SUNLINK HEALTH SYSTEMS INC
Form 10-Q
November 15, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2010

OR

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

For the transition period from ______ to ______

Commission File Number 1-12607

SUNLINK HEALTH SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Ohio	**31-0621189**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

900 Circle 75 Parkway, Suite 1120, Atlanta, Georgia 30339

(Address of principal executive offices)

(Zip Code)

(770) 933-7000

(Registrant s telephone number, including area code)

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

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	x

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

The number of Common Shares, without par value, outstanding as of November 15, 2010 was 8,081,732.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	September 30, 2010 (unaudited)	June 30, 2010
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 2,877	$ 1,704
Receivables net	16,420	17,233
Inventory	4,718	4,823
Income tax receivable	1,315	345
Deferred income tax asset	5,631	6,030
Prepaid expenses and other	3,918	4,499
Total Current Assets	34,879	34,634
Property, Plant and Equipment, at cost	73,176	72,474
Less accumulated depreciation and amortization	32,547	31,118
Property, Plant and Equipment net	40,629	41,356
Intangible assets-net	11,616	11,776
Goodwill	9,024	9,024
Other assets	1,581	1,700
Total Assets	$ 97,729	$ 98,490
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities:		
Accounts payable	$ 8,106	$ 8,445
Revolving advances	1,200	
Current maturities of long-term debt	30,448	1,797
Current maturities of subordinated long-term debt	300	300
Accrued payroll and related taxes	5,498	5,129
Third-party payor settlements	1,436	
Income taxes		607
Other accrued expenses	2,906	2,828
Total Current Liabilities	49,894	19,106
Long-Term Liabilities:		
Long-term debt	20	29,090
Subordinated long-term debt	2,250	2,250
Noncurrent liability for professional liability risks	3,379	2,956
Noncurrent deferred income tax liabilities	1,506	1,625
Other noncurrent liabilities	738	771

Total Long-term Liabilities		7,893	36,692
Commitments and Contingencies			
Shareholders Equity:			
Preferred shares, authorized and unissued, 2,000 shares			
Common shares, without par value:			
Issued and outstanding, 8,082 shares at September 30, 2010 and 8,079 shares at June 30, 2010		4,039	4,039
Additional paid-in capital		11,720	11,701
Retained earnings		23,796	26,565
Accumulated other comprehensive loss		(301)	(301)
Total Parent Company Shareholders Equity		39,254	42,004
Noncontrolling interest		688	688
Total Shareholders Equity		39,942	42,692
Total Liabilities and Shareholders Equity	$	97,729	$ 98,490

See notes to condensed consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(in thousands, except per share amounts)

(unaudited)

	THREE MONTHS ENDED SEPTEMBER 30, 2010	THREE MONTHS ENDED SEPTEMBER 30, 2009
Net Revenues	$ 44,204	$ 48,067
Costs and Expenses		
Cost of goods sold	5,808	6,630
Salaries, wages and benefits	19,301	19,960
Provision for bad debts	6,224	6,512
Supplies	3,653	3,868
Purchased services	3,051	3,018
Other operating expenses	6,343	5,891
Rent and lease expense	839	820
Depreciation and amortization	1,593	1,662
Gain on sale of Home Health businesses		(2,342)
Operating Profit (Loss)	(2,608)	2,048
Other Income (Expense):		
Interest expense	(848)	(919)
Interest income	1	3
Earnings (Loss) from Continuing Operations before Income Taxes	(3,455)	1,132
Income Tax Expense (Benefit)	(810)	583
Earnings (Loss) from Continuing Operations	(2,645)	549
Loss from Discontinued Operations	(124)	(53)
Net Earnings (Loss)	$ (2,769)	$ 496
Earnings (Loss) Per Share:		
Continuing Operations:		
Basic	$ (0.33)	$ 0.07
Diluted	$ (0.33)	$ 0.07
Discontinued Operations:		
Basic	$ (0.02)	$ (0.01)
Diluted	$ (0.02)	$ (0.01)
Net Earnings (Loss):		
Basic	$ (0.34)	$ 0.06
Diluted	$ (0.34)	$ 0.06
Weighted-Average Common Shares Outstanding:		

Basic	8,081	8,050
Diluted	8,081	8,070

See notes to condensed consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	THREE MONTHS ENDED SEPTEMBER 30, 2010	THREE MONTHS ENDED SEPTEMBER 30, 2009
Net Cash Provided by (Used In) Operating Activities	$ 981	$ (504)
Cash Flows From Investing Activities:		
Proceeds from sale of Home Health businesses		3,300
Expenditures for property, plant and equipment	(565)	(872)
Net Cash Provided by (Used in) Investing Activities	(565)	2,428
Cash Flows From Financing Activities:		
Revolving advances, net	1,200	(1,100)
Payments on long-term debt	(451)	(457)
Proceeds from issuance of common shares under stock option plans	8	
Net Cash Provided by (Used in) Financing Activities	757	(1,557)
Net Increase in Cash and Cash Equivalents	1,173	367
Cash and Cash Equivalents at Beginning of Period	1,704	2,364
Cash and Cash Equivalents at End of Period	$ 2,877	$ 2,731
Supplemental Disclosure of Cash Flow Information:		
Cash Paid For:		
Interest	$ 748	$ 885
Income taxes	$ 413	$ 1,665
Non-cash investing and financing activities:		
Assets acquired under capital lease obligation	$ 32	$

See notes to condensed consolidated financial statements.

SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED SEPTEMBER 30, 2010

(all dollar amounts in thousands except per share amounts)

(unaudited)

Note 1. Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements as of and for the three month period ended September 30, 2010 have been prepared in accordance with Rule 10-01 of Regulation S-X of the Securities and Exchange Commission (SEC) and, as such, do not include all information required by accounting principles generally accepted in the United States of America. These Condensed Consolidated Financial Statements should be read in conjunction with the audited consolidated financial statements included in the SunLink Health Systems, Inc. (SunLink , we , our , ours , us or the Company) Annual Report on Form 10-K for the fiscal year ended June 30, 2010, filed with the SE October 12, 2010. In the opinion of management, the Condensed Consolidated Financial Statements, which are unaudited, include all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position and results of operations for the periods indicated. The results of operations for the three month period ended September 30, 2010 are not necessarily indicative of the results that may be expected for the entire fiscal year or any other interim period.

Note 2. Business Operations and Corporate Strategy

Business Operations

SunLink Health Systems, Inc. is a provider of healthcare services in certain rural and exurban markets in the United States. SunLink s business is composed of two business segments:

Healthcare Facilities, which consist of

Our seven community hospitals which have a total of 402 licensed beds;

Our three nursing homes, which have a total of 261 licensed beds, each of which is located adjacent to a corresponding SunLink community hospital; and

Our one home health agency, which operates for a corresponding SunLink community hospital.

Specialty Pharmacy, which consists of

Specialty pharmacy services;

Durable medical equipment;

Institutional pharmacy services; and

Three retail pharmacies offering products and services, all of which are conducted in rural markets.

SunLink has conducted its healthcare facilities business since 2001 and its specialty pharmacy business since April 2008. Our Specialty Pharmacy Segment currently is operated through Carmichael s Cashway Pharmacy, Inc. (Carmichael), a subsidiary of our ScriptsRx LLC subsidiary, and is composed of a specialty pharmacy business acquired in April 2008 with four service lines.

Strategy

SunLink s business strategy is to focus its efforts on internal growth of its existing healthcare facilities and its pharmacy business, supplemented by growth from selected rural and exurban healthcare acquisitions, including but not limited to hospitals, nursing homes, home care businesses, and pharmacy businesses. However, as was the case in 2004 with our Mountainside Medical Center hospital and in September 2009 with the sale of three home health agencies, we consider dispositions of one or more of our facilities or operations based on a variety of factors including asset values, return on investment, competition from existing and potential facilities, capital improvement needs and other corporate objectives. In addition, as we have previously announced, we have engaged Fennebresque & Co. and Health Strategy Partners, LLC as financial advisors to aid in our evaluation of strategic alternatives as well as in connection with a potential refinancing of our outstanding indebtedness. Currently no agreement has been reached or approved by the Board of SunLink to effect any strategic transaction or to refinance any of our outstanding indebtedness.

Operations

Our operational strategy is focused on efforts to improve operations and generate internal growth. Our primary operational strategy for our community hospitals is to improve the operations and profitability of such hospitals by reducing out-migration of patients, recruiting physicians, expanding services and implementing and maintaining effective cost controls. Our operational strategy for our nursing homes and home health agency is similar to that for our community hospitals and is focused on expanding services and implementing and maintaining effective cost controls.

Finally, our operational strategy for our Specialty Pharmacy Segment is focused on continuing the integration of the Carmichael operations acquired in April 2008, increasing market share, increasing collection efforts, expanding services and implementing and maintaining effective cost controls.

