

UNIVERSAL HEALTH REALTY INCOME TRUST

Form 10-Q

November 07, 2013

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from _____ to _____

Commission file number 1-9321

UNIVERSAL HEALTH REALTY
INCOME TRUST

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(Exact name of registrant as specified in its charter)

MARYLAND
(State or other jurisdiction of

23-6858580
(I. R. S. Employer

incorporation or organization)

Identification No.)

UNIVERSAL CORPORATE CENTER

367 SOUTH GULPH ROAD

KING OF PRUSSIA, PENNSYLVANIA
(Address of principal executive offices)

19406
(Zip Code)

Registrant's telephone number, including area code (610) 265-0688

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

Indicate by check mark whether the registrant 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 shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

Large accelerated filer ☐ Accelerated Filer ☒

Non-accelerated filer ☐ Smaller reporting company ☐

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

Number of common shares of beneficial interest outstanding at October 31, 2013 - 12,701,613

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UNIVERSAL HEALTH REALTY INCOME TRUST

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This Quarterly Report on Form 10-Q is for the quarter ended September 30, 2013. In this Quarterly Report, we, us, our and the Trust refer to Universal Health Realty Income Trust and its subsidiaries.

As disclosed in this Quarterly Report, including in *Part I, Item 1. - Relationship with Universal Health Services, Inc. (UHS) and Related Party Transactions*, a wholly-owned subsidiary of UHS (UHS of Delaware, Inc.) serves as our Advisor pursuant to the terms of an annually renewable Advisory Agreement dated December 24, 1986. Our officers are all employees of UHS through UHS of Delaware, Inc. In addition, four of our hospital facilities are leased to subsidiaries of UHS and twelve medical office buildings, including certain properties owned by limited liability companies in which we either hold 100% of the ownership interest or various non-controlling, majority ownership interests, include or will include tenants which are subsidiaries of UHS. Any reference to UHS or UHS facilities in this report is referring to Universal Health Services, Inc.'s subsidiaries, including UHS of Delaware, Inc.

In this Quarterly Report, the term revenues does not include the revenues of the unconsolidated limited liability companies (LLCs) in which we have various non-controlling equity interests ranging from 33% to 95%. We currently account for our share of the income/loss from these investments by the equity method (see Note 5 to the Consolidated Financial Statements included herein).

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Part I. Financial Information

Item I. Financial Statements

Universal Health Realty Income Trust

Condensed Consolidated Statements of Income

For the Three and Nine Months Ended September 30, 2013 and 2012

(dollar amounts in thousands, except per share amounts)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Revenues:				
Base rental - UHS facilities	\$ 3,587	\$ 4,068	\$ 11,181	\$ 11,556
Base rental - Non-related parties	6,905	6,623	20,979	20,265
Bonus rental - UHS facilities	1,075	955	3,214	3,109
Tenant reimbursements and other - Non-related parties	1,782	1,816	5,091	5,341
Tenant reimbursements and other - UHS facilities	99	148	370	356
	13,448	13,610	40,835	40,627
Expenses:				
Depreciation and amortization	4,577	5,263	14,113	15,484
Advisory fees to UHS	603	540	1,759	1,594
Other operating expenses	3,636	3,578	11,045	11,244
Transaction costs	39	14	170	663
	8,855	9,395	27,087	28,985
Income before equity in income of unconsolidated limited liability companies (LLCs), interest expense and gain, net	4,593	4,215	13,748	11,642
Equity in income of unconsolidated LLCs	515	645	1,545	1,803
Gain on divestiture of property owned by an unconsolidated LLC, net	0	0	0	7,375
Interest expense, net	(1,805)	(1,874)	(5,622)	(5,853)
Net income	\$ 3,303	\$ 2,986	\$ 9,671	\$ 14,967
Basic earnings per share	\$ 0.26	\$ 0.24	\$ 0.76	\$ 1.18
Diluted earnings per share	\$ 0.26	\$ 0.24	\$ 0.76	\$ 1.18

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Weighted average number of shares outstanding - Basic	12,681	12,666	12,676	12,658
Weighted average number of share equivalents	13	10	14	7
Weighted average number of shares and equivalents outstanding - Diluted	12,694	12,676	12,690	12,665

See the accompanying notes to these condensed consolidated financial statements.

