

NATIONAL HEALTHCARE CORP  
Form 10-Q  
November 05, 2009

**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, 2009

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

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

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

13,682,787 shares of common stock of the registrant were outstanding as of November 4, 2009.

**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      |            |
|                                     | 2009               | 2008       | 2009              | 2008       |
| <b>REVENUES:</b>                    |                    |            |                   |            |
| Net patient revenues                | \$ 154,546         | \$ 146,521 | \$ 463,462        | \$ 433,649 |
| Other revenues                      | 17,084             | 16,750     | 48,873            | 50,325     |
| Net revenues                        | 171,630            | 163,271    | 512,335           | 483,974    |
| <b>COSTS AND EXPENSES:</b>          |                    |            |                   |            |
| Salaries, wages and benefits        | 91,834             | 88,036     | 274,435           | 261,889    |
| Other operating                     | 47,199             | 44,755     | 142,588           | 134,708    |
| Rent                                | 8,032              | 7,834      | 24,064            | 23,628     |
| Depreciation                        | 6,335              | 6,218      | 18,865            | 18,239     |
| Interest                            | 159                | 274        | 554               | 663        |
| Total costs and expenses            | 153,559            | 147,117    | 460,506           | 439,127    |
| Income Before Income Taxes          | 18,071             | 16,154     | 51,829            | 44,847     |
| Income Tax Provision                | (5,727)            | (2,381)    | (18,934)          | (13,416)   |
| Net Income                          | 12,344             | 13,773     | 32,895            | 31,431     |
| Dividends to preferred stockholders | 2,169              | 2,169      | 6,505             | 6,505      |

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|   |    |        |    |        |    |        |    |        |
|---|----|--------|----|--------|----|--------|----|--------|
| Net income available to common stockholders | \$ | 10,175 | \$ | 11,604 | \$ | 26,390 | \$ | 24,926 |
|---|----|--------|----|--------|----|--------|----|--------|

Earnings Per Common Share:

|         |    |     |    |     |    |      |    |      |
|---------|----|-----|----|-----|----|------|----|------|
| Basic   | \$ | .74 | \$ | .91 | \$ | 1.95 | \$ | 1.95 |
| Diluted | \$ | .74 | \$ | .88 | \$ | 1.95 | \$ | 1.90 |

Weighted Average Common Shares Outstanding:

|         |            |            |            |            |
|---------|------------|------------|------------|------------|
| Basic   | 13,675,162 | 12,788,968 | 13,522,351 | 12,778,786 |
| Diluted | 13,685,572 | 15,678,702 | 13,540,066 | 13,099,488 |

*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<br>30    | December<br>31 |
|--|--------------------|----------------|
|  | 2009               | 2008           |
|  | <i>(unaudited)</i> |                |
| <b>Assets</b>  |                    |                |
| Current Assets:  |                    |                |
| Cash and cash equivalents  | \$ 75,119          | \$ 49,033      |
| Restricted cash  | 112,192            | 119,407        |
| Marketable securities  | 61,783             | 54,682         |
| Restricted marketable securities   | 1,502              | 1,537          |
| Investment in cash fund in liquidation   | 1,739              | 7,804          |
| Accounts receivable, less allowance for doubtful accounts of \$5,349 and \$5,017, respectively | 64,822             | 70,728         |
| Notes receivable   | 189                | 189            |
| Inventories  | 6,884              | 7,142          |
| Prepaid expenses and other assets  | 1,716              | 1,246          |
| Deferred income taxes  |                    | 984            |
| Total current assets   | 325,946            | 312,752        |
| Property and Equipment:  |                    |                |
| Property and equipment, at cost  | 600,986            | 571,960        |
| Accumulated depreciation and amortization  | (177,753)          | (158,478)      |
| Net property and equipment   | 423,233            | 413,482        |
| Other Assets:  |                    |                |

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|   |            |            |
|---|------------|------------|
| Deposits  | 186        | 529        |
| Goodwill  | 5,978      | 3,033      |
| Notes receivable  | 26,937     | 20,389     |
| Notes receivable from<br>National                       |            | 2,918      |
| Deferred income taxes                                   | 15,898     | 13,672     |
| Investments in limited<br>liability companies and other | 11,893     | 10,521     |
| Total other assets                                      | 60,892     | 51,062     |
| Total assets  | \$ 810,071 | \$ 777,296 |

*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, 2008 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       | December 31 |
|--|--------------------|-------------|
|  | 2009               | 2008        |
|  | <i>(unaudited)</i> |             |
| <b>Liabilities and Stockholders Equity</b>   |                    |             |
| Current Liabilities:   |                    |             |
| Current portion of long-term debt  | \$ 50,500          | \$ 50,502   |
| Trade accounts payable   | 11,781             | 13,809      |
| Accrued payroll  | 34,723             | 48,480      |
| Amounts due to third party payors  | 17,659             | 15,594      |
| Accrued risk reserves  | 107,821            | 106,000     |
| Deferred income taxes  | 1,031              |             |
| Other current liabilities  | 14,224             | 12,139      |
| Dividends payable  | 5,726              | 5,291       |
| Accrued interest   | 99                 | 104         |
| Total current liabilities  | 243,564            | 251,919     |
| Long-Term Debt, less Current Portion   | 10,000             | 10,000      |
| Other Noncurrent Liabilities   | 19,458             | 15,807      |
| Deferred Lease Credits   | 2,726              | 3,635       |
| Deferred Revenue   | 16,383             | 15,118      |
| Commitments, Contingencies and Guarantees  |                    |             |
| Stockholders Equity:   |                    |             |
| Series A Convertible Preferred Stock;<br>\$.01 par value; 25,000,000 shares<br>authorized; 10,841,062 shares, issued<br>and outstanding; stated at liquidation of<br>\$15.75 per share | 170,555            | 170,555     |
| Common stock, \$.01 par value;<br>30,000,000 shares authorized; 13,682,787<br>and 13,031,696 shares, respectively,   | 137                | 130         |

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|   |            |         |
|---|------------|---------|
| issued and outstanding                                  |            |         |
| Capital in excess of par value                          | 130,453    | 113,580 |
| Retained earnings                                       | 195,715    | 179,710 |
| Unrealized gains on marketable securities, net of taxes | 21,080     | 16,842  |
| Total stockholders equity                               | 517,940    | 480,817 |
| Total liabilities and stockholders equity \$            | 810,071 \$ | 777,296 |

*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 Cash Flows

*(Unaudited)*

|   | Nine Months Ended     |           |
|---|-----------------------|-----------|
|   | September 30          |           |
|   | 2009                  | 2008      |
|   | <i>(in thousands)</i> |           |
| <b>Cash Flows From Operating Activities:</b>                                      |                       |           |
| Net income  | \$ 32,895             | \$ 31,431 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                       |           |
| Depreciation  | 18,865                | 18,239    |
| Provision for doubtful accounts receivable  | 332                   | 1,616     |
| Amortization of deferred income   | (3)                   | (243)     |
| Equity in earnings of unconsolidated investments                                  | (6,593)               | (5,415)   |
| Deferred income taxes   | (5,056)               | (692)     |
| Stock-based compensation  | 1,116                 | 1,822     |
| Changes in operating assets and liabilities:                                      |                       |           |
| Restricted cash   | 7,215                 | (13,927)  |
| Accounts (and other) receivables  | 5,574                 | 5,994     |
| Inventories   | 258                   | 116       |
| Prepaid expenses and other assets   | (470)                 | 136       |
| Trade accounts payable  | (2,028)               | (1,260)   |
| Accrued payroll   | (13,757)              | (1,537)   |
| Amounts due to third party payors   | 2,065                 | 1,093     |
| Accrued interest  | (5)                   | 468       |
| Other current liabilities and accrued risk reserves                               | 3,906                 | 10,556    |
| Entrance fee deposits   | (400)                 | (139)     |
| Other noncurrent liabilities  | 3,651                 | (2,387)   |
| Deferred income   | 1,668                 | 1,032     |
| Net cash provided by operating activities   | 49,233                | 46,903    |
| <b>Cash Flows From Investing Activities:</b>                                      |                       |           |
| Additions to and acquisitions of property and equipment                           | (32,070)              | (34,367)  |
| Decrease in deposits reserved for land acquisition                                |                       | 941       |

