022            | \$ 49,033 | \$ (10,011)       | (20.4%)    |
| Cash provided from operating activities           | 45,799               | 54,518    | (8,719)           | (16.0%)    |
| Cash (used in) investing activities               | (33,684)             | (29,635)  | (4,049)           | (13.7%)    |
| Cash (used in) provided from financing activities | (22,269)             | 1,203     | (23,472)          | (1,951.1%) |
| Cash and cash equivalents at end of period        | \$ 28,868            | \$ 75,119 | \$ (46,251)       | (61.6%)    |

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*Operating Activities* - Net cash provided by operating activities for the nine months ended September 30, 2010 was \$45,799,000 as compared to \$54,518,000 provided by operating activities in the same period last year. Cash used in operating activities for the current period were from increases in accounts receivable, restricted cash and cash equivalents, equity in earnings of unconsolidated investments, and a decrease in accrued payroll and other noncurrent liabilities. The decreases in operating activities were offset by an increase in amounts due to third party payors and a decrease in income tax receivable. The increase in restricted cash and cash equivalents is from NHC healthcare entities paying insurance premiums into NHC insurance companies, which restrict the cash payment. The increase in accounts receivable is due to the timing of receipts and payments between NHC and our managed healthcare facilities. The decrease in accrued payroll is due to the timing of payroll payments as well as payments of payroll taxes.

*Investing Activities* - Cash used in investing activities totaled \$33,684,000 and \$29,635,000 for the nine months ended September 30, 2010 and 2009, respectively. Cash used for property and equipment additions was \$33,261,000 for the nine months ended September 30, 2010 and \$32,070,000 in the comparable period in 2009. Cash provided by net collections of notes receivable was \$1,026,000 in 2010 compared to \$4,697,000 in 2009. The enhanced cash fund balance was liquidated in December 2009; therefore, there was no activity during the first nine months of 2010. There has been \$48,018,000 funded from our restricted cash and cash equivalents into restricted marketable securities for the nine months ended September 30, 2010. Cash was used in purchasing restricted marketable securities of \$85,484,000 and cash was provided from the sale of marketable securities of \$36,017,000 for the first nine months of 2010.

Costs included in property and equipment additions include \$1,962,000 for the completed 120-bed long-term health care center in Bluffton, South Carolina, \$1,299,000 for the completed 45-unit assisted living community in Mauldin, South Carolina, and \$5,673,000 for the construction-in-progress of a 75-unit assisted living community in Parklane, South Carolina and a 46-unit assisted living addition to our Franklin, Tennessee community. Also included in property and equipment additions and acquisitions for the nine-month period ended September 30, 2010 was goodwill in the amount of \$14,342,000. Goodwill was recorded from the purchase of three homecare locations effective May 1, 2010. The purchases of restricted marketable securities were funded from restricted cash balances to earn a better rate of return.

*Financing Activities* - Net cash used in financing activities totaled \$22,269,000 in the nine months ended September 30, 2010 compared to \$1,203,000 net cash provided by financing activities in the same period in 2009. Cash used for dividend payments to common and preferred stockholders totaled \$17,487,000. In the prior period, cash used for dividend payments to common and preferred stockholders totaled \$16,455,000. In the current period, cash of \$5,944,000 was used to repurchase 182,900 shares of common stock and \$1,012,000 of cash was provided by the

issuance of common stock. Cash of \$14,179,000 was provided by the issuance of common stock in the same period last year. Tax benefits from exercise of stock options provided cash of \$189,000 in 2010 and \$3,602,000 in 2009.