Acquisitions

Although the Company s situation could change, based on its current financial position as well as uncertainties in the healthcare industry, the Company is not actively seeking acquisitions for its Healthcare Facilities or Specialty Pharmacy Segments. However, during the last fiscal year, we evaluated certain rural and exurban hospitals and healthcare businesses, which were for sale, and monitored other selected rural and exurban healthcare acquisition targets which we believed might become available for sale.

Note 3. Sale of Home Health Businesses

In September 2009, we sold three of our home health businesses for approximately $3,300 resulting in a pre-tax gain of approximately $2,342. Included in the net assets of the three home health businesses sold was $429 of goodwill related to our Healthcare Facilities Segment. The home health businesses were located in Adel, GA, Clanton, AL and Fulton, MO.

Note 4. Discontinued Operations

All of the businesses discussed below are reported as discontinued operations and the condensed consolidated financial statements for all prior periods have been adjusted to reflect this presentation.

Results for all of the businesses included in discontinued operations are presented in the following table:

	Three Months Ended September 30, 2010	2009
Loss from discontinued operations:		
Housewares Segment:		
Loss from operations	$	$ (35)
Income tax benefit		14
Loss from Housewares Segment after taxes		(21)
Mountainside Medical		
Loss from operations	(178)	(36)
Income tax benefit	67	15
Loss from Mountainside Medical Center after taxes	(111)	(21)
Life sciences and engineering segment:		
Loss from operations	(21)	(18)
Income tax benefit	8	7
Loss from life sciences and engineering segment after taxes	(13)	(11)
Loss from discontinued operations	$ (124)	$ (53)

Housewares Segment All claims in a liquidation proceeding with respect to SunLink s former Housewares Segment were settled on April 13, 2010 and are no longer outstanding with SunLink agreeing to pay approximately $1,400. SunLink s insurer under a Directors and Officers insurance policy contributed $480 with SunLink paying the difference of $920 in April 2010. The Company cancelled all preferred stock of its SunLink subsidiary held by the former Housewares Segment subsidiary. The pre-tax loss of $35 for the quarter ended September 30, 2009 resulted from legal expenses incurred.

Mountainside Medical Center On June 1, 2004, SunLink sold its Mountainside Medical Center (Mountainside) hospital in Jasper, Georgia, for approximately $40,000 pursuant to the terms of an asset sale agreement. In connection with this sale, a claim by the buyer of Mountainside and a counter claim by SunLink had been in litigation since July 2006. On October 26, 2006, SunLink obtained a judgment for damages of $1,056 plus accrued prejudgment interest from the Superior Court of Cobb County, Georgia. The damage amount of $1,056 was a net amount including $1,560 of disputed Medicaid receipts owed to SunLink (and previously disputed by the buyer) less $504 SunLink owed to the buyer under the asset sale agreement. After additional judicial proceedings, on May 27, 2010, the buyer paid SunLink $1,246 representing the amount of the judgment plus accrued interest minus an offset of $90 for a separate claim the buyer was pursuing against SunLink. Under the terms of the asset sale agreement, SunLink had the right to be indemnified by the buyer for losses (including reasonable attorneys fees and expenses of litigation) incurred in enforcing the covenants and agreements of the buyer.

Life Sciences and Engineering Segment SunLink retained a defined benefit retirement plan which covered substantially all of the employees of this segment when it was sold in fiscal 1998. Effective February 28, 1997, the plan was amended to freeze participant benefits and close the plan to new participants. Included in discontinued operations for the three months ended September 30, 2010 and 2009, respectively, were the following:

	Three Months Ended September 30, 2010	2009
Interest cost	18	18

Expected return on assets	(11)	(11)
Amortization of prior service cost	14	11
Net pension expense	21	18

SunLink did not contribute to the plan in the three months ended September 30, 2010. We expect to make no contribution to the plan through the end of the fiscal year ending June 30, 2011.

Discontinued Operations Reserves Over the past 21 years, SunLink has discontinued operations carried on by its former Mountainside Medical Center and its former industrial, U.K. leisure marine, life sciences and engineering, and European child safety segments, as well as the U.K. housewares segment. SunLink s reserves relating to discontinued operations of these segments represent management s best estimate of SunLink s possible liability for property, product liability and other claims for which SunLink may incur liability. These estimates are based on management s judgments, using currently available information, as well as, in certain instances, consultation with its insurance carriers, third party advisors and legal counsel. While estimates have been based on the evaluation of available information, it is not possible to predict with certainty the ultimate outcome of many contingencies relating to discontinued operations. SunLink intends to continue to adjust its estimates of the reserves as additional information is developed and evaluated. However, management believes that the final resolution of these contingencies will not have a material adverse impact on the financial position, cash flows or results of operations of SunLink.

Note 5. Stock-Based Compensation

For the three months ended September 30, 2010 and 2009, the Company recorded $12 and $13, respectively, in salaries, wages and benefit expense for share options issued to employees and directors of the Company. The fair value of the share options granted was estimated using the Black-Scholes option pricing model. There were no share options granted during the three months ended September 30, 2010 and 2009.

Note 6. Receivables- net

Summary information for receivables is as follows:

	September 30, 2010	June 30, 2010
Accounts receceivable (net of contractual allowances)	31,994	$ 33,741
Less allowance for doubtful accounts	(15,574)	(16,508)
Receivables - net	$ 16,420	$ 17,233

Net revenues include an increase of $9 and a decrease of $100 for the three months ended September 30, 2010 and 2009, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports.

Note 7. Goodwill And Intangible Assets

SunLink has goodwill and intangible assets related to its Healthcare Facilities and Specialty Pharmacy Segments.

Intangibles consist of the following, net of amortization:

	September 30, 2010	June 30, 2010
Healthcare Facilities Segment		
Certificates of Need	$ 630	$ 630
Noncompetition Agreements	83	83
	713	713
Accumulated Amortization	(240)	(226)
	$ 473	$ 487
Specialty Pharmacy Segment		
Trade Name	5,400	5,400
Customer Relationships	6,400	6,400
Medicare License	769	769
	12,569	12,569
Accumulated Amortization	(1,426)	(1,280)
	11,143	11,289
Total	$ 11,616	$ 11,776

Amortization expense was $160, and $211, for the quarters ended September 30, 2010 and 2009, respectively.

Goodwill consists of the following:

	September 30, 2010	June 30, 2010
Healthcare Facilities Segment	$ 2,515	$ 2,515
Specialty Pharmacy Segment	6,509	6,509
	$ 9,024	$ 9,024

In September 2009, we sold three of our home health businesses for approximately $3,300. Included in the net assets of the three home health businesses sold was $429 of goodwill related to our Healthcare Facilities Segment.

Note 8. Long-Term Debt

Long-term debt consisted of the following:

	September 30, 2010	June 30, 2010
Term Loan	$ 30,398	$ 30,836
Capital lease obligations	70	51
Total	30,468	30,887
Less current maturities	(30,448)	(1,797)
	$ 20	$ 29,090

SunLink Credit Facilities On April 23, 2008, SunLink entered into a $47,000 seven-year senior secured credit facility (2008 Credit Facility) comprised of a revolving line of credit of up to $12,000 (the Revolving Loan) and a $35,000 term loan (the Term Loan). Interest under the 2008 Credit Facility is LIBOR (defined as the Thirty-day published rate) plus the applicable margin. Pursuant to a waiver agreement discussed below, the termination date of the 2008 Credit Facility was changed from April 22, 2015 to September 30, 2011 and the interest rate for the Revolving Loan is LIBOR plus 6.50% from the waiver date through November 14, 2010, LIBOR plus 7.50% from November 15, 2010 to February 15, 2011, LIBOR plus 8.50% from February 16, 2011 to May 14, 2011 and LIBOR plus 9.50% from May 15, 2011 to the September 30, 2011 termination date. The interest rate for the Term Loan is LIBOR plus 8.07% from the waiver date through November 14, 2010, LIBOR plus 9.07% from November 15, 2010 to February 15, 2011, LIBOR plus 10.07% from February 16, 2011 to May 14, 2011 and LIBOR plus 11.07% from May 15, 2011 to August 14, 2011. We also agreed to a reduction in the revolving line of credit facility commitment from $12,000 to $9,000 which we believe is adequate for our current level of operations. The total availability of credit under all components of the 2008 Credit Facility is keyed to the level of SunLink s earnings, which, based upon the Company s estimates, provided for current borrowing capacity, before any draws, of approximately $39,114 at September 30, 2010. The 2008 Credit Facility is secured by a first priority security interest in substantially all real and personal property of the Company and its consolidated domestic subsidiaries, including a pledge of all of the equity interests in such subsidiaries.