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|   |                  |                  |
|---|------------------|------------------|
| Investments in notes receivable                       | (8,327)          | (2,746)          |
| Collections of notes receivable                       | 4,697            | 4,674            |
| Purchase of marketable securities, net                |                  | (152)            |
| Changes in cash fund in liquidation                   | 6,065            | 22,830           |
| Distributions from unconsolidated investments         | 5,285            | 4,354            |
| Net cash provided by (used in) investing activities   | (24,350)         | (4,466)          |
| <b>Cash Flows From Financing Activities:</b>          |                  |                  |
| Proceeds from debt                                    |                  | 20,500           |
| Payments on debt                                      | (2)              | (7,433)          |
| Tax benefit from exercise of stock options            | 3,602            | 1,439            |
| Dividends paid to preferred shareholders              | (6,505)          | (6,168)          |
| Dividends paid to common shareholders                 | (9,950)          | (8,424)          |
| Issuance of common shares                             | 14,179           | 5,180            |
| Decrease (increase) in deposits                       | 343              | (113)            |
| Other   | (464)            | (40)             |
| Net cash provided by financing activities             | 1,203            | 4,941            |
| <b>Net Increase in Cash and Cash Equivalents</b>      | <b>26,086</b>    | <b>47,378</b>    |
| <b>Cash and Cash Equivalents, Beginning of Period</b> | <b>49,033</b>    | <b>2,379</b>     |
| <b>Cash and Cash Equivalents, End of Period</b>       | <b>\$ 75,119</b> | <b>\$ 49,757</b> |

**NATIONAL HEALTHCARE CORPORATION**

**Interim Condensed Consolidated Statements of Cash Flows**

*(continued)*

Nine Months  
 Ended  
 September 30  
 2009      2008

*(in thousands)*

**Supplemental Information:**

Effective January 7, 2008, cash proceeds that were being held by a facilitator pending the completion of an IRC §1031 exchange were disbursed to acquire property and equipment

|  |    |             |
|--|----|-------------|
| Acquisitions of property and equipment | \$ | \$ (11,420) |
| Deposits reserved for land acquisition |    | 11,420      |

*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 in                | Retained   | Unrealized                           | Total                  |
|--|-----------------|------------|--------------|--------|---------------------------|------------|--------------------------------------|------------------------|
|  | Shares          | Amount     | Shares       | Amount | Excess of<br>Par<br>Value | Earnings   | Gains on<br>Marketable<br>Securities | Shareholders<br>Equity |
| Balance at<br>December 31,<br>2007                                 | 10,841,062      | \$ 170,555 | 12,757,907   | \$ 127 | \$ 103,221                | \$ 164,003 | \$ 17,802                            | \$ 455,708             |
| Net<br>income  |                 |            |              |        |                           | 31,431     |                                      | 31,431                 |
| Unrealized<br>gains on<br>securities<br>(net of tax<br>of \$4,901) |                 |            |              |        |                           |            | 7,353                                | 7,353                  |
| Total<br>comprehensive<br>income                                   |                 |            |              |        |                           |            |                                      | 38,784                 |
| Stock-based<br>compensation  |                 |            |              |        | 1,822                     |            |                                      | 1,822                  |
| Tax<br>benefit<br>from<br>exercise of<br>stock<br>options          |                 |            |              |        | 1,439                     |            |                                      | 1,439                  |
| Shares<br>sold -<br>options<br>exercised                           |                 |            | 237,918      |        | 5,178                     |            |                                      | 5,180                  |
| Dividends<br>declared<br>to<br>preferred<br>stockholders           |                 |            |              |        |                           | (6,505)    |                                      | (6,505)                |

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|   |            |            |            |        |            |            |           |       |          |
|---|------------|------------|------------|--------|------------|------------|-----------|-------|----------|
| (\$0.60 per share)  |            |            |            |        |            |            |           |       |          |
| Dividends declared to common stockholders (\$0.69 per share)    |            |            |            |        |            |            | (8,868)   |       | (8,868)  |
| Balance at September 30, 2008                                   | 10,841,062 | \$ 170,555 | 12,995,825 | \$ 129 | \$ 111,660 | \$ 180,061 | \$ 25,155 | \$    | 487,560  |
| Balance at December 31, 2008                                    | 10,841,062 | \$ 170,555 | 13,031,696 | \$ 130 | \$ 113,580 | \$ 179,710 | \$ 16,842 | \$    | 480,817  |
| Net income  |            |            |            |        |            |            | 32,895    |       | 32,895   |
| Unrealized gains on securities (net of tax of \$2,828)          |            |            |            |        |            |            |           | 4,238 | 4,238    |
| Total comprehensive income                                      |            |            |            |        |            |            |           |       | 37,133   |
| Stock-based compensation  |            |            |            |        |            | 1,116      |           |       | 1,116    |
| Tax benefit from exercise of stock options                      |            |            |            |        |            | 1,585      |           |       | 1,585    |
| Shares sold options exercised                                   |            |            | 651,091    | 7      | 14,172     |            |           |       | 14,179   |
| Dividends declared to preferred stockholders (\$0.60 per share) |            |            |            |        |            |            | (6,505)   |       | (6,505)  |
| Dividends declared to   |            |            |            |        |            |            | (10,385)  |       | (10,385) |

common  
stockholders  
(\$0.76 per  
share)

Balance at  
September

30, 2009      10,841,062 \$ 170,555    13,682,787 \$      137 \$    130,453 \$ 195,715 \$      21,080 \$      517,940

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



NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

**Note 1 Consolidated Financial Statements**

The unaudited financial statements to which these notes are attached include, in our opinion, all normal, recurring adjustments which are necessary to fairly present the financial position, results of operations and cash flows of National HealthCare Corporation (ANHC@ or the ACompany@). We assume that users of these interim financial statements have read or have access to the audited December 31, 2008 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, 2008 consolidated financial statements are available at our web site: [www.nhccare.com](http://www.nhccare.com).

**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 non-health care related earnings.

Other revenues include the following:

| Three Months<br>Ended | Nine Months<br>Ended |
|-----------------------|----------------------|
|-----------------------|----------------------|

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|  | September 30          |           | September 30 |           |
|--|-----------------------|-----------|--------------|-----------|
|  | 2009                  | 2008      | 2009         | 2008      |
|  | <i>(in thousands)</i> |           |              |           |
| Insurance services                               | \$ 4,329              | \$ 4,539  | \$ 12,941    | \$ 12,771 |
| Management and accounting services fees          | 5,054                 | 4,354     | 12,686       | 13,535    |
| Dividends and other realized gains on securities | 1,062                 | 1,062     | 3,185        | 3,311     |
| Equity in earnings of unconsolidated investments | 2,251                 | 1,922     | 6,593        | 5,415     |
| Interest income                                  | 930                   | 1,301     | 2,953        | 3,942     |
| Rental income                                    | 3,161                 | 3,169     | 9,464        | 10,094    |
| Other  | 297                   | 403       | 1,051        | 1,257     |
|  | \$ 17,084             | \$ 16,750 | \$ 48,873    | \$ 50,325 |

Certain of our affiliates manage five long-term care centers owned by National Health Corporation ( National ). During the nine months ended September 30, 2009 and 2008, we recognized management fees and interest on management fees of \$1,200,000 and \$-0-, respectively.

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 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

NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

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, 2009 and 2008, we recognized \$2,248,000 and \$2,219,000, 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 2009 and 2008. 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 providers. 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 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 4 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* (previously FIN 48, *Accounting for Uncertainty of Income Taxes* an interpretation of SFAS No. 109 ). Our liabilities for unrecognized tax benefits are presented in the consolidated balance sheets within Other Noncurrent Liabilities.

At September 30, 2009, we had \$13,755,000 of unrecognized tax benefits, composed of \$10,330,000 of deferred tax assets, \$-0- of deferred tax liabilities, and \$3,425,000 of permanent differences. Accrued interest and penalties of \$5,703,000 relate to unrecognized tax benefits at September 30, 2009. Unrecognized tax benefits of \$3,425,000, net of federal benefit, at September 30, 2009, attributable to permanent differences, would favorably impact our effective tax rate if recognized. Accrued interest and penalties of \$1,996,000 relate to these permanent differences at September 30, 2009. We do not expect to recognize significant increases or decreases in unrecognized tax benefits within twelve months of September 30, 2009, except for the effect of decreases related to the lapse of statute of limitations estimated at \$1,704,000, composed of temporary differences of \$-0-, and permanent tax differences of \$1,704,000. Interest and penalties of \$941,000 relate to these permanent difference changes within 12 months of September 30, 2009.