Table of Contractual Cash Obligations

Our contractual cash obligations for periods subsequent to September 30, 2010 are as follows (*in thousands*):

|                                         | Total      | 1 year    | 1-3<br>Years | 3-5<br>Years | After<br>5 Years |
|-----------------------------------------|------------|-----------|--------------|--------------|------------------|
| Long-term debt – principal              | \$ 10,000  | \$ –      | \$ –         | \$ –         | \$ 10,000        |
| Long-term debt – interest               | 2,003      | 276       | 553          | 553          | 621              |
| Obligations to complete<br>construction | 11,549     | 11,549    | –            | –            | –                |
| Operating leases                        | 379,125    | 33,700    | 67,400       | 67,400       | 210,625          |
| Total Contractual Cash Obligations      | \$ 402,677 | \$ 45,525 | \$ 67,953    | \$ 67,953    | \$ 221,246       |

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Other noncurrent liabilities for uncertain tax positions of \$5,463,000, attributable to permanent differences, at September 30, 2010 has not been included in the above table because of the inability to estimate the period in which the tax payment is expected to occur. See Note 11 of the Interim Condensed Consolidated Financial Statements for a discussion on income taxes.

We started paying quarterly dividends in the second quarter of 2004 and anticipate the continuation of dividend payments as approved quarterly by the Board of Directors.

Short-term liquidity

Effective October 26, 2010, we extended the maturity of our \$75,000,000 revolving credit agreement to October 25, 2011. We currently do not have any funds drawn against the credit agreement and the amount of \$75,000,000 is available to be drawn for general corporate purposes, including working capital and acquisitions.

As to short-term liquidity commitments, we have entered into an agreement to complete construction of a 75-unit assisted living community in Parklane, South Carolina and a 46-unit assisted living addition to our Franklin, Tennessee community. At September 30, 2010, we are obligated on construction contracts in the amount of approximately \$11,549,000, all of which is expected to require funding within the next twelve months.

We expect to meet our short-term liquidity requirements primarily from our cash flows from operating activities. In addition to cash flows from operations, our current cash on hand of \$28,868,000 at September 30, 2010, marketable securities of \$83,349,000 at September 30, 2010 and as needed, our borrowing capacity, are expected to be adequate to meet our contractual obligations and to finance our operating requirements and our growth and development plans in the next twelve months.

Long-term liquidity

Our \$75,000,000 revolving credit agreement matures on October 25, 2011. We currently anticipate renewing the credit agreement at that time and while we have had no indication from the lender that there is any question about renewal, there has been no commitment at this time. We entered into this loan originally on October 30, 2007, and have renewed the loan three times with one year maturities. At the inception and at each renewal, the lender offered longer maturities, but the Company chose a one-year maturity because of the terms. If we are not able to refinance our debt as it matures, we will be required to use our cash and marketable securities to meet our debt and contractual obligations and will be limited in our ability to fund future growth opportunities.

Our ability to refinance the credit agreement, to meet our long-term contractual obligations and to finance our operating requirements, and growth and development plans will depend upon our future performance, which will be affected by business, economic, financial and other factors, including potential changes in state and federal government payment rates for healthcare, customer demand, success of our marketing efforts, pressures from competitors, and the state of the economy, including the state of financial and credit markets.

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Guarantees and Contingencies

*Debt Guarantees*

At September 30, 2010, we have no guaranteed debt obligations.

*Governmental Regulations*

Laws and regulations governing the Medicare, Medicaid and other federal healthcare programs are complex and subject to interpretation. Management believes that it is in compliance with all applicable laws and regulations in all material respects. However, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusions from the Medicare, Medicaid and other federal healthcare programs. We are not aware of any material regulatory proceeding or investigation underway or threatened involving allegations of potential wrongdoing.

On July 24, 2009, the Company received a civil investigative demand from the Tennessee Attorney General's Office, requesting production of documents related to NHC's business relationships with non-profit entities. The Company has responded to the demand and will comply as required with the terms of the demand.

*Acquisitions*

We have acquired and will continue to acquire businesses with prior operating histories. Acquired companies may have unknown or contingent liabilities, including liabilities for failure to comply with healthcare laws and regulations, such as billing and reimbursement, anti-kickback and physician self-referral laws. Although we institute policies designed to conform practices to our standards following completion of acquisitions and attempts to structure our

acquisitions as asset acquisitions in which we do not assume liability for seller wrongful actions, there can be no assurance that we will not become liable for past activities that may later be alleged to be improper by private plaintiffs or government agencies. Although we obtain general indemnifications from sellers covering such matters, there can be no assurance that any specific matter will be covered by such indemnifications, or if covered, that such indemnifications will be adequate to cover potential losses and fines.