The 2008 Credit Facility contains various terms and conditions, including operational and financial restrictions and limitations, and affirmative and negative covenants. The covenants include financial covenants measured on a quarterly basis which require SunLink to comply with maximum leverage and minimum fixed charge ratios, maximum capital expenditure amounts, collateral value to loan amount and liquidity and cash flow measures, all as defined in the 2008 Credit Facility. At June 30, 2010, SunLink was in non-compliance with certain financial covenants of the 2008 Credit Facility. On October 8, 2010 (the Waiver Date), the Company received a waiver (Credit Agreement Waiver) from its lenders of these financial covenants for the fiscal quarter ended June 30, 2010, and subject to certain conditions, also for the fiscal quarters ended September 30, 2010, December 31, 2010 and March 31, 2011.

The Credit Agreement Waiver also contains conditions for waivers of the non-compliance with financial covenants for the quarters ended September 30, 2010, December 31, 2010 and March 31, 2011. These conditions include, among other things, compliance by SunLink with minimum consolidated adjusted earnings before interest, taxes depreciation and amortization but at a level reduced from that formerly applicable. The Company was in compliance with the terms of the 2008 Credit Agreement, including the revised levels of financial covenants for the September 30, 2010 financial statements. A waiver fee of 2% of the current 2008 Credit Facility commitment totaling approximately $788 was paid to the Lenders by SunLink at the Waiver Date, which will be expensed in the quarter ending December 31, 2010, and additional waiver fees of 0.5% of the total 2008 Credit Facility commitment will be payable at November 15, 2010, February 15, 2011 and May 15, 2011. The waiver includes other conditions which may increase the interest rate for both the Term Loan and the Revolving Loan by an additional 2% over the prescribed interest rate for the remainder of the 2008 Credit Facility. Amortization of the fees and expenses recorded in interest expense were approximately $107 for the three months ended September 30, 2010 and $98 for the three month ended September 30, 2009. As a result of the increased interest rates, waiver fees and new termination date for the 2008 Credit Agreement under the Credit Agreement Waiver, SunLink expects interest expense (including increased amortization of certain non-cash deferred financing costs) to be approximately $2,250 higher for the quarter ending December 31, 2010 than it would have been. In addition, as a result of the new termination date of September 30, 2011 for the 2008 Credit Facility, SunLink will have to refinance or otherwise source funds to repay the existing indebtedness outstanding thereunder prior to the termination date. SunLink is currently pursuing alternatives, including refinancing arrangements, to refinance or repay the amounts outstanding under the 2008 Credit Facility and to finance certain capital improvements to its hospital facilities, but there can be no assurance that it will be able to effect such a refinancing or regarding the terms or conditions thereof.

Note 9. Subordinated Long-Term Debt

Subordinated long-term debt consisted of the following:

	September 30, 2010	June 30, 2010
Carmichael	$ 2,550	$ 2,550
Less current maturities	(300)	(300)
	$ 2,250	$ 2,250

Carmichael Loan On April 22, 2008, SunLink Scripts Rx, LLC (formerly known as SunLink Homecare Services LLC) entered into a $3,000 promissory note agreement with an interest rate of 8% with the former owners of Carmichael as part of the acquisition purchase price. The note is payable in semi-annual installments of $150 beginning on April 22, 2009 with the remaining balance of $1,200 due April 22, 2015. Interest is payable in arrears semi-annually on the six-month anniversary of the issuance of the note. The note is guaranteed by SunLink Health Systems, Inc. for the payment of the note and accrued interest. The note is subordinate to our Credit Facility.

Under the terms of the 2008 Credit Facility (see Note 8), if SunLink is in violation of certain terms and conditions of this Facility, the Company cannot make principal payments of the Carmichael Loan without permission of the 2008 Credit Facility lender. At June 30, 2010, SunLink was in violation of certain financial covenants of the 2008 Credit Facility, but has received a waiver of the restriction of paying the principal and interest due under the Carmichael Loan as long as SunLink is not in violation of the terms of the Credit Waiver Agreement.

Note 10. Income Taxes

Income tax benefit of $810 ($1,005 federal tax benefit and $195 state tax expense) and income tax expense of $583 ($526 federal tax expense and $57 state tax expense) was recorded for the three months ended September 30, 2010 and 2009, respectively.

We had an estimated net operating loss carry-forward for federal income tax purposes of approximately $6,150 at September 30, 2010. Use of this net operating loss carry-forward is subject to the limitations of the provisions of Internal Revenue Code Section 382. As a result, not all of the net operating loss carry-forward is available to offset federal taxable income in the current year. At September 30, 2010, we have provided a partial valuation allowance against the domestic deferred tax asset so that the net domestic tax asset was $4,127. Based upon management s assessment that it was more likely than not that a portion of its domestic deferred tax asset (primarily its domestic net operating losses subject to limitation) would not be recovered, the Company established a valuation allowance for the portion of the domestic tax asset which may not be utilized. The Company has provided a valuation allowance for the entire amount of the foreign tax asset as it is more likely than not that none of the foreign deferred tax assets will be realized through future taxable income or implementation of tax planning strategies.

The Company accounts for uncertainty in income taxes for a change in judgment related to prior years tax positions in the quarter of such change. Activity in the unrecognized tax benefit liability account is as follows from July 1, 2008 through September 30, 2010:

Balance at July 1, 2008	$ 58
Additions based on tax positions related to current year	31
Reduction for tax positions of prior years	(23)
Balance at June 30, 2009	66
Additions based on tax positions related to current year	35
Reduction for tax positions of prior years	(30)
Balance at June 30, 2010	71
Additions based on tax positions related to current year	18
Reduction for tax positions of prior years	(8)
Balance at September 30, 2010	$ 81

SunLink or one or more of our subsidiaries files income tax returns with the United States and various states in the United States. We are not currently subject to U.S. federal, state or local, or non-U.S. income tax examinations by tax authorities for any tax years. We therefore believe that there is no tax jurisdiction in which the outcome of unresolved issues or claims is likely to be material to our financial position, cash flows or results of operations. We further believe that we have made adequate provision for all income tax uncertainties.

At July 1, 2010, our unrecognized tax benefits, the aggregate tax effect of differences between tax return positions and the benefits recognized in our financial statements as shown above, amounted to $71. If recognized, all of our unrecognized tax benefits would not reduce our income tax expense or effective tax rate except as such recognition related to the removal of the liability associated with interest classified as income tax expense. No portion of any such reduction might be reported as discontinued operations. During fiscal year 2011, certain factors could potentially reduce our unrecognized tax benefits, either because of the expiration of open statutes of limitation or modifications to our intercompany accounting policies and procedures. Of these tax positions, none relate to positions that would affect our total tax provision or effective tax rate (except as such recognition related to the removal of the liability associated with interest classified as income tax expense).

We classify interest on tax deficiencies as tax expense and classify income tax penalties as tax expense. At September 30, 2010, before any tax benefits, our accrued interest on unrecognized tax benefits amounted to $18 and we had recorded no related accrued penalties.

Note 11. Noncontrolling Interest

On February 1, 2008, SunLink sold 17% of the Chilton Medical Center in Clanton, Alabama, to individual physicians, most of whom practice at that facility. The noncontrolling interest reported reflects these physicians ownership interest at September 30, 2010. The results of operations for the period from February 1, 2008 to September 30, 2010 were a loss and did not impact the ownership interest of the physicians or the corporation. On July 1, 2009, SunLink sold 49% of the pharmacy operations subsidiary in Ellijay, Georgia, to an unaffiliated buyer. In December 2007, the FASB issued new guidance relating to accounting for noncontrolling interests in consolidated financial statements and requires that noncontrolling interest in subsidiaries be reported in the equity section of the controlling company s balance sheet. The Company adopted this guidance on July 1, 2009.

Note 12. Comprehensive Earnings

Our comprehensive earnings may include foreign currency translation adjustments and change in minimum pension liability. Foreign currency translation adjustment results primarily from the effect of changes in the exchange rates of the UK pound on our reserve for claims in connection with our former Housewares Segment (See Note 4. - Discontinued Operations).

Total comprehensive earnings for the following periods were as follows:

	Three Months Ended	
	September 30, 2010	September 30, 2009
Net earnings (loss)	$ (2,769)	$ 496
Other comprehensive income net of tax:		
Change in equity due to:		
Foreign currency translation adjustments		24
Comprehensive earnings	$ (2,769)	$ 520

Note 13. Commitments and Contingencies

Legal Proceedings

On December 7, 2007, Southern Health Corporation of Ellijay, Inc. (SHC-Ellijay), a SunLink subsidiary, filed a Complaint against James P. Garrett and Roberta Mundy, both individually and as Fiduciary of the Estate of Randy Mundy (collectively, Defendants), seeking specific performance of an Option Agreement (the Option Agreement) dated April 17, 2007, between SHC-Ellijay, Mr. Garrett, and Ms. Mundy as Executrix of the Estate of Randy Mundy for the sale of approximately 24.74 acres of real property located in Gilmer County, Georgia, and recovery of SHC-Ellijay s damages suffered as a result of Defendants failure to close the transaction in accordance with the Option Agreement. SHC-Ellijay also stated alternative claims for breach of the Option Agreement and fraud, along with claims to recover attorney s fees and punitive damages.