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

## NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

The Company is no longer subject to U.S. federal and state examinations by tax authorities for years before 2006 (except for certain state exceptions). Currently, there are no U.S. federal or state returns under examination.

**Note 5 Earnings per Share**

Effective January 1, 2009, 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.

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 |            | Nine Months Ended |            |
|---|--------------------|------------|-------------------|------------|
|   | September 30       |            | September 30      |            |
|   | 2009               | 2008       | 2009              | 2008       |
| <b>Basic:</b>   |                    |            |                   |            |
| Weighted average common shares outstanding                    | 13,675,162         | 12,788,968 | 13,522,351        | 12,778,786 |
| Net income  | \$ 12,344          | \$ 13,773  | \$ 32,895         | \$ 31,431  |
| Dividends to preferred stockholders                           | 2,169              | 2,169      | 6,505             | 6,505      |
| Net income available to common stockholders                   | 10,175             | 11,604     | 26,390            | 24,926     |
| Earnings per common share, basic                              | \$ .74             | \$ .91     | \$ 1.95           | \$ 1.95    |
| <b>Diluted:</b>   |                    |            |                   |            |
| Weighted average common shares outstanding                    | 13,675,162         | 12,788,968 | 13,522,351        | 12,778,786 |
| Dilutive effect of stock options                              | 10,410             | 265,763    | 17,715            | 320,702    |
| Convertible preferred stock                                   |                    | 2,623,971  |                   |            |

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|  |            |            |            |            |
|--|------------|------------|------------|------------|
| Assumed average common shares outstanding  | 13,685,572 | 15,678,702 | 13,540,066 | 13,099,488 |
| Net income available to common stockholders  | \$ 10,175  | \$ 11,604  | \$ 26,390  | \$ 24,926  |
| Add dilutive preferred stock dividends for effect of assumed conversion of preferred stock |            | 2,169      |            |            |
| Net income for diluted earnings per common share   | \$ 10,175  | \$ 13,773  | \$ 26,390  | \$ 24,926  |
| Earnings per common share, diluted   | \$ .74     | \$ .88     | \$ 1.95    | \$ 1.90    |

In the above table, 269,245 shares and 238,590 equivalent shares of stock options have been excluded for 2009 and 2008, respectively and 2,623,971 of preferred stock potential common shares issuable upon the conversion of the preferred stock have been excluded for 2009 and 2008, due to their anti-dilutive impact.

**Note 6 Acquisition of South Carolina Hospice Business**

Effective January 1, 2009, we purchased for \$3,100,000 in cash certain assets and assumed certain liabilities of five hospice locations in the state of South Carolina. We accounted for the acquisition in accordance with ASC Topic 805, *Business Combinations* (previously SFAS No. 141(R), *Business Combinations* ), in which the purchase price was 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 \$2,900,000 as goodwill, all of which is expected to be fully deductible for income tax purposes. The results of the five hospice locations have been included in the consolidated financial statements since January 1, 2009, the acquisition date. The unaudited pro forma results are not disclosed due to the results being immaterial to the consolidated financial statements.

## NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

**Note 7 - Long-Term Debt and Commitments***Long-Term Debt*

Long-term debt consists of the following:

|  | Weighted<br>Average<br>Interest<br>Rate | Maturities | Long-Term Debt   |                  |
|--|---|------------|------------------|------------------|
|  |   |            | 9/30/09          | 12/31/08         |
| <i>(dollars in thousands)</i>  |   |            |                  |                  |
| Revolving Credit Facility interest payable monthly   | Variable,<br>0.6%                       | 2009       | \$ 50,500        | \$ 50,500        |
| Notes and other obligations, principal and interest payable periodically                           | Variable,<br>5.43%                      | 2009       |                  | 2                |
| Unsecured term note payable to National, interest payable quarterly, principal payable at maturity | Variable,<br>2.8%                       | 2018       | 10,000<br>60,500 | 10,000<br>60,502 |
| Less current portion   |   |            | (50,500)         | (50,502)         |
|  |   |            | \$ 10,000        | \$ 10,000        |

**Note 8 - \$75,000,000 Revolving Credit Facility**

Effective October 27, 2009, 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. Prior to the extension, the borrowing bore interest at either (i) the Eurodollar rate plus 0.375% or (ii) the prime rate.

Beginning October 27, 2009, commitment fees are payable on the daily unused portion of the Credit Facility at a rate of twenty (20) basis points per annum.

The Credit Facility matures on October 26, 2010. 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 is permitted to prepay the loans outstanding under the Credit Facility at any time, without penalty.

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.



NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

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 9 Stock Option Plans**

Our shareholders approved the 2005 Stock Option, Employee Stock Purchase, Physician Stock Purchase and Stock Appreciation Rights Plan (the APlan@) which provides for the grant of stock options to key employees, directors and non employee consultants. Under the Plan, the Compensation Committee of the Board of Directors (Athe Committee@) has the authority to select the participants to be granted options; to designate whether the option granted is an incentive stock option (AISO@), 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.

Under the Plan, options issued to non employee directors are granted automatically on the date of our annual shareholder meeting, vest immediately upon grant and have a maximum five year term. Options granted to employees in 2000 vested over a six year period and had a maximum six year term. Options granted to employees in 2004 vested over a five year period and had a maximum five year term. Options granted to employees in 2007 vested over a 2.1 year period and had a maximum 2.1 year term.

The Company is required to estimate the fair value of share-based awards on the date of grant. The fair value of each option award is estimated using the Black-Scholes option valuation model with the weighted average assumptions indicated in the following table. Generally, awards are subject to cliff vesting. Each grant is valued as a single award with an expected term based upon expected employment and termination behavior. Compensation cost is recognized as Salaries, wages and benefits in the Consolidated Statements of Income over the requisite service period in a manner consistent with the option vesting provisions. The straight-line attribution method requires that compensation expense is recognized at least equal to the portion of the grant-date fair value that is vested at that date. The expected volatility is derived using weekly historical data for periods immediately preceding the date of grant. The risk-free interest rate is the approximate yield on the United States Treasury Strips having a life equal to the expected option life on the date of grant. The expected life is an estimate of the number of years an option will be held before it is exercised. The following table summarizes the assumptions used to value the options granted in the periods shown.

|                          | Nine Months Ended |           |
|--------------------------|-------------------|-----------|
|                          | September 30      |           |
|                          | 2009              | 2008      |
| Risk-free interest rate  | 0.96%             | 2.60%     |
| Expected volatility      | 29.19%            | 25.5%     |
| Expected life, in years  | 2.0 years         | 2.0 years |
| Expected dividend yield  | 2.98%             | 2.36%     |
| Expected forfeiture rate | 0.00%             | 0.00%     |

## NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

The following table summarizes option activity:

|   | Number of<br>Shares | Weighted<br>Average<br>Exercise Price | Aggregate<br>Intrinsic<br>Value |
|---|---------------------|---------------------------------------|---------------------------------|
| Options outstanding at December 31, 2007  | 1,166,650           | \$ 27.06                              | —                               |
| Options granted                           | 112,586             | 51.86                                 | —                               |
| Options exercised                         | (273,589)           | 24.34                                 | —                               |
| Options forfeited                         | (3,451)             | 50.94                                 | —                               |
| Options cancelled                         | (10,000)            | 20.90                                 | —                               |
| Options outstanding at December 31, 2008  | 992,196             | 30.55                                 | —                               |
| Options granted                           | 108,625             | 39.91                                 | —                               |
| Options exercised                         | (650,891)           | 21.78                                 | —                               |
| Options forfeited                         | (35,000)            | 55.00                                 | —                               |
| Options outstanding at September 30, 2009 | 414,930             | 44.71                                 | \$ (2,734,000)                  |
| Options exercisable at September 30, 2009 | 396,305             | \$ 44.43                              | \$ (2,501,000)                  |

| Options        |                 | Weighted Average |                       |
|----------------|-----------------|------------------|-----------------------|
| Outstanding    |                 | Weighted Average | Remaining Contractual |
| Sept. 30, 2009 | Exercise Prices | Exercise Price   | Life in Years         |
| 220,685        | \$32.01-\$44.25 | \$38.41          | 2.5                   |
| 194,245        | \$50.60-\$52.50 | \$51.85          | 2.8                   |

414,930

At September 30, 2009, 396,305 options outstanding are exercisable. Exercise prices on the options range from \$32.01 to \$52.50. The weighted average remaining contractual life of options outstanding at September 30, 2009 is 2.6 years. The weighted average fair value of options granted during the nine months ended September 30, 2009 and 2008 were \$6.67 (\$835,000 in total) and \$7.36 (\$829,000 in total) per share, respectively. The total intrinsic value of shares exercised during the nine months ended September 30, 2009 and 2008 was \$10,641,000 and \$6,249,000, respectively.