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Condensed Consolidated Balance Sheets

(dollar amounts in thousands)

(unaudited)

	September 30, 2013	December 31, 2012
Assets:		
Real Estate Investments:		
Buildings and improvements	\$ 367,101	\$ 374,416
Accumulated depreciation	(94,798)	(87,088)
	272,303	287,328
Land	27,559	27,058
Net Real Estate Investments	299,862	314,386
Investments in and advances to limited liability companies (LLCs)	39,209	28,636
Other Assets:		
Cash and cash equivalents	2,936	3,048
Base and bonus rent receivable from UHS	2,083	2,041
Rent receivable - other	3,089	2,783
Intangible assets (net of accumulated amortization of \$12.6 million and \$8.2 million at September 30, 2013 and December 31, 2012, respectively)	22,177	26,293
Deferred charges, goodwill and other assets, net	5,961	5,851
Total Assets	\$ 375,317	\$ 383,038
Liabilities:		
Line of credit borrowings	\$ 97,100	\$ 81,750
Mortgage and other notes payable, non-recourse to us (including net debt premium of \$942,000 and \$1.3 million at September 30, 2013 and December 31, 2012, respectively)	107,102	116,186
Accrued interest	470	539
Accrued expenses and other liabilities	4,686	4,920
Tenant reserves, escrows, deposits and prepaid rents	1,929	1,898
Total Liabilities	211,287	205,293
Equity:		
Preferred shares of beneficial interest, \$.01 par value; 5,000,000 shares authorized; none issued and outstanding	0	0
Common shares, \$.01 par value; 95,000,000 shares authorized; issued and outstanding: 2013 - 12,702,192; 2012 - 12,688,998	127	127
Capital in excess of par value	214,572	214,094
Cumulative net income	476,546	466,875
Cumulative dividends	(527,167)	(503,425)
Accumulated other comprehensive loss	(48)	0

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Total Universal Health Realty Income Trust Shareholders' Equity	164,030	177,671
Non-controlling equity interest	0	74
Total Equity	164,030	177,745
Total Liabilities and Equity	\$ 375,317	\$ 383,038

See the accompanying notes to these condensed consolidated financial statements.

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Condensed Consolidated Statement of Cash Flows

(dollar amounts in thousands)

(unaudited)

	Nine Months Ended September 30,	
	2013	2012
Cash flows from operating activities:		
Net income	\$ 9,671	\$ 14,967
<i>Adjustments to reconcile net income to net cash provided by operating activities:</i>		
Depreciation and amortization	14,181	15,484
Amortization on debt premium	(325)	(509)
Restricted/stock-based compensation expense	287	238
Gain on divestiture of property owned by an unconsolidated LLC	0	(7,375)
<i>Changes in assets and liabilities:</i>		
Rent receivable	(555)	(1,017)
Accrued expenses and other liabilities	75	(152)
Tenant reserves, escrows, deposits and prepaid rents	64	543
Accrued interest	(43)	68
Other, net	(352)	196
Net cash provided by operating activities	23,003	22,443
Cash flows from investing activities:		
Investments in LLCs	(2,593)	(1,677)
Repayments of advances made to LLCs	109	499
Advances made to LLCs	(4,431)	(8,000)
Cash distributions in excess of income from LLCs	1,775	2,622
Additions to real estate investments, net	(2,322)	(2,733)
Deposits on real estate assets	0	100
Net cash paid for acquisition of medical office buildings	(4,675)	(7,324)
Payment of assumed liabilities on acquired properties	0	(553)
Cash proceeds received from divestiture of property owned by an unconsolidated LLC, net	0	8,077
Net cash used in investing activities	(12,137)	(8,989)
Cash flows from financing activities:		
Net borrowings on line of credit	15,350	5,850
Proceeds from mortgages and other notes payable	11,150	7,000
Repayments of mortgages and other notes payable	(13,694)	(11,242)
Financing costs paid on mortgage and other notes payable	(95)	(524)
Dividends paid	(23,742)	(23,328)
Issuance of shares of beneficial interest, net	194	292
Net cash used in financing activities	(10,837)	(21,952)
Increase/(decrease) in cash and cash equivalents	29	(8,498)
Decrease in cash due to recording of LLC on unconsolidated basis	(141)	0

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Cash and cash equivalents, beginning of period	3,048	11,649
Cash and cash equivalents, end of period	\$ 2,936	\$ 3,151

Supplemental disclosures of cash flow information:

Interest paid	\$ 5,680	\$ 6,033
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Supplemental disclosures of non-cash transactions:

Deconsolidation of LLC:		
Net real estate investments	\$ 11,597	\$ 0
Cash and cash equivalents	141	0
Rent receivable - other	207	0
Deferred charges, goodwill and other assets, net	135	0
Mortgage and other notes payable, non-recourse to us	6,215	0
Accrued interest	26	0
Accrued expenses and other liabilities	342	0
Third-party equity interest	54	0

Investment in LLCs	\$ 5,443	\$ 0
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See accompanying notes to these condensed consolidated financial statements.