#### New Accounting Pronouncements

In July 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. This update requires increased disclosures about the credit quality of financing receivables and allowances for credit losses, including disclosure about credit quality indicators, past due information and modifications of finance receivables. The guidance is generally effective for reporting periods ending after December 15, 2010. We are currently assessing the effects of this update and will provide the required disclosure in the 2010 Annual Report.

In February 2010, the FASB issued ASU No. 2010-09, *Amendments to Certain Recognition and Disclosure Requirements*. This update removes the requirement for an SEC filer to disclose the date through which subsequent events have been evaluated and became effective immediately. The adoption of this guidance did not have a material impact on our condensed consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-06, *Improving Disclosures about Fair Value Measurements*. This update requires the disclosure of transfers between the observable input categories and activity in the unobservable input category for fair value measurements. The guidance also requires disclosures about the inputs and valuation techniques used to measure fair value and became effective for our interim and annual reporting periods beginning January 1, 2010. The adoption of this guidance is reflected in Note 7 Fair Value Measurements.



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In September 2009, the FASB issued ASU No. 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* (VIEs). This guidance replaces the quantitative-based risks and rewards calculation for determining which enterprise might have a controlling financial interest in a VIE. The new, more qualitative evaluation focuses on who has the power to direct the significant economic activities of the VIE and also who has the obligation to absorb losses or rights to receive benefits from the VIE. It also requires an ongoing reassessment of whether an enterprise is the primary beneficiary of a VIE and calls for certain expanded disclosures about an enterprise's involvement with variable interest entities. This update was effective for our interim and annual reporting periods beginning January 1, 2010. The adoption did not have a material impact on the Company's consolidated financial statements.

Forward Looking Statements

References throughout this document to the Company include National HealthCare Corporation and its wholly owned subsidiaries. In accordance with the Securities and Exchange Commission's Plain English guidelines, this Quarterly Report on Form 10-Q has been written in the first person. In this document, the words "we", "our", "ours" and "us" refer to National HealthCare Corporation and its wholly owned subsidiaries and not any other person.

This Quarterly Report on Form 10-Q and other information we provide from time to time, contains certain forward looking statements as that term is defined by the Private Securities Litigation Reform Act of 1995. All statements regarding our expected future financial position, results of operations or cash flows, continued performance improvements, ability to service and refinance our debt obligations, ability to finance growth opportunities, ability to control our patient care liability costs, ability to respond to changes in government regulations, ability to execute our three year strategic plan, and similar statements including, without limitations, those containing words such as "believes", "anticipates", "expects", "intends", "estimates", "plans", and other similar expressions are forward looking statements.

Forward looking statements involve known and unknown risks and uncertainties that may cause our actual results in future periods to differ materially from those projected or contemplated in the forward looking statements as a result

of, but not limited to, the following factors:

C

national and local economic conditions, including their effect on the availability and cost of labor, utilities and materials;

C

the effect of government regulations and changes in regulations governing the healthcare industry, including our compliance with such regulations;

C

changes in Medicare and Medicaid payment levels and methodologies and the application of such methodologies by the government and its fiscal intermediaries;

C

liabilities and other claims asserted against us, including patient care liabilities, as well as the resolution of current litigation (see Note 12: Guarantees and Contingencies);

C

the ability of third parties for whom we have guaranteed debt, if any, to refinance certain short term debt obligations;

C

the ability to attract and retain qualified personnel;

C

the availability and terms of capital to fund acquisitions and capital improvements;



NATIONAL HEALTHCARE CORPORATION

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C

the ability to refinance existing debt on favorable terms;

C

the competitive environment in which we operate;

C

the ability to maintain and increase census levels; and

C

demographic changes.

See the notes to the quarterly financial statements, and Item 1. Business as is found in our 2009 Annual Report on Form 10-K for a discussion of various governmental regulations and other operating factors relating to the healthcare industry and the risk factors inherent in them. This may be found on our web site at [www.nhccare.com](http://www.nhccare.com). You should carefully consider these risks before making any investment in the Company. These risks and uncertainties are not the only ones facing us. There may be additional risks that we do not presently know of or that we currently deem immaterial. If any of the risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our shares of stock could decline, and you may lose all or part of your investment. Given these risks and uncertainties, we can give no assurances that these forward looking statements will, in fact, transpire and, therefore, caution investors not to place undue reliance on them.