Additionally, the Plan allows employees to purchase our shares of stock through payroll deductions. Employees may terminate participation at any time.

Our policy is to issue new shares to satisfy share option exercises. In addition to the stock options issued and outstanding under the Plan, we have reserved an additional 811,652 shares of common stock for issuance under the Plan.

NHC recognized \$1,116,000 and \$1,822,000 of share-based compensation expense for the nine month periods ended September 30, 2009 and 2008, respectively. Current accounting guidance requires the benefits of tax deductions in excess of amounts recognized as compensation cost be reported as a financing cash flow, rather than an operating cash flow, as required under prior accounting guidance. Tax deductions in excess of amounts recognized as compensation costs totaled \$9,006,000 and \$3,597,000 for the nine months ended September 30, 2009 and 2008, respectively. No share based compensation cost was capitalized during the current periods. The total compensation cost related to non-vested awards not yet recognized at September 30, 2009 is \$29,000 and the weighted average period over which it is to be recognized is .25 years.

NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

**Note 10 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 \$107,821,000 and \$106,000,000 at September 30, 2009 and December 31, 2008, 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 would 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. It is possible that claims against us could exceed our coverage limits and our reserves, which would have a material adverse effect on our financial position, results of operations and cash flows.

*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, 2009 and 2008, respectively, are \$4,037,000 and \$4,992,000. 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, 2009, we and/or our managed centers are currently defendants in 34 such claims covering the years 1999 through September 30, 2009.

When bids were solicited for third party professional liability insurance coverage for 2002, only two companies would quote coverage. Both quotations were so onerous and expensive that we elected to pay the premiums into a wholly-owned licensed captive insurance company, incorporated in the Cayman Islands, for the purpose of managing the Company's losses related to these risks. Thus, for years 2002-2009, 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. Policies are written for a duration of twelve months.

Our coverages for all years include both primary policies and excess policies. Commencing with 2002, deductibles were eliminated with first dollar coverage being provided through the wholly-owned insurance company.

NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

For the period 2003-2009, both primary and excess professional liability insurance coverage is provided through our wholly-owned liability insurance company. Primary coverage is in the amount of \$1 million per incident, \$3 million per location subject to an annual primary aggregate limit. That limit was \$16 million for 2008 and \$17 million for 2009. Excess coverage under a \$7.5 million annual excess aggregate policy is applicable to years 2003-2007. The 2008 and 2009 years are subject to annual excess aggregate policies in the total amount of \$9 million.

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, 2009 and 2008, respectively, are \$3,485,000 and \$3,013,000. 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 is in the process of responding to the demand and will comply as required with the terms of the demand.

**Note 11 - Fair Value Measurements**

The carrying amounts of cash and cash equivalents, accounts receivable, notes receivable, and accounts payable approximate fair value due to their short-term nature. Our long-term debt approximates fair value due to variable interest rates and the short term maturity of the Revolving Credit Facility. At September 30, 2009 and 2008, there were no material differences between the carrying amounts and fair values of NHC's financial instruments.

Effective January 1, 2009, we fully adopted ASC Topic 820, *Fair Value Measurements and Disclosures* (previously SFAS No. 157, *Fair Value Measurements* ), as it relates to both financial and nonfinancial assets and liabilities. Prior to January 1, 2009, the standard applied only to our financial assets and financial liabilities. ASC Topic 820 defines fair value, establishes a consistent framework for measuring fair value, and expands disclosures for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. The standard clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. Valuation techniques are the market, cost or income approach. The adoption did not have an impact on our financial position, results of operations or cash flows.

As a basis for considering such assumptions, fair value guidance establishes a three-tier fair value hierarchy which prioritizes the inputs used in measuring fair value as follows: Level 1 – quoted prices for identical assets or liabilities in active markets, Level 2 – quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active and model-based valuations in which significant inputs are corroborated by observable market data and Level 3 – valuation techniques in which significant inputs are unobservable.



## NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

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

|   | Fair<br>Value At<br>Sept. 30,<br>2009 | Quoted Prices in<br>Active Markets<br>For Identical<br>Assets (Level 1) | Significant Other<br>Observable Inputs (Level<br>2) | Significant<br>Unobservable Inputs<br>(Level 3) |
|---|---------------------------------------|---|---|---|
| Marketable securities                     | \$ 61,783                             | \$ 61,783   | \$  | \$  |
| Restricted marketable<br>securities       | 1,502                                 | 1,502   |   |   |
| Investment in cash<br>fund in liquidation | 1,739                                 |   |   | 1,739   |

*Marketable securities and restricted marketable securities*

The fair value of our investments in marketable securities and restricted marketable securities is derived using quoted market prices of identical securities or other observable inputs such as trading prices of identical securities in active markets.

Marketable securities consist of the following:

|                       | September 30, 2009 |      | December 31, 2008 |      |
|-----------------------|--------------------|------|-------------------|------|
| <i>(in thousands)</i> | Amortized          | Fair | Amortized         | Fair |

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|                              | Cost      | Value     | Cost      | Value     |
|------------------------------|-----------|-----------|-----------|-----------|
| Available for sale:          |           |           |           |           |
| Marketable equity securities | \$ 29,604 | \$ 61,783 | \$ 29,604 | \$ 54,682 |
| U.S. government securities   | 1,475     | 1,502     | 1,474     | 1,537     |
|                              | \$ 31,079 | \$ 63,285 | \$ 31,078 | \$ 56,219 |

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

*(in thousands, except share amounts)*

|                  | September 30, 2009 |           |           | December 31, 2008 |           |           |
|------------------|--------------------|-----------|-----------|-------------------|-----------|-----------|
|                  |                    | Fair      |           |                   | Fair      |           |
|                  | Shares             | Cost      | Value     | Shares            | Cost      | Value     |
| NHI Common Stock | 1,630,642          | \$ 24,734 | \$ 51,610 | 1,630,642         | \$ 24,734 | \$ 44,729 |

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

|                       | September 30, 2009 |            | December 31, 2008 |            |
|-----------------------|--------------------|------------|-------------------|------------|
|                       | Cost               | Fair Value | Cost              | Fair Value |
| <i>(in thousands)</i> |                    |            |                   |            |
| Maturities:           |                    |            |                   |            |
| Within 1 year         | \$ 1,475           | \$ 1,502   | \$ -              | \$ -       |
| 1 to 5 years          | -                  | -          | 1,474             | 1,537      |
|                       | \$ 1,475           | \$ 1,502   | \$ 1,474          | \$ 1,537   |

NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

Gross unrealized gains related to available for sale securities are \$32,206,000 and \$25,141,000 as of September 30, 2009 and December 31, 2008, respectively. There were no gross unrealized losses related to available for sale securities as of September 30, 2009 and December 31, 2008, respectively.

Proceeds from the sale of investments in marketable securities during the nine months ended September 30, 2009 and 2008 were \$-0- and \$225,000, respectively. No gross investment gains or losses were realized on these sales for the nine months ended September 30, 2008.

*Investment in Cash Fund in Liquidation*

At September 30, 2009, we reported in current assets in our consolidated balance sheets an investment of \$1,739,000 (\$7,804,000 at December 31, 2008) in the Columbia Strategic Cash Portfolio Fund (the Fund). The Fund invests in obligations denominated in U.S. dollars consisting of asset-backed and mortgage-backed securities, structured investment vehicles, corporate bonds and notes, certificates of deposit, short-term corporate debt obligations, commercial paper, extendible commercial notes and municipal bonds. A portion of the securities in the Fund have their fair values determined through readily available market data; however, some of the securities in the Fund have limited market activity such that the determination of fair value requires significant judgment or estimation. Given current market conditions, as these securities are not actively traded, certain significant inputs (e.g. spreads, yield curves, prepayments and volatilities) are unobservable. These securities are valued primarily using broker pricing models that incorporate transaction details such as contractual terms, maturity, timing and amount of future cash inflows, as well as assumptions about liquidity. As a result, the Company has categorized its investment in the Fund as Level 3 within the fair value hierarchy at September 30, 2009.