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UNIVERSAL HEALTH REALTY INCOME TRUST

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2013

(unaudited)

(1) General

This Quarterly Report on Form 10-Q is for the Quarterly Period ended September 30, 2013. In this Quarterly Report, we, us, our and the Trust refer to Universal Health Realty Income Trust.

You should carefully review all of the information contained in this Quarterly Report, and should particularly consider any risk factors that we set forth in this Quarterly Report and in other reports or documents that we file from time to time with the Securities and Exchange Commission (the SEC). In this Quarterly Report, we state our beliefs of future events and of our future financial performance. In some cases, you can identify those so-called forward-looking statements by words such as may, will, should, could, would, predicts, potential, continue, expect, future, intends, plans, believes, estimates, appears, projects and similar expressions, as well as statements in future tense. You should be aware that those statements are only our predictions. Actual events or results may differ materially. In evaluating those statements, you should specifically consider various factors, including the risks outlined herein and in our Annual Report on Form 10-K for the year ended December 31, 2012 in *Item 1A Risk Factors* and in *Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations - Forward Looking Statements*. Those factors may cause our actual results to differ materially from any of our forward-looking statements.

Our future results of operations could be unfavorably impacted by continued deterioration in general economic conditions which could result in increases in the number of people unemployed and/or uninsured. Should that occur, it may result in decreased occupancy rates at our medical office buildings as well as a reduction in the revenues earned by the operators of our hospital facilities which would unfavorably impact our future bonus rentals (on the Universal Health Services, Inc. hospital facilities) and may potentially have a negative impact on the future lease renewal terms and the underlying value of the hospital properties. Additionally, the general real estate market has been unfavorably impacted by the deterioration in economic and credit market conditions which may adversely impact the underlying value of our properties. The tightening in the credit markets and the instability in certain banking and financial institutions over the past several years has not had a material impact on us. However, there can be no assurance that unfavorable credit market conditions will not materially increase our cost of borrowings and/or have a material adverse impact on our ability to finance our future growth through borrowed funds.

In this Quarterly Report on Form 10-Q, the term revenues does not include the revenues of the unconsolidated limited liability companies (LLCs) in which we have various non-controlling equity interests ranging from 33% to 95%. We currently account for our share of the income/loss from these investments by the equity method (see Note 5). As of September 30, 2013, we had investments or commitments in thirteen jointly-owned LLCs, all of which are accounted for by the equity method as of September 30, 2013. Palmdale Medical Properties was consolidated in our financial statements through June 30, 2013. As previously disclosed, the master lease with a wholly-owned subsidiary of UHS related to Palmdale Medical Properties expired effective as of July 1, 2013 and, as of that date, we began accounting for Palmdale Medical Properties under the equity method.

The financial statements included herein have been prepared by us, without audit, pursuant to the rules and regulations of the SEC and reflect all normal and recurring adjustments which, in our opinion, are necessary to fairly present results for the interim periods. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although we believe that the accompanying disclosures are adequate to make the information presented not misleading. It is suggested that these financial statements be read in conjunction with the financial statements, the notes thereto and accounting policies included in our Annual Report on Form 10-K for the year ended December 31, 2012.

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

Leases: We commenced operations in 1986 by purchasing properties of certain subsidiaries from UHS and immediately leasing the properties back to the respective subsidiaries. Most of the leases were entered into at the time we commenced operations and provided for initial terms of 13 to 15 years with up to six additional 5-year renewal terms. The current base rentals and lease and rental terms for each facility are provided below. The base rents are paid monthly and each lease also provides for additional or bonus rents which are computed and paid on a quarterly basis based upon a computation that compares current quarter revenue to a corresponding quarter in the base year. The leases with subsidiaries

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of UHS are unconditionally guaranteed by UHS and are cross-defaulted with one another.