**Item 3.**

## **Quantitative and Qualitative Disclosures About Market Risk.**

### *Interest Rate Risk*

Our cash and cash equivalents and restricted cash and cash equivalents consist of highly liquid investments with an original maturity of less than three months. As a result of the short term nature of our cash instruments, a hypothetical 10% change in interest rates would have no material impact on our future earnings and cash flows related to these instruments.

Approximately \$19.8 million of our notes receivable bear interest at fixed interest rates. As the interest rates on these notes receivable are fixed, a hypothetical 10% change in interest rates would have no impact on our future earnings and cash flows related to these instruments. Approximately \$6.0 million of our notes receivable bear interest at variable rates (generally at prime plus 2%). Because the interest rates of these instruments are variable, a hypothetical 10% change in interest rates would result in a related increase or decrease in annual interest income of approximately \$32,000.

As of September 30, 2010 all of our long term debt bears interest at variable interest rates. Because the interest rates of these instruments are variable, a hypothetical 10% change in interest rates would result in a related increase or decrease in annual interest expense of approximately \$28,000.

The investments in restricted marketable securities, which consist of fixed-income debt securities, are primarily exposed to interest rate risk and credit risk. Generally, the fair value of fixed-income investments moves inversely with movements in market interest rates. The majority of the fixed-income portfolio is comprised of investments with short-term and intermediate-term maturities, which allows flexibility in reacting to fluctuations of interest rates. The fixed-income portfolio is managed to achieve an adequate risk-adjusted return while maintaining sufficient liquidity to meet current and intermediate obligations.

### *Equity Price Risk*

We consider our investments in marketable securities as available for sale securities and unrealized gains and losses, net of applicable income taxes, are recorded in stockholders' equity in accordance with ASC Topic 320, *Investments Debt and Equity Securities*. The investments in marketable securities, which consist of equity securities, are recorded at their fair market value based on quoted market prices. Thus, there is exposure to equity price risk, which



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is the potential change in fair value due to a change in quoted market price. Hypothetically, a 10% change in quoted market prices would result in a related 10% change in the fair value of our investments in marketable equity securities.

**Item 4. Controls and Procedures.**

As of September 30, 2010, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ( CEO ) and Principal Accounting Officer ( PAO ), of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and PAO, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2010. There have been no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2010 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings.**

For a discussion of prior, current and pending litigation of material significance to NHC, please see Note 12 of this Form 10-Q.

**Item 1A. Risk Factors.**

During the nine months ended September 30, 2010, there were no material changes to the risk factors that were disclosed in Item 1A of National HealthCare Corporation's Annual Report on Form 10-K for the year ended December 31, 2009.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.** Not applicable

**Item 3. Defaults Upon Senior Securities.** None

**Item 5. Other Information.** None

**Item 6. Exhibits.**

(a)

List of exhibits

| <u>Exhibit No.</u> | <u>Description</u> |
|--------------------|--------------------|
|--------------------|--------------------|

|      |                                                                   |
|------|-------------------------------------------------------------------|
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer |
|------|-------------------------------------------------------------------|

|      |                                                                       |
|------|-----------------------------------------------------------------------|
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer |
|------|-----------------------------------------------------------------------|

|    |                                                                                                            |
|----|------------------------------------------------------------------------------------------------------------|
| 32 | Certification pursuant to 18 U.S.C. Section 906 by Chief Executive Officer and Principal Financial Officer |
|----|------------------------------------------------------------------------------------------------------------|





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**SIGNATURES**

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

NATIONAL HEALTHCARE  
CORPORATION

(Registrant)

Date: November 8, 2010

/s/ Robert G. Adams

\_\_\_\_\_  
Robert G. Adams  
Chief Executive Officer

Date: November 8, 2010

/s/ Donald K. Daniel

\_\_\_\_\_  
Donald K. Daniel  
Senior Vice President and Controller

(Principal Financial Officer)