The following table presents a reconciliation of Level 3 assets measured at fair value on a recurring basis at September 30, 2009. Considering the continuing deterioration in market conditions during the fourth quarter of 2008 and the lack of current observable market activity, our investment in the Fund was transferred from Level 2 to Level 3 as of October 1, 2008.

|  | Fair Value Measurements Using<br>Significant Unobservable Inputs<br>(Level 3) |      |                      |      |
|--|---|------|----------------------|------|
|  | Three Months<br>Ended   |      | Nine Months<br>Ended |      |
|  | September 30  |      | September 30         |      |
| <i>(in thousands)</i>                        | 2009  | 2008 | 2009                 | 2008 |
| Balance at beginning of the period           | \$ 5,111  | \$   | \$ 7,804             | \$   |
| Total gains or losses (realized/unrealized): |   |      |                      |      |
| Included in earnings                         | 57  |      | 355                  |      |
| Included in other comprehensive income       |   |      |                      |      |
| Purchases, issuances and settlements         | (3,429)   |      | (6,420)              |      |
| Transfers in/out or out of Level 3           |   |      |                      |      |
| Balance at end of the period                 | \$ 1,739  | \$   | \$ 1,739             | \$   |

The Company has adopted an accounting policy for Level 3 fair value measurements that provides for transfer of the asset or liability into/out of Level 3 as of the beginning of the quarter in which the change is determined.

## NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

As to our total investment in the Fund, gains and losses (realized and unrealized) included in earnings for the periods ended above are reported in interest income as follows:

|  | Three Months Ended   |          | Nine Months Ended    |          |
|--|----------------------|----------|----------------------|----------|
|  | September 30<br>2009 | 2008     | September 30<br>2009 | 2008     |
| <i>(in thousands)</i>  |                      |          |                      |          |
| Total realized gains or losses   | \$ 57                | \$ (202) | \$ 355               | \$ (363) |
| Change in unrealized gains or losses relating to assets still held at reporting date | \$                   | \$ (12)  | \$                   | \$ (272) |

*Historical Information Related to the Investment in Cash Fund in Liquidation* - We received notice on December 6, 2007, at a time when our carrying value in the Fund was \$39,500,000, that the Fund cash redemptions were suspended and that the Fund would begin an orderly liquidation and dissolution of its assets for distribution to the Fund holders, including to NHC. Activity in the Fund for the periods indicated is summarized as follows:

| <i>(in thousands)</i>  | 25 Days Ended<br>December 31, 2007 | Year Ended<br>December 31, 2008 | Nine Months Ended<br>Sept. 30, 2009 |
|--|------------------------------------|---------------------------------|-------------------------------------|
| Fund balance, beginning of period  | \$ 39,500                          | \$ 35,492                       | \$ 7,804                            |
| Realized gains (losses)  | (42)                               | (817)                           | 355                                 |
| Reduction to adjust the Fund balance to its net asset value, charged to earnings | (453)                              | (1,343)                         |                                     |
| Cash distributed to NHC  | (3,513)                            | (25,528)                        | (6,420)                             |
| Fund balance, end of period  | \$ 35,492                          | \$ 7,804                        | \$ 1,739                            |
| Interest earned, in addition to the cash distributed above                       | \$ 156                             | \$ 654                          | \$ 32                               |

The Fund's valuation fluctuates based on changes in the market value of the securities held by the Fund. In addition to the transaction gains or losses reported by the Fund to us, since December, 2007, we have adjusted our carrying value to the Fund's net asset value, which adjustments have required us to charge earnings and reduce our carrying value in the Fund. Because the Fund is invested in financial instruments with exposure to the current turmoil in the credit markets in the United States and because the Fund currently intends to substantially liquidate the investments in the Fund within the next twelve months, we consider the write-down amount to be an other-than-temporary impairment. It is difficult to predict the timing or magnitude of these other-than-temporary impairments and additional impairments may occur. Under such circumstances, our earnings will be negatively affected.

As to balance sheet classification, prior to December 6, 2007, we classified the investment as a cash equivalent in the consolidated balance sheets because the funds were immediately available for distribution. Since the suspension by the Fund manager of Fund redemptions, we no longer consider the investment in the Fund to be a cash equivalent and classify it instead as Investments in Cash Fund in Liquidation. We have classified the Fund as a current asset because we believe that the Fund will be substantially liquidated during the next twelve months.

#### **Note 12 New Accounting Pronouncements**

In June 2009, the FASB issued ASC Topic 810, *Consolidation-Overall* (previously SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*). This updated guidance requires an analysis to determine whether a variable interest gives the entity a controlling financial interest in a variable interest entity. It also requires an ongoing reassessment and eliminates the quantitative approach previously required for determining whether an entity is the primary beneficiary. This update is effective for our fiscal year beginning January 1, 2010 and we are currently evaluating the

NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

impact of this update in our consolidated financial statements.

In June 2009, the Financial Accounting Standards Board ( FASB ) issued ASC Topic 105, *Generally Accepted Accounting Principles* (previously SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* ), which is effective for interim and annual periods ending after September 15, 2009. The Accounting Standards Codification ( ASC ) does not alter current U.S. GAAP, but rather integrates existing accounting standards with other authoritative guidance. ASC will be the single source of authoritative U.S. GAAP for nongovernmental entities and supersedes all other previously issued non-SEC accounting and reporting guidance. The adoption of ASC did not have any impact on the Company's consolidated financial statements.

In May 2009, the FASB issued ASC Topic 855, *Subsequent Events* (previously SFAS 165, *Subsequent Events* ), which provides guidance to establish general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The Company adopted this pronouncement for the quarter ended June 30, 2009. We evaluated subsequent events through November 5, 2009; the issuance date of the Company's consolidated financial statements, and determined that no subsequent event disclosure is needed.

In April 2009, the FASB issued ASC Topic 820, *Fair Value Measurements and Disclosure - Overall* (previously FSP SFAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ) which provides additional guidance for estimating fair value in accordance with ASC Topic 820 (previously SFAS No. 157, *Fair Value Measurements* ), when the volume and level of activity for the asset or liability have significantly decreased. The Company adopted this guidance on April 1, 2009. The adoption did not have a material impact on the Company's consolidated financial statements.

In April 2009, the FASB issued ASC Topic 320, *Investments-Debt and Equity Securities* (previously FSP SFAS 115-2 and SFAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* ) to amend the other-than-temporary guidance in debt securities to be based on intent and not more likely than not that the Company would be required to sell the security before the recovery and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. The Company adopted this guidance on April 1, 2009. The adoption did not have a material impact on the Company's consolidated financial

statements.

In April 2009, the FASB issued ASC Topic 825, *Financial Instruments* (previously FSP SFAS 107-1 and APB 28-1, *Interim Disclosure about Fair Value of Financial Instruments* ). This update requires fair value disclosures for financial instruments for interim reporting periods as well as in annual financial statements. The Company adopted this guidance on April 1, 2009.

In June 2008, the FASB issued ASC Topic 260, *Earnings per Share* (previously FASB Staff Position EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities* ). This guidance addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share under the two-class method. Non-vested share awards granted to employees contain nonforfeitable dividend rights and, therefore, are now considered participating securities. The guidance is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. The Company's adoption as of January 1, 2009 did not have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB issued ASC Topic 805, *Business Combinations* (previously SFAS No. 141(R), *Business Combinations* ). This guidance establishes principles and requirements for how the acquirer (i) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (ii) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (iii) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The guidance applies prospectively to business combinations for which



NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company's adoption as of January 1, 2009 did not have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB issued ASC Topic 810, *Consolidation* (previously SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*). This guidance clarifies that a noncontrolling interest should be reported as equity in the consolidated financial statements and requires net income attributable to both the parent and the noncontrolling interest to be disclosed separately on the face of the consolidated statement of income. These presentation and disclosure provisions require retrospective application to all prior periods presented. The Company's adoption as of January 1, 2009 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 (ANHC@ or the ACompany@) is a leading provider of long term health care services. We operate or manage, through certain affiliates, 76 long term health care centers with 9,772 beds in 10 states and provide other services in two additional states. 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.