The combined revenues generated from the leases on the UHS hospital facilities comprised approximately 30% and 29% of our consolidated revenues for the three months ended September 30, 2013 and 2012, respectively, and approximately 30% of our consolidated revenues during each of the nine months ended September 20, 2013 and 2012. Including 100% of the revenues generated

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at the unconsolidated LLCs in which we have various non-controlling equity interests ranging from 33% to 95%, the leases on the UHS hospital facilities accounted for approximately 22% and 21% of the combined consolidated and unconsolidated revenue for the three-month periods ended September 30, 2013 and 2012, respectively, and 22% and 21% of the combined consolidated and unconsolidated revenue for the nine months ended September 30, 2013 and 2012, respectively. In addition, twelve MOBs, that are either wholly or jointly-owned, include or will include tenants which are subsidiaries of UHS.

Pursuant to the Master Lease Document by and among us and certain subsidiaries of UHS, dated December 24, 1986 (the "Master Lease"), which governs the leases of all hospital properties with subsidiaries of UHS, UHS has the option to renew the leases at the lease terms described below by providing notice to us at least 90 days prior to the termination of the then current term. In addition, UHS has rights of first refusal to: (i) purchase the respective leased facilities during and for 180 days after the lease terms at the same price, terms and conditions of any third-party offer, or; (ii) renew the lease on the respective leased facility at the end of, and for 180 days after, the lease term at the same terms and conditions pursuant to any third-party offer. UHS also has the right to purchase the respective leased facilities at the end of the lease terms or any renewal terms at the appraised fair market value. In addition, the Master Lease, as amended during 2006, includes a change of control provision whereby UHS has the right, upon one month's notice should a change of control of the Trust occur, to purchase any or all of the four leased hospital properties listed below at their appraised fair market value.

The table below details the existing lease terms and renewal options for each of the UHS hospital facilities, giving effect to the above-mentioned renewals:

Hospital Name	Type of Facility	Annual Minimum Rent	End of Lease Term	Renewal Term (years)
McAllen Medical Center	Acute Care	\$ 5,485,000	December, 2016	15(a)
Wellington Regional Medical Center	Acute Care	\$ 3,030,000	December, 2016	15(b)
Southwest Healthcare System, Inland Valley Campus	Acute Care	\$ 2,648,000	December, 2016	15(b)
The Bridgeway	Behavioral Health	\$ 930,000	December, 2014	10(c)

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

We have funded \$6.0 million in equity and member loans as of September 30, 2013, and are committed to fund an additional \$2.9 million, in exchange for a 95% non-controlling equity interest in an LLC (Palmdale Medical Properties) that constructed, owns, and operates the Palmdale Medical Plaza, located in Palmdale, California, on the campus of a UHS hospital. The LLC has a third-party term loan of \$6.2 million, which is non-recourse to us, outstanding as of September 30, 2013. As previously disclosed, through June 30, 2013, this MOB had a triple net, 75% master lease commitment by UHS of Palmdale, Inc., a wholly-owned subsidiary of UHS, pursuant to the terms of which the master lease for each suite would be cancelled at such time that the suite was leased to another tenant acceptable to the LLC and UHS of Palmdale, Inc. This MOB, tenants of which include subsidiaries of UHS, was completed and opened during the third quarter of 2008 at which time the master lease commenced. The master lease arrangement expired effective as of July 1, 2013, and although the expiration will have an unfavorable impact on our net income and funds from operations, we do not believe the impact will be material to our financial condition or liquidity. This LLC, which was deemed to be a variable interest entity during the term of the master lease, is consolidated in our financial statements through June 30, 2013 since we were the primary beneficiary through that date. Effective July 1, 2013, this LLC is no longer be deemed a variable interest entity and is accounted for in our financial statements on an unconsolidated basis pursuant to the equity method.

We have funded \$2.1 million in equity as of September 30, 2013, and are committed to fund an additional \$2.3 million, in exchange for a 95% non-controlling equity interest in an LLC (Texoma Medical Properties) that developed, constructed, owns and operates the Texoma Medical Plaza located in Denison, Texas, which was completed and opened during the first quarter of 2010. This MOB is located on the campus of a UHS acute care hospital which is owned and operated by Texoma Medical Center ("Texoma Hospital"), a wholly-owned subsidiary of UHS. This MOB has tenants that include subsidiaries of UHS. This LLC has a third-party term loan of \$12.6 million, which is non-recourse to us, outstanding as of September 30, 2013. As this LLC is not considered to be a variable interest entity, it is accounted for pursuant to the equity method.