In January 2008, the Mundys filed a motion to strike, motion to dismiss, answer, affirmative defenses, and a counterclaim against SHC-Ellijay. On March 3, 2009, SHC-Ellijay filed a First Amended and Restated Complaint for Damages, which effectively dropped the cause of action for specific performance of the Option Agreement. On May 7, 2009, Mr. Garrett and Ms. Mundy served a motion for summary judgment on all counts and causes of action stated in the First Amended Complaint. The court has postponed consideration of the defendants motion for summary judgment and SHC-Ellijay s response thereto until after a discovery dispute between the parties has been resolved.

SunLink denies that it has any liability to the Mundys and intends to vigorously defend the claims asserted against SunLink by the Mundys complaint and to vigorously pursue its claims against the Mundys. While the ultimate outcome and materiality of the litigation cannot be determined, in management s opinion the litigation will not have a material adverse effect on SunLink s financial condition or results of operations.

SunLink is a party to claims and litigation incidental to its business, for which it is not currently possible to determine the ultimate liability, if any. Based on an evaluation of information currently available and consultation with legal counsel, management believes that resolution of such claims and litigation is not likely to have a material effect on the financial position, cash flows, or results of operations of the Company. The Company expenses legal costs as they are incurred.

Contractual Obligations, Commitments and Contingencies

Contractual obligations, commitments and contingencies related to long-term debt, non-cancelable operating leases, physician guarantees and interest (including 2008 Credit Agreement waiver fees and scheduled increases in interest rates) on outstanding debt from continuing operations at September 30, 2010 were as follows:

Payments due in:	**Long-Term Debt**	**Subordinated Long-Term Debt**	**Operating Leases**	**Physician Guarantees**	**Interest On Outstanding Debt**	**Interest On Subordinated Outstanding Debt**
1 year (2011)	$ 30,448	$ 300	$ 3,143	$ 140	$ 5,386	$ 192
2 years (2012)	11	300	1,243		1	168
3 years (2013)	9	300	714			144
4 years (2014)		300	506			120
5 years (2015)		1,350	423			108
5 years +			880			
	$ 30,468	$ 2,550	$ 6,909	$ 140	$ 5,387	$ 732

At September 30 2010, SunLink had contracts with two physicians which contained guaranteed minimum gross receipts. A physician with whom a guarantee agreement is made generally agrees to maintain his/her practice within the hospital geographic area for a specific period (normally three years) or be liable to repay all or a portion of the guarantee received. The physician s liability for any guarantee repayment due to non-compliance with guarantee provisions generally is collateralized by the physician s patient accounts receivable and/or a promissory note from the physician. Included in the Company s consolidated balance sheet at September 30, 2010 is a liability of $18 for two physician guarantees. SunLink expensed $89 and $227 on physician guarantees and recruiting for the three months ended September 30, 2010 and 2009, respectively. The table above shows non-cancelable commitments under physician guarantee contracts as of September 30, 2010.

Note 14. Related Party Transactions

A director of the Company and our company secretary (who was a director of SunLink until November 2003 and is now a director emeritus) are members of two different law firms, each of which provides services to SunLink. The Company has paid an aggregate of $267 and $183 for legal services to these law firms in the three months ended September 30, 2010 and 2009, respectively.

Note 15. Financial Information By Segments

Under ASC Topic No. 280, Segment Reporting, operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision-making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision-making group is composed of the chief executive officer and members of senior management. Our two reportable operating segments are Healthcare Facilities and Specialty Pharmacy.

We evaluate performance of our operating segments based on revenue and operating income (loss). Segment information for the quarters ended September 30, 2010 and 2009 is as follows:

2010	**Healthcare Facilities**	**Specialty Pharmacy**	**Corporate And Other**	**Total**
Net Revenues from external customers	$ 35,302	$ 8,902	$	$ 44,204
Operating loss	(1,132)	(205)	(1,271)	(2,608)
Depreciation and amortization	1,090	388	115	1,593
Assets	57,785	25,335	14,609	97,729
Expenditures for property, plant and equipment	322	171	72	565

2009	**Healthcare Facilities**	**Specialty Pharmacy**	**Corporate And Other**	**Total**
Net Revenues from external customers	$ 38,041	$ 10,026	$	$ 48,067
Operating income (loss)	3,038	291	(1,281)	2,048
Depreciation and amortization	1,157	397	108	1,662
Assets	64,583		we also could be subject to the federal alternative minimum tax and possibly increased state and local taxes; and	

unless we are entitled to relief under applicable statutory provisions, we could not elect to be taxed as a REIT for four taxable years following the year during which we were disqualified.

Any such corporate tax liability could be substantial and would reduce our cash available for, among other things, our operations and distributions to stockholders. In addition, if we fail to qualify as a REIT, we will not be required to make distributions to our stockholders. As a result of all these factors, our failure to qualify as a REIT also could impair our ability to expand our business and raise capital, and could materially and adversely affect the value of our common stock.

Qualification as a REIT involves the application of highly technical and complex Code provisions for which there are only limited judicial and administrative interpretations. The complexity of these provisions and of the applicable Treasury regulations that have been promulgated under the Code, or the Treasury Regulations, is greater in the case of a REIT that, like us, holds its assets through a partnership. The determination of various factual matters and circumstances not entirely within our control may affect our ability to qualify as a REIT. In order to qualify as a REIT, we must satisfy a number of requirements, including requirements regarding the ownership of our stock, requirements regarding the composition of our assets and a requirement that at least 95% of our gross income in any year must be derived from qualifying sources, such as rents from real property. Also, we must make distributions to stockholders aggregating annually at least 90% of our REIT taxable income, excluding net capital gains. In addition, legislation, new regulations, administrative interpretations or court decisions may materially adversely affect our investors, our ability to qualify as a REIT for federal income tax purposes or the desirability of an investment in a REIT relative to other investments.

Even if we qualify as a REIT for federal income tax purposes, we may be subject to some federal, state and local income, property and excise taxes on our income or property and, in certain cases, a 100% penalty tax, in the event we sell property as a dealer. In addition, our taxable REIT subsidiaries will be subject to tax as regular corporations in the jurisdictions they operate.

If our Operating Partnership failed to qualify as a partnership for federal income tax purposes, we would cease to qualify as a REIT and suffer other adverse consequences.

We believe that our Operating Partnership will be treated as a partnership for federal income tax purposes. As a partnership, our Operating Partnership will not be subject to federal income tax on its income. Instead, each of its partners, including us, will be allocated, and may be required to pay tax with respect to, its share of our Operating Partnership s income. We cannot be assured, however, that the IRS will not challenge the status of our Operating Partnership or any other subsidiary partnership in which we own an interest as a partnership for federal income tax purposes, or that a court would not sustain such a challenge. If the IRS were successful in treating our operating partnership or any such other subsidiary partnership as an entity taxable as a corporation for federal income tax purposes, we would fail to meet the gross income tests and certain of the asset tests applicable to REITs and, accordingly, we would likely cease to qualify as a REIT. Also, the failure of our Operating Partnership or any subsidiary partnerships to qualify as a partnership could cause it to become subject to federal and state corporate income tax, which would reduce significantly the amount of cash available for debt service and for distribution to its partners, including us.

Our ownership of taxable REIT subsidiaries will be limited, and we will be required to pay a 100% penalty tax on certain income or deductions if our transactions with our taxable REIT subsidiaries are not conducted on arm s length terms.

We own an interest in one taxable REIT subsidiary, our TRS lessee, and may acquire securities in additional taxable REIT subsidiaries in the future. A taxable REIT subsidiary is a corporation other than a REIT in which a REIT directly or indirectly holds stock, and that has made a joint election with such REIT to be treated as a taxable REIT subsidiary. If a taxable REIT subsidiary owns more than 35% of the total voting power or value of the outstanding securities of another corporation, such other corporation will also be treated as a taxable REIT subsidiary. Other than some activities relating to lodging and health care facilities, a taxable REIT subsidiary may generally engage in any business, including the provision of customary or non-customary services to tenants of its parent REIT. A taxable REIT subsidiary is subject to federal income tax as a regular C corporation. In addition, a 100% excise tax will be imposed on certain transactions between a taxable REIT subsidiary and its parent REIT that are not conducted on an arm s length basis.