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 July, 2008 we opened a 60 bed addition to an existing facility located in North Augusta, South Carolina. We broke ground in September, 2008 for construction of a new 120 bed health care center in Bluffton, South Carolina (expected cost of \$22,645,000), and in 2009 we broke ground on a new assisted living facility in Mauldin, South Carolina (expected cost of \$6,600,000).

In January, 2008, we purchased a 109-bed skilled nursing rehabilitation facility located in Knoxville, Tennessee for \$6,347,000 in cash.

Also in January 2008, we purchased for \$5,073,000 in cash, two tracts of land located in the state of South Carolina and one tract of land located in the state of Tennessee. The tracts are undeveloped and are held for future development.

Effective February 1, 2008, we were selected by McKendree Village, Inc. to manage under a five-year contract McKendree Village, a continuing care retirement community located on 42 acres in the Nashville, Tennessee suburb of Hermitage. McKendree Village offers nursing care in the 300-bed McKendree Health Center, assisted living services in the 85-unit McKendree Manor, and independent senior care living in a 234-unit residential tower and in 39 individually designed cottages.

In August 2008, we purchased for \$13,250,000 in cash, a 132-bed skilled nursing and rehabilitation facility and a 60-bed assisted living facility located in Charleston, South Carolina.



NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

In 2009, we are continuing to develop an active hospice program in South Carolina independently of our partnership with Caris Healthcare and are also exploring opportunities to expand our home health care services. Effective January 1, 2009, we purchased five hospice locations in South Carolina for approximately \$3,100,000. During 2009, we will apply for Certificates of Need for additional beds in select markets and new NHC 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 \$107,821,000 at September 30, 2009 and are a primary area of management focus. We have set aside restricted cash to fund substantially all of our professional liability and workers= compensation reserves.

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. Furthermore, we are continuing efforts to identify and restructure the ownership or management of our higher risk operations and locations to eliminate NHC liability exposure.

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 61% (2008), 60% (2007), and 63% (2006) 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, 2009, we have made provisions for amounts due third party payors of approximately \$17,659,000. Revenues and results of operations in the nine months ended September 30, 2009 and 2008 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.

NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

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, 2009, we and/or our managed centers are defendants in 34 such claims inclusive of years 1999 through 2009. 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 in all provider locations owned, leased or managed by us. The coverages include both primary policies and umbrella 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.

Certain of our accounts receivable from private paying patients and certain of 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* (previously SFAS No. 114, *Accounting by Creditors for Impairment of a Loan - an Amendment of SFAS Nos. 5 and 15* ). 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 (ANational@), 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

NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

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 the \$2,000,000 working capital loan which obligation was extended until January 20, 2018 with the extension of the management agreement with National to that date.

*Guarantees* At September 30, 2009, 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, 2008 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. In February 2006, Congress enacted the Deficit Reduction Act, or DRA, which reduced net Medicare and Medicaid spending, and in December 2006, Congress passed the Tax Relief and Health Care Act of 2006, which also affects payments under the Medicare and Medicaid programs. In the Tax Relief and Health Care Act of 2006, Congress reduced the limit on Medicaid provider taxes for the period January 1, 2008 through September 30, 2011 from the 6 percent set by CMS regulations to a 5.5 percent limit set by statute.

### *Medicare*

Effective October 1, 2008, our SNF PPS rates were increased by 3.4% due to an inflation update. Our annual 2008 Medicare revenues increased by 6.5% over our annual 2007 Medicare revenues. The inflation update (or market basket increase) was 3.1% in 2006 and 3.3% in 2007.

For the first nine months of 2009 our average Medicare per diem increased by 3.08% over the same period of 2008.

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.

CMS released the final Medicare SNF PPS rule on July 31, 2009. In this rule, payment system changes for fiscal years 2010 and 2011 include the following:

NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

Fiscal Year 2010 Effective October 1, 2009

- 
- The federal rates will be updated by a market basket increase of 2.2%.
- 
- A recalibration of the nursing weights will be implemented, resulting in a reduction of 3.3%.
- 
- The net impact of these adjustments is a reduction of 1.1%.

Fiscal Year 2011 Effective October 1, 2010

- 
- The MDS 3.0 and RUG-IV payment system will be implemented on October 1, 2010.
- 
- Services rendered prior to the admission of the individual to the SNF will no longer be counted for classification to a RUG category. Only services rendered in the SNF will be reported on the MDS 3.0, and recognized for reimbursement purposes.
- 
- Concurrent therapy cannot be provided to more than 2 individuals. The MDS 3.0 will capture individual and concurrent therapy separately.

*Medicaid*

South Carolina Medicaid fully funded their normal October 1, 2008 rate increases and a retroactive settlement was received and recognized in June, 2009. The per diem rate increases have resulted in additional revenues of approximately \$321,000 per quarter.

Tennessee annual Medicaid rate increases were implemented effective July 1, 2009. Due to budget cuts, the increase in revenue to our owned and leased centers is limited by approximately \$89,000 per quarter. The amount is approximately 20% of the amount of increases that would have been paid if Tennessee had fully funded its payment formula.

Missouri Medicaid funded a global rate increase for all providers of \$6.00 per day effective after July 1, 2008. The first nine months of 2009 effect was approximately \$990,000. Missouri has indicated that it will increase current reimbursement rates retroactively to July 1, 2009. However, no increase in rates has been implemented currently.

For the first nine months of 2009, our average Medicaid per diem increased by 3.03% over the same period in 2008. We face challenges with respect to states' Medicaid payments, because many states currently do not 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. The DRA includes 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.

#### *Potential Healthcare Reform*

The increase in the number of individuals and families without healthcare coverage has heightened debate about whether and how to implement comprehensive reform of the United States healthcare system. The Obama administration has made healthcare reform its primary domestic agenda item, and Congress is currently considering multiple plans on how to change the healthcare system and how to fund those changes. Generally, President Obama and most members of Congress believe that the current healthcare system is too inefficient and leaves too many individuals without healthcare coverage. Much of the current healthcare reform debate includes the following considerations; whether a public insurance option should be established; the impact to private insurance companies; the impact to consumer choice of healthcare services; the impact to small businesses; and the impact of funding alternatives including personal tax rate increases, business surcharges, service provider assessments and increasing the federal deficit. We are not able to predict whether healthcare reform will be implemented, what provisions a potential reform plan may include or what impact these developments may have on our future operating results or cash flows at this time.



NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

Results of Operations

*Three Months Ended September 30, 2009 Compared to Three Months Ended September 30, 2008.*

Results for the three month period ended September 30, 2009 include a 5.1% increase in net revenues and an 11.9% increase in income before taxes compared to the same period in 2008.

Net patient revenues increased \$8,025,000 or 5.5% compared to the same period last year. Medicare, Medicaid and private pay per diem rates increased 3.1%, 2.4%, and 5.2%, respectively, compared to the quarter a year ago. Additionally, the January 1, 2009 acquisition of five hospice locations in South Carolina and the acquisition of a 132-bed skilled nursing and rehabilitation facility and a 60-bed assisted living facility located in Charleston, South Carolina, effective August 1, 2008 added approximately \$2,339,000 in net patient revenues. Homecare operations also increased net patient revenues in the amount of \$1,895,000.

The total census at owned and leased centers for the quarter averaged 92.0% (92.4% if operations owned less than one year are removed) compared to an average of 92.4% (92.7% if operations owned less than one year are removed) for the same quarter a year ago.

Other revenues increased \$334,000 or 2.0% in the three month 2009 period to \$17,084,000 from \$16,750,000 in the 2008 three month period. Increases in other revenues include increased management and accounting services fees (\$699,000) and greater earnings from our equity in unconsolidated investments (primarily from Caris HealthCare L.P. (\$329,000)). The increases were offset due to a decrease in interest income (\$371,000). Interest income decreased due to decreasing interest rate yields.