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Advisory Agreement: UHS of Delaware, Inc. (the "Advisor"), a wholly-owned subsidiary of UHS, serves as Advisor to us under an Advisory Agreement (the "Advisory Agreement") dated December 24, 1986. Pursuant to the Advisory Agreement, the Advisor is obligated to present an investment program to us, to use its best efforts to obtain investments suitable for such program (although it is not obligated to present any particular investment opportunity to us), to provide administrative services to us and to conduct our day-to-day affairs. All transactions between us and UHS must be approved by the Trustees who are unaffiliated with UHS (the "Independent Trustees"). In performing its services under the Advisory Agreement, the Advisor may utilize independent professional services, including accounting, legal, tax and other services, for which the Advisor is reimbursed directly by us. The Advisory Agreement may be terminated for any reason upon sixty days written notice by us or the Advisor. The Advisory Agreement expires on December 31 of each year; however, it is renewable by us, subject to a determination by the Independent Trustees, that the Advisor's performance has been satisfactory. In December of 2012, based upon a review of our advisory fee and other general and administrative expenses, as compared to an industry peer group, the Advisory agreement was renewed for 2013 and, effective January 1, 2013, the fee was increased to 0.70% (from 0.65%) of our average invested real estate assets, as derived from our consolidated balance sheet.

The Advisory Agreement provides that the Advisor is entitled to receive an annual advisory fee equal to 0.70% of our average invested real estate assets, as derived from our consolidated balance sheet. The average real estate assets for advisory fee calculation purposes exclude certain items from our consolidated balance sheet such as, among other things, accumulated depreciation, cash and cash equivalents, base and bonus rent receivables, deferred charges and other assets. The advisory fee is payable quarterly, subject to adjustment at year-end based upon our audited financial statements. In addition, the Advisor is entitled to an annual incentive fee equal to 20% of the amount by which cash available for distribution to shareholders for each year, as defined in the Advisory Agreement, exceeds 15% of our equity as shown on our consolidated balance sheet, determined in accordance with generally accepted accounting principles without reduction for return of capital dividends. The Advisory Agreement defines cash available for distribution to shareholders as net cash flow from operations less deductions for, among other things, amounts required to discharge our debt and liabilities and reserves for replacement and capital improvements to our properties and investments. No incentive fees were paid during the first nine months of 2013 or 2012 since the incentive fee requirements were not achieved. Advisory fees incurred and paid (or payable) to UHS amounted to \$603,000 and \$540,000 for the three months ended September 30, 2013 and 2012, respectively, and were based upon average invested real estate assets of \$345 million and \$332 million for the three-month periods ended September 30, 2013 and 2012, respectively. Advisory fees incurred and paid (or payable) to UHS amounted to \$1.8 million and \$1.6 million for the nine months ended September 30, 2013 and 2012, respectively, and were based upon average invested real estate assets of \$335 million and \$327 million for the nine-month periods ended September 30, 2013 and 2012, respectively.

Officers and Employees: Our officers are all employees of UHS (through UHS of Delaware, Inc.) and although as of September 30, 2013 we had no salaried employees, our officers do receive stock-based compensation.

Share Ownership: As of September 30, 2013 and December 31, 2012, UHS owned 6.2% of our outstanding shares of beneficial interest.

SEC reporting requirements of UHS: UHS is subject to the reporting requirements of the SEC and is required to file annual reports containing audited financial information and quarterly reports containing unaudited financial information. Since the leases on the hospital facilities leased to wholly-owned subsidiaries of UHS comprised approximately 30% of our consolidated revenues during each of the three and nine months ended September 30, 2013 and 29% and 30% for the three and nine months ended September 30, 2012, respectively, and since a subsidiary of UHS is our Advisor, you are encouraged to obtain the publicly available filings for Universal Health Services, Inc. from the SEC's website at www.sec.gov. These filings are the sole responsibility of UHS and are not incorporated by reference herein.

(3) Dividends and Equity Issuance Program

We declared and paid dividends of \$7.9 million, or \$.625 per share, during the third quarter of 2013 and \$7.8 million, or \$.615 per share, during the third quarter of 2012. We declared and paid dividends of \$23.7 million, or \$1.87 per share, during the nine-month period ended September 30, 2013 and \$23.3 million, or \$1.84 per share, during the nine-month period ended September 30, 2012.