A REIT s ownership of securities of a taxable REIT subsidiary is not subject to the 5% or 10% asset tests applicable to REITs. Not more than 25% of our total assets may be represented by securities (including securities of one or more taxable REIT subsidiaries), other than those securities includable in the 75% asset test. We anticipate that the aggregate value of the stock and securities of our taxable REIT subsidiaries and other nonqualifying assets will be less than 25% of the value of our total assets, and we will monitor the value of these investments to ensure compliance with applicable ownership limitations. In addition, we intend to structure our transactions with our taxable REIT subsidiaries to ensure that they are entered into on arm s length terms to avoid incurring the 100% excise tax described above. There can be no assurance, however, that we will be able to comply with the 25% limitation or to avoid application of the 100% excise tax discussed above.

To maintain our REIT status, we may be forced to borrow funds during unfavorable market conditions, and the unavailability of such capital on favorable terms at the desired times, or at all, may cause us to curtail our investment activities and/or to dispose of assets at inopportune times, which could adversely affect our financial condition, results of operations, cash flow and per share trading price of our common stock.

To qualify as a REIT, we generally must distribute to our stockholders at least 90% of our REIT taxable income each year, excluding net capital gains, and we will be subject to regular corporate income taxes to the extent that we distribute less than 100% of our REIT taxable income each year. In addition, we will be subject to a 4% nondeductible excise tax on the amount, if any, by which distributions paid by us in any calendar year are less than the sum of 85% of our ordinary income, 95% of our capital gain net income and 100% of our undistributed income from prior years. In order to maintain our REIT status and avoid the payment of income and excise taxes, we may need to borrow funds to meet the REIT distribution requirements even if the then prevailing market conditions are not favorable for these borrowings. These borrowing needs could result from, among other things, differences in timing between the actual receipt of cash and inclusion of income for federal income tax purposes, or the effect of non-deductible capital expenditures, the creation of reserves or required debt or amortization payments. These sources, however, may not be available on favorable terms or at all. Our access to third-party sources of capital depends on a number of factors, including the market s perception of our growth potential, our current debt levels, the market price of our common stock, and our current and potential future earnings. We cannot assure you that we will have access to such capital on favorable terms at the desired times, or at all, which may cause us to curtail our investment activities and/or to dispose of assets at inopportune times, and could adversely affect our financial condition, results of operations, cash flow and per share trading price of our common stock.

We may in the future choose to pay dividends in our common stock, in which case you may be required to pay tax in excess of the cash you receive.

We may distribute taxable dividends that are payable in our stock. Under recent IRS guidance, up to 90% of any such taxable dividend with respect to calendar years through 2011, and in some cases declared as late as

December 31, 2012, could be payable in our stock. Taxable stockholders receiving such dividends will be required to include the full amount of the dividend as ordinary income to the extent of our current and accumulated earnings and profits for federal income tax purposes. As a result, a U.S. stockholder may be required to pay tax with respect to such dividends in excess of the cash received. If a U.S. stockholder sells the stock it receives as a dividend in order to pay this tax, the sales proceeds may be less than the amount included in income with respect to the dividend, depending on the market price of our stock at the time of the sale. Furthermore, with respect to non-U.S. stockholders, we may be required to withhold U.S. tax with respect to such dividends, including in respect of all or a portion of such dividend that is payable in stock. In addition, if a significant number of our stockholders determine to sell shares of our stock in order to pay taxes owed on dividends, such sales may have an adverse effect on the per share trading price of our common stock.

Dividends payable by REITs do not qualify for the reduced tax rates available for some dividends.

The maximum tax rate applicable to income from qualified dividends payable to U.S. stockholders that are individuals, trusts and estates is 15% through the end of 2012. Dividends payable by REITs, however, generally are not eligible for the 15% rate. Although these rules do not adversely affect the taxation of REITs or dividends payable by REITs, to the extent that the 15% rate continues to apply to regular corporate qualified dividends, investors who are individuals, trusts and estates may perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of the shares of REITs, including the per share trading price of our common stock.

The tax imposed on REITs engaging in prohibited transactions may limit our ability to engage in transactions which would be treated as sales for federal income tax purposes.

A REIT s net income from prohibited transactions is subject to a 100% penalty tax. In general, prohibited transactions are sales or other dispositions of property, other than foreclosure property, held primarily for sale to customers in the ordinary course of business. Although we do not intend to hold any properties that would be characterized as held for sale to customers in the ordinary course of our business, unless a sale or disposition qualifies under certain statutory safe harbors, such characterization is a factual determination and no guarantee can be given that the IRS would agree with our characterization of our properties or that we will always be able to make use of the available safe harbors.

Complying with REIT requirements may affect our profitability and may force us to liquidate or forgo otherwise attractive investments.

To qualify as a REIT, we must continually satisfy tests concerning, among other things, the nature and diversification of our assets, the sources of our income and the amounts we distribute to our stockholders. We may be required to liquidate or forgo otherwise attractive investments in order to satisfy the asset and income tests or to qualify under certain statutory relief provisions. We also may be required to make distributions to stockholders at disadvantageous times or when we do not have funds readily available for distribution. As a result, having to comply with the distribution requirement could cause us to: (1) sell assets in adverse market conditions; (2) borrow on unfavorable terms; or (3) distribute amounts that would otherwise be invested in future acquisitions, capital expenditures or repayment of debt. Accordingly, satisfying the REIT requirements could have an adverse effect on our business results, profitability and ability to execute our business plan. Moreover, if we are compelled to liquidate our investments to meet any of these asset, income or distribution tests, or to repay obligations to our lenders, we may be unable to comply with one or more of the requirements applicable to REITs or may be subject to a 100% tax on any resulting gain if such sales constitute prohibited transactions.

Table of Contents

Legislative or other actions affecting REITs could have a negative effect on us, including our ability to qualify as a REIT or the federal income tax consequences of such qualification.

The rules dealing with federal income taxation are constantly under review by persons involved in the legislative process and by the IRS and the U.S. Department of the Treasury. Changes to the tax laws, with or without retroactive application, could adversely affect our investors or us. We cannot predict how changes in the tax laws might affect our investors or us. New legislation, Treasury Regulations, administrative interpretations or court decisions could significantly and negatively affect our ability to qualify as a REIT or the federal income tax consequences of such qualification.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

Table of Contents

ITEM 2. PROPERTIES
Our Portfolio

As of December 31, 2011, our operating portfolio was comprised of 21 retail, office, multifamily and mixed-use properties with an aggregate of approximately 5.3 million rentable square feet of retail and office space (including mixed-use retail space), 922 residential units (including 122 RV spaces) and a 369-room hotel. Additionally, as of December 31, 2011, we owned land at five of our properties that we classified as held for development.

Retail and Office Portfolios

Property	Location	Year Built/ Renovated	Number of Buildings	Net Rentable Square Feet	Percentage Leased	Annualized Base Rent	Annualized Base Rent Per Leased Square Foot
RETAIL PROPERTIES							
Carmel Country Plaza	San Diego, CA	1991	9	78,098	93.2%	$ 3,243,397	$ 44.56
Carmel Mountain Plaza (1)	San Diego, CA	1994	13	520,228	90.6	8,957,952	19.01
South Bay Marketplace (1)	San Diego, CA	1997	9	132,873	100.0	2,072,901	15.60
Rancho Carmel Plaza	San Diego, CA	1993	3	30,421	81.1	761,525	30.87
Lomas Santa Fe Plaza	Solana Beach, CA	1972/1997	9	209,569	96.9	5,219,694	25.70
Solana Beach Towne Centre	Solana Beach, CA	1973/2000/2004	12	246,730	97.3	5,361,639	22.33
Del Monte Center (1)	Monterey, CA	1967/1984/2006	16	674,224	97.5	8,805,222	13.39
The Shops at Kalakaua	Honolulu, HI	1971/2006	3	11,671	100.0	1,556,610	133.37
Waikele Center	Waipahu, HI	1993/2008	9	538,024	94.8	16,447,740	32.25
Alamo Quarry Market (1)	San Antonio, TX	1997/1999	16	589,501	94.1	11,611,355	20.93
Subtotal / Weighted Average			99	3,031,339	95.0%	$ 64,038,035	$ 22.24
OFFICE PROPERTIES							
Torrey Reserve	San Diego, CA	1996-2000	9	456,801	93.4%	$ 14,872,698	$ 34.86
Solana Beach Corporate Centre	Solana Beach, CA	1982/2005	4	211,971	89.7	6,114,179	32.16
160 King Street	San Francisco, CA	2002	1	167,986	100.0	5,949,114	35.41
The Landmark at One Market (2)	San Francisco, CA	1917/2000	1	421,934	100.0	18,397,224	43.60
First & Main	Portland, OR	2010	1	360,955	96.3	10,629,931	30.58
Lloyd District Portfolio	Portland, OR	1940-2011	6	610,081	90.2	12,070,105	21.93
Subtotal / Weighted Average Office			22	2,229,728	94.4%	$ 68,033,251	$ 32.32
Total / Weighted Average Retail and Office			**121**	**5,261,067**	**94.7%**	**$ 132,071,286**	**$ 26.51**