Total costs and expenses for the 2009 third quarter compared to the 2008 third quarter increased \$6,442,000 or 4.4% to \$153,559,000 from \$147,117,000. Salaries, wages and benefits, the largest operating costs of this service company, increased \$3,798,000 or 4.3% to \$91,834,000 from \$88,036,000. Other operating expenses increased \$2,444,000 or

5.5% to \$47,199,000 for the 2009 period compared to \$44,755,000 in the 2008 period. Rent expense increased \$198,000 or 2.5% to \$8,032,000 compared to \$7,834,000 in the 2008 period. Depreciation and amortization increased \$117,000 or 1.9% to \$6,335,000 from \$6,218,000. Interest costs decreased \$115,000 to \$159,000.

Increases in salaries, wages and benefits are due to increased staffing due to the acquisition of a skilled health care facility (132 long-term beds), a 60-bed assisted living facility and five hospice locations (\$1,686,000), increased costs for therapist services (\$1,082,000), increased costs for homecare services (\$1,033,000), and inflationary wage increases. Increases in other operating costs are due to costs associated with the recently acquired health care facility (132 long-term beds), a 60-bed assisted living facility, five hospice locations (\$891,000), increased operating costs for homecare services (\$806,000) and also an increase in professional liability expenses (\$590,000).

Depreciation expense increased primarily due to the acquisition of certain depreciable assets during the last year, including a 132-bed skilled health facility and a 60-bed assisted living facility.

The income tax provision for the three months ended September 30, 2009 is \$5,727,000 (an effective income tax rate of 31.7%). The income tax provision and effective tax rate for 2009 were favorably impacted by statute of limitation expirations and adjustment to unrecognized tax benefits resulting in a benefit to the provision of \$1,553,000 (including \$612,000 of interest and penalties) or 8.6% of income before taxes. The income tax provision for the three months ended September 30, 2008 was \$2,381,000 (an effective tax rate of 14.7%). The income tax provision and effective tax rate for the three months ended 2008 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of \$4,187,000 (including \$2,050,000 of interest and penalties) or 25.9% of income before taxes.

NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

*Nine Months Ended September 30, 2009 Compared to Nine Months Ended September 30, 2008.*

Results for the nine month period ended September 30, 2009 include a 5.9% increase in net revenues and a 15.6% increase in income before income taxes compared to the same period in 2008.

Net patient revenues increased \$29,813,000 or 6.9% compared to the same period last year. Medicare, Medicaid and private pay per diem rates increased 3.1%, 3.0%, and 5.0%, respectively, compared to the nine months a year ago. Additionally, the January 1, 2009 acquisition of five hospice locations in South Carolina and the acquisition of a 132-bed skilled nursing and rehabilitation facility and a 60-bed assisted living facility located in Charleston, South Carolina, effective August 1, 2008 added approximately \$11,632,000 in net patient revenues. Homecare operations also increased net patient revenues in the amount of \$4,773,000.

The total census at owned and leased centers for the nine month period averaged 92.0% (92.3% if operations owned less than one year are removed) compared to an average of 92.7% (92.4% if operations owned less than one year are removed) for the same nine month period a year ago.

Other revenues decreased \$1,452,000 or a decline of 2.9% in the nine month 2009 period to \$48,873,000 from \$50,325,000 in the 2008 nine month period. Decreases in other revenues include decreased management and accounting services fees (\$849,000), decreased interest income due to lower yield rates (\$989,000), and decreased rental income (\$630,000). Decreases in other revenues in the 2009 period over the 2008 period were offset in part due to greater earnings from our equity in unconsolidated investments (primarily from Caris HealthCare L.P. (\$1,178,000)).

Total costs and expenses for the 2009 nine months compared to the 2008 nine months increased \$21,379,000 or 4.9% to \$460,506,000 from \$439,127,000. Salaries, wages and benefits, the largest operating costs of this service company, increased \$12,546,000 or 4.8% to \$274,435,000 from \$261,889,000. Other operating expenses increased \$7,880,000 or 5.8% to \$142,588,000 for the 2009 period compared to \$134,708,000 in the 2008 period. Rent expense increased \$436,000 or 1.8% to \$24,064,000 compared to \$23,628,000 in the 2008 period. Depreciation and amortization increased \$626,000 or 3.4% to \$18,865,000 from \$18,239,000. Interest costs decreased \$109,000 to \$554,000.

Increases in salaries, wages and benefits are due to increased staffing due to the acquisition of a skilled health care facility (132 long-term beds), a 60-bed assisted living facility and five hospice locations (\$6,962,000), increased costs for therapist services (\$2,327,000), increased costs for homecare services (\$2,815,000), and inflationary wage increases. Increases in other operating costs are due to costs associated with the acquisition of a health care facility (132 long-term beds), a 60-bed assisted living facility, five hospice locations (\$4,746,000) and increased homecare services (\$1,750,000).

Depreciation expense increased primarily due to the acquisition of certain depreciable assets during the last year, including a 132-bed skilled health facility and a 60-bed assisted living facility.

The income tax provision for the nine months ended September 30, 2009 is \$18,934,000 (an effective income tax rate of 36.5%). The income tax provision and effective tax rate for 2009 were favorably impacted by statute of limitation expirations and adjustment to unrecognized tax benefits resulting in a benefit to the provision of \$1,553,000 (including \$612,000 of interest and penalties) or 3.0% of income before taxes. The income tax provision for the nine months ended September 30, 2008 was \$13,416,000 (an effective tax rate of 29.9%). The income tax provision and effective tax rate for the nine months ending 2008 were favorably impacted by statute of limitation expirations of \$4,187,000 (including \$2,050,000 of interest and penalties) or 9.3% of income before taxes.

#### 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, debt service payments (including principal and interest) and dividend



## NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

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):

|   | Three Months Ended |           | Three Month Change |          |
|---|--------------------|-----------|--------------------|----------|
|   | September 30       |           | \$                 | %        |
|   | 2009               | 2008      |                    |          |
| Cash and Cash equivalents at beginning of period  | \$ 64,536          | \$ 29,791 | \$ 34,745          | 116.6%   |
| Cash provided from (used in) operating activities | 29,335             | 18,876    | 10,459             | 55.4%    |
| Cash provided from (used in) investing activities | (13,678)           | (12,434)  | (1,244)            | (10.0%)  |
| Cash provided from (used in) financing activities | (5,074)            | 13,524    | (18,598)           | (137.5%) |
| Cash and cash equivalents at end of period        | \$ 75,119          | \$ 49,757 | \$ 25,362          | 51.0%    |
|   | Nine Months Ended  |           | Nine Month Change  |          |
|   | September 30       |           | \$                 | %        |
|   | 2009               | 2008      |                    |          |
| Cash and Cash equivalents at beginning of period  | \$ 49,033          | \$ 2,379  | \$ 46,654          | 1,961.1% |
| Cash provided from (used in) operating activities | 49,233             | 46,903    | 2,330              | 5.0%     |
| Cash provided from (used in) investing activities | (24,350)           | (4,466)   | (19,884)           | (445.2%) |
| Cash provided from (used in) financing activities | 1,203              | 4,941     | (3,738)            | (75.7%)  |
| Cash and cash equivalents at end of period        | \$ 75,119          | \$ 49,757 | \$ 25,362          | 51.0%    |

*Operating Activities* - Net cash provided by operating activities for the nine months ended September 30, 2009, was \$49,233,000 as compared to \$46,903,000 provided in the same period last year. Cash provided by operating activities for the current period benefited from increases in other current liabilities and accrued risk reserves, deferred income, other non-current liabilities, amounts due to third party payors, and decreases in inventory, accounts receivable, and restricted cash. The increases to operating activities were offset by increases in the equity in earnings of unconsolidated investments, prepaid expenses and other assets and decreases in accrued payroll, accounts payable and entrance fee deposits. The decrease in accrued payroll is due to the timing of payroll payments as well as payments of payroll taxes and accrued bonuses. The decrease in accounts receivable is due to collections and timing differences.

*Investing Activities* - Cash used in investing activities totaled \$24,350,000 for the nine months ended September 30, 2009, as compared to \$4,466,000 provided from investing activities for the nine months ended September 30, 2008. Cash used for property and equipment additions was \$32,070,000 for the nine months ended September 30, 2009 and \$34,367,000 in the comparable period in 2008. Investments in notes receivable totaled \$8,327,000 in 2009 compared to \$2,746,000 in 2008. Cash provided by net collections of notes receivable was \$4,697,000 in 2009 compared to \$4,674,000 in 2008. Collections of our investment in the cash fund in liquidation balance totaled \$6,065,000 in the first nine months of 2009 compared to \$22,830,000 in 2008.