We filed a Registration Statement with the Securities and Exchange Commission which became effective in November 2012, under which we can offer up to an aggregate sales price of \$50 million of our securities pursuant to supplemental prospectuses which we may file from time to time. No offering will be made except pursuant to such supplemental prospectuses, and none have been made as of September 30, 2013.

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(4) Acquisitions, Dispositions and New Construction

Nine Months Ended September 30, 2013:

Acquisition:

On August 22, 2013, we purchased the Ward Eagle Office Village, a medical office building (MOB) located in Farmington Hills, Michigan. This multi-tenant MOB, which was purchased for approximately \$4.1 million, consists of approximately 16,282 rentable square feet. The net tangible and intangible property preliminary and estimated asset allocation of the total purchase price was recorded during the third quarter of 2013 and will be adjusted based upon their respective fair values at acquisition, subject to a third-party appraisal.

On June 6, 2013, we purchased the 5004 Poole Road MOB, located in Denison, Texas, on the campus of Texoma Medical Center, a wholly-owned subsidiary of UHS. This single-tenant MOB, which was purchased for approximately \$625,000, consists of approximately 4,400 rentable square feet and is located adjacent to our Texoma Medical Plaza MOB.

New Construction:

The newly constructed Forney Medical Plaza II located in Forney, Texas was completed and opened in April, 2013. This multi-tenant medical office building, consisting of 30,000 rentable square feet, is owned by a limited partnership in which we hold a 95% non-controlling ownership interest. As this LLC is not considered to be a variable interest entity, it is accounted for pursuant to the equity method.

Divestitures:

There were no divestitures during the first nine months of 2013.

Nine Months Ended September 30, 2012:

Acquisition:

In January, 2012, we purchased, as part of a planned, like-kind exchange transaction pursuant to Section 1031 of the Internal Revenue Code, the PeaceHealth Medical Clinic, a single-tenant medical office building consisting of approximately 99,000 rentable square feet, located in Bellingham, Washington. The property was purchased for approximately \$30.4 million, including the assumption of approximately \$22.4 million of third-party financing. The aggregate purchase price of this MOB was allocated to the assets and liabilities acquired consisting of tangible property (\$26.8 million) and identified intangible assets (\$3.6 million), based on the respective fair values at acquisition, as determined by an appraisal. Intangible assets include the value of the in-place lease at the time of acquisition and will be amortized over the average remaining lease term of approximately ten years.

Divestiture:

In February, 2012, Canyon Healthcare Properties, a limited liability company (LLC) in which we owned a 95% noncontrolling ownership interest, completed the divestiture of the Canyon Springs Medical Plaza. As partial consideration for the transaction, the buyer assumed an existing third-party mortgage related to this property. The divestiture by this LLC generated approximately \$8.1 million of cash proceeds to us, net of closing costs and the minority members' share of the proceeds. This divestiture resulted in a gain of approximately \$7.4 million which is included in our consolidated statement of income for the nine months ended September 30, 2012.

(5) Summarized Financial Information of Equity Affiliates

Our consolidated financial statements include the consolidated accounts of our controlled investments and those investments that meet the criteria of a variable interest entity where we are or were the primary beneficiary. In accordance with the Financial Accounting Standards Board's (FASB) standards and guidance relating to accounting for investments and real estate ventures, we account for our unconsolidated investments in LLCs which we do not control using the equity method of accounting. The third-party members in

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these investments have equal voting rights with regards to issues such as, but not limited to: (i) divestiture of property; (ii) annual budget approval, and; (iii) financing commitments. These investments, which represent 33% to 95% non-controlling ownership interests, are recorded initially at our cost and subsequently adjusted for our net equity in the net income, cash contributions to, and distributions from, the investments. Pursuant to certain agreements, allocations of sales proceeds and profits and losses of some of the LLC investments may be allocated disproportionately as compared to ownership interests after specified preferred return rate thresholds have been satisfied.