Mixed-Use Portfolio

Retail Portion	Location	Year Built/ Renovated	Number of Buildings	Net Rentable Square Feet	Percent Leased	Annualized Base Rent	Annualized Base Rent Per Leased Square Foot
Waikiki Beach Walk Retail (3)	Honolulu, HI	2006	3	96,569	99.2%	$ 9,489,208	$ 99.06

Hotel Portion	Location	Year Built/	Number of	Units	Average Occupancy	Average Daily Rate	Revenue per

			Renovated	Buildings				Available Room
Waikiki Beach Walk	Embasssy Suites	Honolulu, HI	2008	2	369	88.4%	$ 239.46	$ 211.57

37

Table of Contents

Multifamily Portfolio

Property	Location	Year Built/ Renovated	Number of Buildings	Units	Percentage Leased	Annualized Base Rent	Average Monthly Base Rent per Leased Unit
Loma Palisades	San Diego, CA	1958/2001-2008	80	548	94.5%	$ 9,882,012	$ 1,590
Imperial Beach Gardens	Imperial Beach, CA	1959/2008-present	26	160	94.4	2,510,604	1,385
Mariner s Point	Imperial Beach, CA	1986	8	88	95.5	1,130,712	1,121
Santa Fe Park RV Resort (4)	San Diego, CA	1971/2007-2008	1	126	74.0	740,124	661
Total / Weighted Average Multifamily			**115**	**922**	**91.8%**	**$ 14,263,452**	**$ 1,404**

(1) Net rentable square feet at certain of our retail properties includes square footage leased pursuant to ground leases, as described in the following table:

Property	Number of Ground Leases	Square Footage Leased Pursuant to Ground Leases	Aggregate Annualized Base Rent
Carmel Mountain Plaza	6	127,112	$ 1,020,900
South Bay Marketplace	1	2,824	$ 81,540
Del Monte Center	2	295,100	$ 201,291
Alamo Quarry Market	4	31,994	$ 428,250

(2) This property contains 421,934 net rentable square feet consisting of The Landmark at One Market (377,714 net rentable square feet) as well as a separate long-term leasehold interest in approximately 44,220 net rentable square feet of space located in an adjacent six-story leasehold known as the Annex. We currently lease the Annex from an affiliate of the Paramount Group pursuant to a long-term master lease effective through June 30, 2016, which we have the option to extend until 2026 pursuant to two five-year extension options.

(3) Waikiki Beach Walk Retail contains 96,569 net rentable square feet consisting of 93,955 net rentable square feet that we own in fee and approximately 2,614 net rentable square feet of space in which we have a subleasehold interest pursuant to a sublease from First Hawaiian Bank effective through December 31, 2021.

(4) The Santa Fe Park RV Resort is subject to seasonal variation, with higher rates of occupancy occurring during the summer months. The number of units at the Santa Fe Park RV Resort includes 122 RV spaces and four apartments.

In the tables above:

The net rentable square feet for each of our retail properties and the retail portion of our mixed-use property is the sum of (1) the square footages of existing leases, plus (2) for available space, the field-verified square footage. The net rentable square feet for each of our office properties is the sum of (1) the square footages of existing leases, plus (2) for available space, management s estimate of net rentable square feet based, in part, on past leases. The net rentable square feet included in such office leases is generally determined consistently with the Building Owners and Managers Association, or BOMA, 1996 measurement guidelines.

Percentage leased for each of our retail and office properties and the retail portion of the mixed-use property is calculated as square footage under leases as of December 31, 2011, divided by net rentable square feet, expressed as a percentage. The square footage under lease includes leases which may not have commenced as of December 31, 2011. Percentage leased for our multifamily properties is calculated as total units rented as of December 31, 2011, divided by total units available, expressed as a percentage.

Annualized base rent is calculated by multiplying base rental payments (defined as cash base rents, before abatements) for the month ended December 31, 2011, by 12. Annualized base rent per leased

38

square foot is calculated by dividing annualized base rent, by square footage under lease as of December 31, 2011. In the case of triple net or modified gross leases, annualized base rent does not include tenant reimbursements for real estate taxes, insurance, common area or other operating expenses. Total abatements for leases in effect as of December 31, 2011 for our retail and office portfolio equaled approximately $4.1 million for the year ended December 31, 2011. There were no abatements for the retail portion of our mixed-use portfolio for the year ended Decemeber 31, 2011. Total abatements for leases in effect as of December 31, 2011 for our multifamily portfolio equaled approximately $0.3 million for the year ended December 31, 2011.

Units represent the total number of units available for sale/rent at December 31, 2011.

Average occupancy represents the percentage of available units that were sold during the 12-month period ended December 31, 2011, and is calculated by dividing the number of units sold by the product of the total number of units and the total number of days in the period. Average daily rate represents the average rate paid for the units sold and is calculated by dividing the total room revenue (i.e., excluding food and beverage revenues or other hotel operations revenues such as telephone, parking and other guest services) for the 12-month period ended December 31, 2011, by the number of units sold. Revenue per available room, or RevPAR, represents the total unit revenue per total available units for the 12-month period ended December 31, 2011 and is calculated by multiplying average occupancy by the average daily rate. RevPAR does not include food and beverage revenues or other hotel operations revenues such as telephone, parking and other guest services.

Average monthly base rent per leased unit represents the average monthly base rent per leased units for the 12-month period ended December 31, 2011.

Table of Contents

Tenant Diversification

At December 31, 2011, our operating portfolio had approximately 705 leases with office and retail tenants, of which 7 expired on December 31, 2011 and 15 had not yet commenced. Our residential properties had approximately 753 leases with residential tenants at December 31, 2011, excluding Santa Fe Park RV Resort. The retail portion of our mixed-use property had approximately 64 leases with retailers. No one tenant or affiliated group of tenants accounted for more than 7.2% of our annualized base rent as of December 31, 2011 for our retail, office and retail portion of our mixed-use property portfolio. The following table sets forth information regarding the 25 tenants with the greatest annualized base rent for our combined retail, office and retail portion of our mixed-use property portfolios as of December 31, 2011.

Tenant	Property(ies)	Lease Expiration	Total Leased Square Feet	Rentable Square Feet as a Percentage of Total	Annualized Base Rent [1]	Annualized Base Rent as a Percentage of Total
salesforce.com, inc.	The Landmark at One Market	6/30/19 4/30/20 5/31/21	226,892	4.2%	$ 10,254,426	7.2%
Lowe s	Waikele Center	5/31/18	155,000	2.9	4,059,585	2.9
Kmart	Waikele Center	6/30/18	119,590	2.2	3,826,880	2.7
DLA Piper [2]	160 King Street	2/28/12	69,656	1.3	3,260,545	2.3
Veterans Benefits Administration	First & Main	8/31/20	93,572	1.7	3,006,453	2.1
Microsoft [3]	The Landmark at One Market	2/28/13 2/28/15	45,795	0.9	2,930,880	2.1
Autodesk [3]	The Landmark at One Market	12/31/15 12/31/17	68,869	1.3	2,847,100	2.0
Treasury Tax Administration [4]	First & Main	8/31/15	70,660	1.3	2,583,330	1.8
Insurance Company of the West	Torrey Reserve Campus	12/31/16	81,040	1.5	2,378,284	1.7
Foodland Super Market [5]	Waikele Center	1/25/14	50,000	0.9	2,337,481	1.7
Treasury Call Center [6]	First & Main	8/31/20	63,648	1.2	2,184,302	1.5
Sports Authority	Carmel Mountain Plaza,Waikele Center	11/30/13 7/18/13	90,722	1.7	2,076,602	1.5
Ross Dress for Less	South Bay Marketplace, Lomas Santa Fe Plaza, Carmel Mountain Plaza	1/31/13 1/31/14	81,125	1.5	1,595,826	1.1
Quiksilver	Waikiki Beach Walk	12/31/15	6,214	0.1	1,554,743	1.1
Integra Telecom Holdings, Inc.	Lloyd District Portfolio	1/31/14 5/31/14 3/31/16 12/31/20	62,640	1.2	1,460,651	1.0
California Bank & Trust	Torrey Reserve Campus	5/31/19 10/31/19	29,985	0.6	1,362,918	1.0
McDermott Will & Emery [7]	Torrey Reserve Campus	11/30/18	25,044	0.5	1,316,143	0.9
Portland Energy Conservation, Inc. [8]	First & Main	1/31/21	73,422	1.4	1,259,958	0.9
Old Navy	Waikele Center, Alamo Quarry Market, South Bay Marketplace	7/31/12 9/30/12 4/30/13	59,780	*	*	*
Vistage Worldwide, Inc.	Torrey Reserve Campus	6/30/13	36,980	0.7	1,175,964	0.8
Drug Enforcement Administration [9]	First & Main	8/31/25	31,376	0.6	1,170,062	0.8
Officemax	Alamo Quarry Market, Waikele Center	11/30/12 1/31/14	47,962	0.9	1,164,761	0.8
Brown & Toland	160 King Street	7/31/17	53,148	1.0	1,141,162	0.8

Marshalls	Solana Beach Towne Centre, Carmel Mountain Plaza	1/13/15 1/31/19	68,055	1.3	1,106,146	0.8
Wells Fargo	Torrey Reserve Campus	6/30/12 9/30/15	24,829	0.5	1,080,239	0.8
TOTAL			**1,736,004**	**31.4%**	**$ 57,134,441**	**40.3%**

* Data withheld at tenant s request.