Costs included in property and equipment additions include \$12,138,000 for a new 120-bed long-term health care center under construction in Bluffton, South Carolina and \$2,620,000 for a 60-bed assisted living facility in Mauldin, South Carolina. A note receivable investment was made during the period in the amount of \$8,049,000 to a third party healthcare provider in which we provide financial/accounting services.

## NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

*Financing Activities* - Net cash provided by financing activities totaled \$1,203,000 in the nine months ended September 30, 2009 compared to \$4,941,000 net cash used for the same period in 2008. Cash used for payments of debt totaled \$2,000 and dividend payments to common and preferred shareholders totaled \$16,455,000. In the prior year, cash used for payments of debt totaled \$7,433,000, proceeds from debt totaled \$20,500,000 and dividend payments to common and preferred shareholders totaled \$14,592,000. Tax benefits from exercise of stock options provided cash of \$3,602,000 in 2009 and \$1,439,000 in 2008. In the current period, \$14,179,000 of cash was provided by the issuance of common stock compared to \$5,180,000 in the same period last year.

At September 30, 2009, our ratio of long term debt to total capitalization (total debt plus deferred income plus shareholders equity) is 10.2% compared to 10.9% at December 31, 2008.

Table of Contractual Cash Obligations

Our contractual cash obligations for periods subsequent to September 30, 2009 are as follows (in thousands):

|                                      | Total      | Less than<br>1 year | 1-3<br>Years | 3-5<br>Years | After<br>5 Years |
|--------------------------------------|------------|---------------------|--------------|--------------|------------------|
| Long-term debt principal             | \$ 60,500  | \$ 50,500           | \$ -         | \$ -         | \$ 10,000        |
| Long-term debt – interest            | 2,376      | 303                 | 553          | 553          | 967              |
| Obligations to complete construction | 7,986      | 7,986               | -            | -            | -                |
| Operating leases                     | 412,825    | 33,700              | 67,400       | 67,400       | 244,325          |
| Total Contractual Cash Obligations   | \$ 483,687 | \$ 92,489           | \$ 67,953    | \$ 67,953    | \$ 255,292       |

Income taxes payable for uncertain tax positions of \$5,269,000, attributable to permanent differences, at September 30, 2009 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 4 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 27, 2009, we extended the maturity of our \$75,000,000 revolving credit agreement to October 26, 2010. We have currently borrowed \$50,500,000 against the credit agreement and an additional amount up to \$24,500,000 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 120-bed long-term health care center located in Bluffton, South Carolina. At September 30, 2009, we are obligated on construction contracts in the amount of approximately \$7,986,000, 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 \$75,119,000 at September 30, 2009, marketable securities of \$61,783,000 at September 30, 2009 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.

NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

Long-term liquidity

Our \$75,000,000 revolving credit agreement upon which we have currently borrowed \$50,500,000 matures on October 26, 2010. 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 twice 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 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, 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.

Guarantees and Contingencies

*Debt Guarantees*

At September 30, 2009, 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.

### *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 June 2009, the FASB issued ASC Topic 810, *Consolidation-Overall* (previously SFAS No. 167, Amendments to FASB Interpretation No. 46(R) ). This updated guidance requires an analysis to determine whether a variable interest gives the entity a controlling financial interest in a variable interest entity. It also requires an ongoing reassessment and eliminates the quantitative approach previously required for determining whether an entity is the primary beneficiary. This update is effective for our fiscal year beginning January 1, 2010 and we are currently evaluating the impact of this update in our consolidated financial statements.

NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

In June 2009, the Financial Accounting Standards Board ( FASB ) issued ASC Topic 105, *Generally Accepted Accounting Principles* (previously SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* ), which is effective for interim and annual periods ending after September 15, 2009. The Accounting Standards Codification ( ASC ) does not alter current U.S. GAAP, but rather integrates existing accounting standards with other authoritative guidance. ASC will be the single source of authoritative U.S. GAAP for nongovernmental entities and supersedes all other previously issued non-SEC accounting and reporting guidance. The adoption of ASC did not have any impact on the Company's consolidated financial statements.

In May 2009, the FASB issued ASC Topic 855, *Subsequent Events* (previously SFAS 165, *Subsequent Events* ), which provides guidance to establish general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The Company adopted this pronouncement for the quarter ended June 30, 2009. We evaluated subsequent events through November 5, 2009; the issuance date of the Company's consolidated financial statements, and notes that no subsequent event disclosure is needed.

In April 2009, the FASB issued ASC Topic 820, *Fair Value Measurements and Disclosure - Overall* (previously FSP SFAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ) which provides additional guidance for estimating fair value in accordance with ASC Topic 820 (previously SFAS No. 157, *Fair Value Measurements* ), when the volume and level of activity for the asset or liability have significantly decreased. The Company adopted this guidance on April 1, 2009. The adoption did not have a material impact on the Company's consolidated financial statements.

In April 2009, the FASB issued ASC Topic 320, *Investments-Debt and Equity Securities* (previously FSP SFAS 115-2 and SFAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* ) to amend the other-than-temporary guidance in debt securities to be based on intent and not more likely than not that the Company would be required to sell the security before the recovery and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. The Company adopted this guidance on April 1, 2009. The adoption did not have a material impact on the Company's consolidated financial statements.

In April 2009, the FASB issued ASC Topic 825, *Financial Instruments* (previously FSP SFAS 107-1 and APB 28-1, *Interim Disclosure about Fair Value of Financial Instruments* ). This update requires fair value disclosures for financial instruments for interim reporting periods as well as in annual financial statements. The Company adopted this guidance on April 1, 2009.

In June 2008, the FASB issued ASC Topic 260, *Earnings per Share* (previously FASB Staff Position EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities* ). This guidance addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share under the two-class method. Non-vested share awards granted to employees contain nonforfeitable dividend rights and, therefore, are now considered participating securities. The guidance is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. The Company's adoption as of January 1, 2009 did not have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB issued ASC Topic 805, *Business Combinations* (previously SFAS No. 141(R), *Business Combinations* ). This guidance establishes principles and requirements for how the acquirer (i) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (ii) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (iii) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The guidance applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15,



NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

2008. The Company's adoption as of January 1, 2009 did not have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB issued ASC Topic 810, *Consolidation* (previously SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*). This guidance clarifies that a noncontrolling interest should be reported as equity in the consolidated financial statements and requires net income attributable to both the parent and the noncontrolling interest to be disclosed separately on the face of the consolidated statement of income. These presentation and disclosure provisions require retrospective application to all prior periods presented. The Company's adoption as of January 1, 2009 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 only 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 9: 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;

C

the ability to refinance existing debt on favorable terms;

C

the competitive environment in which we operate;

NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

C

the ability to maintain and increase census levels; and

C

demographic changes.

See the notes to the quarterly financial statements, and AItem 1. Business@ as is found in our 2008 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 side 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 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 \$20.4 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 \$6.7 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 \$34,000. As of September 30, 2009 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 \$59,000.

#### *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* (previously SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities). The investments in marketable securities are recorded at their fair market value based on quoted market prices. Thus, there is exposure to equity price risk, which 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 securities.

#### *Investment in Cash Fund in Liquidation*

Please see *Note 10 - Fair Value Measurements* regarding market risk related to our investment in a cash fund in liquidation.

#### **Item 4. Controls and Procedures.**

As of September 30, 2009, 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



NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

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, 2009. There have been no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2009 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 9 of this Form 10 Q.

Item 1A.

Risk Factors.

During the nine months ended September 30, 2009, 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, 2008.

Item 2.

Unregistered Sales of Equity Securities and Use of Proceeds. Not applicable

Item 3.

Defaults Upon Senior Securities. None

Item 4.

Submission of Matters to Vote of Security Holders. None

Item 5.

Other Information. None

Item 6.

Exhibits.

(a)

List of exhibits

Exhibit No. Description

|      |  |
|------|--|
| 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 |





NATIONAL HEALTHCARE CORPORATION

September 30, 2009

(unaudited)

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 5, 2009 /s/ Robert G. Adams

Robert G. Adams  
Chief Executive Officer

Date: November 5, 2009 /s/ Donald K. Daniel

Donald K. Daniel  
Senior Vice President and Controller  
(Principal Accounting Officer)