At September 30, 2013, we have non-controlling equity investments or commitments in thirteen jointly-owned LLCs which own MOB. As of September 30, 2013, we accounted for these LLCs on an unconsolidated basis pursuant to the equity method since they are not variable interest entities. Palmdale Medical Properties was consolidated in our financial statements through June 30, 2013. As previously disclosed, the master lease with a wholly-owned subsidiary of UHS related to Palmdale Medical Properties expired effective as of July 1, 2013 and, as of that date, we began accounting for Palmdale Medical Properties under the equity method. The majority of these LLCs are joint-ventures between us and a non-related party that manages and holds minority ownership interests in the entities. Each LLC is generally self-sustained from a cash flow perspective and generates sufficient cash flow to meet its operating cash flow requirements and service the third-party debt (if applicable) that is non-recourse to us. Although there is typically no ongoing financial support required from us to these entities since they are cash-flow sufficient, we may, from time to time, provide funding for certain purposes such as, but not limited to, significant capital expenditures, leasehold improvements and debt financing. Although we are not obligated to do so, if approved by us at our sole discretion, additional cash fundings are typically advanced as equity or member loans.

Palmdale Medical Properties had a master lease with a subsidiary of UHS through June 30, 2013. Additionally, UHS of Delaware, a wholly-owned subsidiary of UHS, serves as advisor to us under the terms of an advisory agreement and manages our day-to-day affairs. All of our officers are officers or employees of UHS (through UHS of Delaware, Inc.). As a result of our related-party relationship with UHS and the master lease, lease assurance or lease guarantee arrangements with subsidiaries of UHS, we have accounted for this LLC on a consolidated basis, since the fourth quarter of 2007 through June 30, 2013, since it was a variable interest entity and we were deemed to be the primary beneficiary. As of July 1, 2013, the master lease expired and this LLC is no longer considered a variable interest entity and we therefore began to account for this LLC on an unconsolidated basis pursuant to the equity method as of July 1, 2013. Although the expiration of the master lease will have an unfavorable impact on our net income and funds from operations, we do not believe the impact will be material to our financial condition or liquidity.

At September 30, 2013, the LLCs in which we hold various non-controlling ownership interests are not variable interest entities and therefore are not subject to consolidation. As a result of master lease arrangements between UHS and various LLCs in which we hold majority non-controlling ownership interests, we have consolidated or deconsolidated these LLCs as required in accordance with the FASB's standards and guidance.

Rental income is recorded by our consolidated and unconsolidated MOB. relating to leases in excess of one year in length using the straight-line method under which contractual rents are recognized evenly over the lease term regardless of when payments are due. The amount of rental revenue resulting from straight-line rent adjustments is dependent on many factors, including the nature and amount of any rental concessions granted to new tenants, scheduled rent increases under existing leases, as well as the acquisition and sales of properties that have existing in-place leases with terms in excess of one year. As a result, the straight-line adjustments to rental revenue may vary from period-to-period.

The following property table represents the thirteen LLCs in which we own a noncontrolling interest and were accounted for under the equity method as of September 30, 2013:

Name of LLC/LP	Ownership	Property Owned by LLC
DVMC Properties	90%	Desert Valley Medical Center
Suburban Properties	33%	Suburban Medical Plaza II
Santa Fe Scottsdale	90%	Santa Fe Professional Plaza
Brunswick Associates	74%	Mid Coast Hospital MOB
PCH Medical Properties	85%	Rosenberg Children's Medical Plaza
Arlington Medical Properties (b.)	75%	Saint Mary's Professional Office Building
Sierra Medical Properties	95%	Sierra San Antonio Medical Plaza
PCH Southern Properties	95%	Phoenix Children's East Valley Care Center
Sparks Medical Properties (a.)	95%	Vista Medical Terrace & The Sparks Medical Building
Grayson Properties (a.)(c.)	95%	Texoma Medical Plaza
3811 Bell Medical Properties	95%	North Valley Medical Plaza
FTX MOB Phase II (d.)	95%	Forney Medical Plaza II