40

(1) Annualized base rent is calculated by multiplying (i) base rental payments (defined as cash base rents before abatements) for the month ended December 31, 2011 for the applicable lease(s) by (ii) 12.
(2) DLA Piper has leased two floors of 160 King Street. DLA Piper has vacated this space in conjunction with its relocation to a new office building and will continue to pay rent on this space until the lease expires in February 2012. As part of DLA Piper s relocation, the manager of DLA Piper s new building is responsible for subleasing DLA Piper s vacated space in 160 King Street. We will continue to collect rent from DLA Piper through February 2012 regardless of whether the remaining space is subleased. Two tenants have signed agreements to lease this space beginning in May 2012.
(3) Autodesk has entered into leases to expand into the 45,795 square feet of space currently leased by Microsoft. Since December 2007, Autodesk has subleased 45,795 square feet of space leased to Microsoft at The Landmark at One Market. We have entered into a lease with Autodesk, for Autodesk to take over this space upon the termination of Microsoft s lease in December 2012 at an initial annualized base rent of $47.00 per square foot.
(4) The earliest option termination date under this lease is September 1, 2013.
(5) Foodland Super Market, Ltd. has ceased all operations in its leased premises and has subleased the premises to International Church of the Foursquare Gospel. Although we are currently collecting the rent for the leased premises, Foodland Super Market, Ltd. s lease expires in 2014 and it is unlikely that it will renew its lease with us. We expect to collect the full amount remaining under the lease in accordance with its terms; however, there can no assurances that we will do so.
(6) The earliest option termination date under this lease is September 1, 2017.
(7) McDermott Will & Emery has vacated this space in conjunction with its relocation to a new office building, and they have subleased a portion of this space. We will continue to collect rent from McDermott Will & Emery regardless of whether the remaining space is subleased. The lease has an early termination option on January 1, 2015.
(8) The earliest option termination date under this lease is February 1, 2016.
(9) The earliest option termination date under this lease is September 1, 2020.

Geographic Diversification

Our properties are located in Southern California, Northern California, Oregon, Hawaii and Texas. The following table shows the number of properties, the net rentable square feet and the percentage of total portfolio net rentable square footage in each region as of December 31, 2011. Our four multifamily properties are excluded from the table below and are all located in Southern California. The hotel portion of our mixed-use property is also excluded and is located in Hawaii.

Region	Number of Properties	Net Rentable Square Feet	Percentage of Net Rentable Square Feet (1)
Southern California	8	1,886,691	35.2%
Northern California	3	1,264,144	23.6
Oregon	2	971,036	18.1
Hawaii (2)	3	646,264	12.1
Texas	1	589,501	11.0
Total	**17**	**5,357,636**	**100.0%**

(1) Percentage of Net Rentable Square Feet is calculated based on the total net rentable square feet available in our retail portfolio, office portfolio and the retail portion of our mixed-use portfolio.
(2) Includes the retail portion related to the mixed-use property.

Table of Contents

Segment Diversification

The following table sets forth information regarding the total property operating income for each of our segments for the year ended December 31, 2011 (dollars in thousands).

Segment	Number of Properties	Property Operating Income	Percentage of Property Operating Income
Retail	10	$ 61,999	47.6%
Office	6	43,729	33.5
Mixed-Use	1	8,743	6.7
Multifamily	4	15,860	12.2
Total	**21**	**$ 130,331**	**100.0%**

Lease Expirations

The following table sets forth a summary schedule of the lease expirations for leases in place as of December 31, 2011, plus available space, for each of the ten calendar years beginning January 1, 2012 at the properties in our retail portfolio, office portfolio and the retail portion of our mixed-use portfolio. The square footage of available space includes the space from 7 leases that terminated on December 31, 2011. The lease expirations for our multifamily portfolio and the hotel portion of our mixed-use portfolio are excluded from this table because multifamily unit leases generally have lease terms ranging from 7 to 15 months, with a majority having 12-month lease terms, and because rooms in the hotel are rented on a nightly basis. The information set forth in the table assumes that tenants do not exercise any renewal options.

Year of Lease Expiration	Square Footage of Expiring Leases	Percentage of Portfolio Net Rentable Square Feet	Annualized Base Rent (1)	Percentage of Portfolio Annualized Base Rent	Annualized Base Rent Per Leased Square Foot (2)
Available	278,357	5.2%	$	%	$
Month to Month	48,482	0.9	792,985	0.6	16.36
2012	476,863	8.9	13,158,665	9.3	27.59
2013	728,764	13.6	20,390,211	14.4	27.98
2014	598,420	11.2	17,613,095	12.4	29.43
2015	603,801	11.3	18,374,046	13.0	30.43
2016	408,219	7.6	14,264,531	10.1	34.94
2017	255,562	4.8	9,165,804	6.5	35.87
2018	821,691	15.3	14,803,334	10.5	18.02
2019	291,093	5.4	12,328,844	8.7	42.35
2020	361,457	6.7	9,703,679	6.8	26.85
2021	189,448	3.5	6,836,295	4.8	36.09
Thereafter	169,289	3.2	4,129,005	2.9	24.39
Signed Leases Not Commenced	126,190	2.4			
Total:	**5,357,636**	**100.0%**	**$ 141,560,494**	**100.0%**	**$ 26.42**

(1) Annualized base rent is calculated by multiplying base rental payments (defined as cash base rents (before abatements)) for the month ended December 31, 2011 for the leases expiring during the applicable period, by 12.
(2) Annualized base rent per leased square foot is calculated by dividing annualized base rent for leases expiring during the applicable period, by square footage under such expiring leases.

42

Table of Contents

ITEM 3. LEGAL PROCEEDINGS

We are not currently a party, as plaintiff or defendant, to any legal proceedings that we believe to be material or which, individually or in the aggregate, would be expected to have a material effect on our business, financial condition or results of operation if determined adversely to us. We may be subject to on-going litigation, including existing claims relating to American Assets, Inc. certain prior direct and indirect owners of our portfolio and the properties comprising our portfolio and we expect to otherwise be party from time to time to various lawsuits, claims and other legal proceedings that arise in the ordinary course of our business.

In addition, American Assets, Inc. (which is a prior investor in our properties and a participant in the Formation Transactions), the Rady Trust and Mr. Rady are subject to on-going litigation filed in California Superior Court in 2009 by four direct and indirect stockholders of American Assets, Inc., alleging, among other things that Mr. Rady breached his fiduciary duties to the plaintiffs in his capacity as an officer, director and controlling shareholder of American Assets, Inc. The claims brought by the plaintiffs include direct and derivative claims for an accounting, injunctive and declaratory relief, and involuntary dissolution of American Assets, Inc., in addition to claims for an unspecified amount of damages. In order to obtain authorization to effectuate the Formation Transactions, we solicited the consent of the prior investors in our properties pursuant to a confidential private placement memorandum. In response to this solicitation, each of the three prior investors who is also a plaintiff in this matter provided his or her consent to the Formation Transactions and, in connection therewith, agreed to waive any claims against us for alleged breaches of fiduciary by Mr. Rady in his capacity as a director, officer or stockholder of American Assets, Inc.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

Table of Contents

PART II

ITEM 5. MARKET FOR OUR COMMON EQUITY AND RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Shares of our common stock began trading on the NYSE under the symbol AAT on January 13, 2011. Prior to that time there was no public market for our common stock. On March 7, 2012, the reported close sale price per share was $21.49.

Period	Per Share Price Low	Per Share Price High	Dividend per Common Share
First Quarter (January 13 March 31) 2011	$ 20.45	$ 22.00	$ 0.17
Second Quarter 2011	$ 21.10	$ 23.34	$ 0.21
Third Quarter 2011	$ 17.73	$ 23.25	$ 0.21
Fourth Quarter 2011	$ 16.47	$ 21.66	$ 0.21

On March 7, 2012, we had 51 stockholders of record of our common stock. Certain shares are held in street name and accordingly, the number of beneficial owners of such shares is not known or included in the foregoing number.

Distribution Policy

We pay and intend to continue to pay regular quarterly dividends to holders of our common stock and to make dividend distributions that will enable us to meet the distribution requirements applicable to REITs and to eliminate or minimize our obligation to pay income and excise taxes. Dividend amounts depend on our available cash flows, financial condition and capital requirements, the annual distribution requirements under the REIT provisions of the Code and such other factors as our board of directors deems relevant.

Recent Sales of Unregistered Equity Securities; Use of Proceeds from Registered Securities

On January 19, 2011, we completed our initial public offering, a sale of 31,625,000 shares of common stock at an offering price of $20.50 per share pursuant to (1) a Registration Statement on Form S-11, as amended (Reg. No. 333-169326) that was declared effective by the SEC on January 12, 2011 and (2) an immediately effective Registration Statement on Form S-11 (Reg. No. 333-171680) filed with the SEC on January 13, 2011 pursuant to Rule 462(b) of the Securities Act. Merrill Lynch, Pierce, Fenner & Smith Incorporated, Wells Fargo Securities, LLC and Morgan Stanley & Co. Incorporated acted as joint book-running managers for our initial public offering and as representatives of the underwriters. We received net proceeds from our initial public offering of approximately $594.6 million, reflecting the gross proceeds of $648.3 million, net of underwriting fees of $45.4 million and offering expenses of $8.3 million.

We contributed the net proceeds of our initial public offering to our Operating Partnership in exchange for common units and our Operating Partnership used the net proceeds received from us as described below:

- approximately $342.0 million to repay in full certain outstanding indebtedness, including applicable prepayment costs, exit fees and defeasance costs of $24.3 million;

- $10.8 million for loan transfer and consent fees and credit facility origination fees;

- approximately $6.1 million to pay non-accredited prior investors in connection with the Formation Transactions;

- approximately $1.2 million for tenant improvements and leasing commissions at The Landmark at One Market; and approximately $0.9 million for the renovation of Solana Beach Towne Centre.

Table of Contents

On March 11, 2011, we used approximately $129.0 million of the net proceeds to acquire First & Main and on July 1, 2011 we used approximately $92.0 million of the net proceeds to acquire Lloyd District Portfolio.

Of the remaining proceeds, we intend to use (1) up to $7.3 million for additional tenant improvements at The Landmark at One Market; and (2) the remainder for general corporate purposes, including working capital, future acquisitions, transfer taxes and, potentially, paying distributions. This use of proceeds does not represent a material change from the use of proceeds described in the final prospectus we filed pursuant to Rule 424(b) of the Securities Act with the SEC on January 14, 2011.

We invested the net proceeds in a money market account and Government National Mortgage Association, or GNMA, securities in a manner that is consistent with our intention to qualify as a REIT for U.S. federal income tax purposes.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

No equity securities were purchased by us during 2011.

Equity Compensation Plan Information

Information about our equity compensation plans is incorporated by reference in Item 12 of Part III of this annual report on Form 10-K.

Table of Contents

Stock Performance Graph

The information below shall not be deemed to be soliciting material or to be filed with the SEC or subject to Regulation 14A or 14C, other than as provided in Item 201 of Regulation S-K, or to the liabilities of Section 18 of the Exchange Act, except to the extent we specifically request that such information be treated as soliciting material or specifically incorporate it by reference into a filing under the Securities Act or the Exchange Act.

The following graph shows our cumulative total stockholder return for the period beginning with the initial listing of our common stock on the NYSE on January 13, 2011 and ending on December 31, 2011. The graph assumes a $100 investment in each of the indices on January 13, 2011 and the reinvestment of all dividends. The graph also shows the cumulative total returns of the Standard & Poor s 500 Stock Index, or S&P 500 Index, and an industry peer group, SNL US REIT Equity Index. Note that historic stock price performance is not necessarily indicative of future stock price performance.

			Period Ending		
Index	**1/31/2011**	**3/31/2011**	**6/30/2011**	**9/30/2011**	**12/31/2011**
American Assets Trust, Inc.	100.00	100.92	107.57	86.96	100.41
S&P 500 Index	100.00	103.69	103.80	89.40	99.97
SNL US REIT Equity Index	100.00	106.67	110.08	93.40	107.91

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth summary selected financial and operating data on a historical combined basis for our Predecessor prior to our initial public offering and a consolidated basis for American Assets Trust, Inc. subsequent to our initial public offering. Our Predecessor was comprised of certain entities and their consolidated subsidiaries that, prior to the completion of the Formation Transactions, owned directly or indirectly 17 retail, office and multifamily properties, and unconsolidated equity interests in four retail, mixed-use and office properties. We refer to these entities and their subsidiaries as the ownership entities. Prior to the completion of the Formation Transactions, each of the ownership entities owned, directly or indirectly, one or more retail, office, mixed-use or multifamily property. Upon completion of our initial public offering and the Formation

46

Table of Contents

Transactions, we acquired the 17 retail, office and multifamily properties owned directly or indirectly by our Predecessor, as well as our Predecessor s unconsolidated equity interests in three other retail, office and mixed-use properties, and assumed the ownership and operation of its business. As a result of the completion of the Formation Transactions we have acquired direct or indirect ownership of a total of 20 retail, office, mixed-use and multifamily properties. Subsequently, we sold one office property and acquired two other office properties.

You should read the following summary selected financial data in conjunction with Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations and Item 8. Financial Statements and Supplementary Data. The following data is in thousands, except per share and share data.

	American Assets Trust, Inc.	Predecessor			
		Year Ended December 31,			
	2011	2010	2009	2008	2007
Statement of Operations Data:					
Revenue:					
Rental income	$ 199,741	$ 120,749	$ 108,648	$ 112,791	$ 109,558
Other property income	10,082	3,778	3,938	3,834	4,173
Total revenues	209,823	124,527	112,586	116,625	113,731
Expenses:					
Rental expenses	59,937	22,150	19,400	21,055	20,905
Real estate taxes	19,555	12,488	7,950	10,546	10,558
General and administrative	13,916	8,766	7,023	8,670	10,452
Depreciation and amortization	57,639	36,356	28,473	29,648	30,121
Total operating expenses	151,047	79,760	62,846	69,919	72,036
Operating income	58,776	44,767	49,740	46,706	41,695
Interest expense	(56,487)	(45,375)	(42,034)	(42,326)	(41,664)
Early extinguishment of debt	(25,867)				
Loan transfer and consent fees	(9,019)				
Gain on acquisition	46,371	4,297			
Other income (expense), net	470	(1,846)	(2,961)	(16,584)	(2,037)
Income (loss) from continuing operations	14,244	1,843	4,745	(12,204)	(2,006)
Discontinued operations:					
Income (loss) from discontinued operations	1,099	331	494	(1,926)	(2,669)
Gain on sale of real estate property	3,981			2,625	
Results from discontinued operations	5,080	331	494	699	(2,669)
Net income (loss)	19,324	2,174	5,239	(11,505)	(4,675)
Net income attributable to restricted shares	(482)				
Net loss attributable to Predecessor s noncontrolling interests in consolidated real estate entities	2,458	2,205	1,205	4,488	2,140
Net (income) loss attributable to Predecessor s controlled owners equity	(16,995)	(4,379)	(6,444)	7,017	2,535
Net income attributable to unitholders in the Operating Partnership	(1,388)				
Net income attributable to American Assets Trust, Inc. stockholders	$ 2,917	$	$	$	$
Loss from continuing operations attributable to common stockholders per share					
Basic earnings per share	$ (0.01)				
Diluted earnings per share	$ (0.01)				

Net income attributable to common stockholders per share	
Basic earnings per share	$ 0.08
Diluted earnings per share	$ 0.08
Weighted average shares of common stock outstanding basic	36,748,806
Weighted average shares of common stock outstanding diluted	54,219,807
Dividends declared per share	$ 0.80

47

Table of Contents

	American Assets Trust, Inc.	Predecessor Year Ended December 31,			
	2011	2010	2009	2008	2007
Balance Sheet Data:					
Net real estate	$ 1,452,681	$ 917,171	$ 747,746	$ 765,843	$ 774,736
Total assets	1,709,281	1,117,357	938,991	971,118	1,039,909
Notes payable	943,479	871,964	720,728	731,067	705,419
Total liabilities	1,029,553	962,236	768,028	781,944	763,717
Stockholders equity and owner s equity	626,031	121,874	133,173	148,864	215,311
Noncontrolling interests	53,697	33,247	37,790	40,310	60,881
Total equity	679,728	155,121	170,963	189,174	276,192
Total liabilities and equity	1,709,281	1,117,357	938,991	971,118	1,039,909
Other Data:					
Funds from operations (FFO) [1]	74,574	55,120	51,840	47,421	40,101