Palmdale Medical Plaza (a.) (e.)	95%	Palmdale Medical Properties
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- (a.) Tenants of this medical office building include or will include subsidiaries of UHS.
- (b.) We have funded \$5.2 million in equity as of September 30, 2013 and are committed to invest an additional \$1.2 million, in exchange for a 75% non-controlling equity interest in an LLC that owns and operates the Saint Mary's Professional Office Building. This LLC has a third-party term loan of \$24.2 million, which is non-recourse to us, outstanding as of September 30, 2013.
- (c.) We have funded \$2.1 million in equity as of September 30, 2013, and are committed to fund an additional \$2.3 million. This building, which is on the campus of a UHS hospital and has tenants that include subsidiaries of UHS, was completed and opened during the first quarter of 2010. This LLC has a third-party term loan of \$12.6 million, which is non-recourse to us, outstanding as of September 30, 2013.
- (d.) During the third quarter of 2012, this limited partnership entered into an agreement to develop, construct, own and operate the Forney Medical Plaza II, which opened on April 1, 2013. We have committed to invest up to \$2.5 million in equity and debt financing, of which \$1.1 million has been funded as of September 30, 2013. This LLC has a third-party construction loan of \$5.6 million, which is non-recourse to us, outstanding as of September 30, 2013.
- (e.) We have funded \$6.0 million in equity and member loans as of September 30, 2013, and are committed to invest an additional \$2.9 million, in exchange for a 95% non-controlling equity interest in an LLC that owns and operates the Palmdale Medical Plaza, which is on the campus of a UHS hospital and has tenants that include subsidiaries of UHS. This LLC has a third-party term loan of \$6.2 million, which is non-recourse to us, outstanding as of September 30, 2013. We began to account for this LLC on an unconsolidated basis pursuant to the equity method as of July 1, 2013, as discussed above.

Below are the condensed combined statements of income (unaudited) for the LLCs accounted for under the equity method at September 30, 2013 and 2012. The combined statements of income for the three and nine month periods ended September 30, 2012 include the prorated amounts for Canyon Springs Medical Plaza, which was divested in February, 2012, and Centinela Medical Building Complex, which was divested in October, 2012.

	Three Months Ended September 30, 2013(b.) 2012		Nine Months Ended September 30, 2013(b.) 2012	
	(amounts in thousands)			
Revenues	\$ 5,320	\$ 5,514	\$ 15,566	\$ 16,499
Operating expenses	2,099	2,327	6,499	6,992
Depreciation and amortization	985	1,062	2,969	3,120
Interest, net	1,716	1,545	4,714	4,716
Net income	\$ 520	\$ 580	\$ 1,384	\$ 1,671
Our share of net income (a.)	\$ 515	\$ 645	\$ 1,545	\$ 1,803
Our share of gain on divestiture	\$	\$	\$	\$ 7,375

- (a.) Our share of net income includes interest income earned by us on various advances made to LLCs of approximately \$511,000 and \$438,000 for the three months ended September 30, 2013 and 2012, respectively, and \$1.4 million and \$1.3 million for the nine months ended September 30, 2013 and 2012, respectively.
- (b.) As mentioned above, we began to account for Palmdale Medical Plaza on an unconsolidated basis pursuant to the equity method as of July 1, 2013. Prior to July 1, 2013, the financial results of this entity were accounted for on a consolidated basis. These amounts include the financial results for Palmdale Medical Plaza for the three months ended September 30, 2013.

Below are the condensed combined balance sheets (unaudited) for the LLCs accounted for under the equity method:

September 30, December 31,
2013 (a.) 2012
(amounts in thousands)

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Net property, including CIP	\$ 119,948	\$ 106,150
Other assets	10,207	9,850
Total assets	\$ 130,155	\$ 116,000
Liabilities	\$ 5,870	\$ 5,368
Mortgage notes payable, non-recourse to us	80,563	77,511
Advances payable to us	22,461	12,658
Equity	21,261	20,463
Total liabilities and equity	\$ 130,155	\$ 116,000
Our share of equity and advances to LLCs	\$ 39,209	\$ 28,636

- (a.) As mentioned above, we began to account for Palmdale Medical Plaza on an unconsolidated basis pursuant to the equity method as of July 1, 2013. Prior to July 1, 2013, the financial results of this entity were accounted for on a consolidated basis.

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As of September 30, 2013, aggregate principal amounts due on mortgage notes payable by unconsolidated LLCs, which are accounted for under the equity method and are non-recourse to us, are as follows (amounts in thousands):

2013	\$ 464
2014	14,180
2015	41,473
2016	578
2017	11,828
Later	12,040
Total	\$ 80,563

Name of LLC	Mortgage/ Construction	
	Loan Balance(a.)	Maturity Date
Grayson Properties	\$ 12,615	2014
Brunswick Associates	7,979	2015
Arlington Medical Properties	24,237	2015
Palmdale Medical Properties (c.)	6,189	2015
DVMC Properties	3,996	2015
FTX MOB Phase II(b.)	5,596	2017
PCH Southern Properties	6,645	2017
Sparks Medical Properties	4,634	