

NATIONAL HEALTHCARE CORP  
Form 10-Q  
August 01, 2013

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

**FORM 10-Q**

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

For the quarterly period ended June 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 001-13489

(Exact name of registrant as specified in its Charter)

Delaware

(State or other jurisdiction of  
incorporation or organization)

52-2057472

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

100 E. Vine Street  
Murfreesboro, TN

37130

(Address of principal executive offices)  
(Zip Code)

(615) 890-2020

Registrant's telephone number, including area code

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

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

Yes  No

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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 file," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer [ ]

Accelerated filer [x]

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

Smaller reporting company [ ]

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

14,065,449 shares of common stock of the registrant were outstanding as of July 29, 2013.

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

|                                     | Three Months Ended |                          | Six Months Ended |                          |
|-------------------------------------|--------------------|--------------------------|------------------|--------------------------|
|                                     | June 30            |                          | June 30          |                          |
|                                     | 2013               | 2012                     | 2013             | 2012                     |
|                                     |                    | <i>(as<br/>adjusted)</i> |                  | <i>(as<br/>adjusted)</i> |
| Revenues:                           |                    |                          |                  |                          |
| Net patient revenues                | \$ 178,401         | \$ 173,737               | \$ 356,831       | \$ 349,850               |
| Other revenues                      | 13,610             | 13,931                   | 29,558           | 27,868                   |
| Net operating revenues              | 192,011            | 187,668                  | 386,389          | 377,718                  |
| Cost and Expenses:                  |                    |                          |                  |                          |
| Salaries, wages and benefits        | 109,358            | 104,713                  | 216,421          | 211,184                  |
| Other operating                     | 48,728             | 49,224                   | 103,139          | 100,752                  |
| Facility rent                       | 9,870              | 9,847                    | 19,738           | 19,694                   |
| Depreciation and amortization       | 6,972              | 7,386                    | 13,928           | 14,766                   |
| Interest                            | 82                 | 108                      | 166              | 226                      |
| Total costs and expenses            | 175,010            | 171,278                  | 353,392          | 346,622                  |
| Income Before Non-Operating Income  | 17,001             | 16,390                   | 32,997           | 31,096                   |
| Non-Operating Income                | 6,632              | 5,907                    | 13,250           | 11,775                   |
| Income Before Income Taxes          | 23,633             | 22,297                   | 46,247           | 42,871                   |
| Income Tax Provision                | (9,291)            | (8,742)                  | (18,100)         | (16,662)                 |
| Net Income                          | 14,342             | 13,555                   | 28,147           | 26,209                   |
| Dividends to Preferred Stockholders | (2,168)            | (2,168)                  | (4,336)          | (4,336)                  |

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|   |            |            |            |            |
|---|------------|------------|------------|------------|
| Net Income Available to Common Stockholders | \$ 12,174  | \$ 11,387  | \$ 23,811  | \$ 21,873  |
| Earnings Per Common Share:                  |            |            |            |            |
| Basic                                       | \$ 0.88    | \$ 0.82    | \$ 1.72    | \$ 1.58    |
| Diluted                                     | \$ 0.86    | \$ 0.81    | \$ 1.68    | \$ 1.57    |
| Weighted Average Common Shares Outstanding: |            |            |            |            |
| Basic                                       | 13,816,536 | 13,845,516 | 13,838,936 | 13,842,797 |
| Diluted                                     | 16,682,970 | 13,975,073 | 16,708,889 | 13,941,674 |
| Dividends Declared Per Common Share         | \$ 0.32    | \$ 0.30    | \$ 0.62    | \$ 0.60    |

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

## NATIONAL HEALTHCARE CORPORATION

## Interim Condensed Consolidated Statements of Comprehensive Income

*(unaudited – in thousands)*

|  | Three Months Ended |   | Six Months Ended |   |
|--|--------------------|---|------------------|---|
|  | 2013               | June 30<br>2012<br><i>(as<br/>adjusted)</i> | 2013             | June 30<br>2012<br><i>(as<br/>adjusted)</i> |
| Net Income   | \$ 14,342          | \$ 13,555                                   | \$ 28,147        | \$ 26,209                                   |
| Other Comprehensive Income (Loss):   |                    |   |                  |   |
| Unrealized gains (losses) on<br>investments in marketable<br>securities                  | (13,606)           | 5,351                                       | 2,158            | 14,007                                      |
| Less: Reclassification<br>adjustment for realized gains on<br>sale of securities         | (154)              | (300)                                       | (384)            | (987)                                       |
| Income tax (expense) benefit<br>related to items of other<br>comprehensive income (loss) | 5,194              | (1,949)                                     | (896)            | (5,059)                                     |
| Other comprehensive income (loss), net of<br>tax   | (8,566)            | 3,102                                       | 878              | 7,961                                       |
| Comprehensive Income   | \$ 5,776           | \$ 16,657                                   | \$ 29,025        | \$ 34,170                                   |

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

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

|   | June 30, 2013 | December 31,<br>2012<br><i>(as adjusted)</i> |
|---|---------------|--|
| <b>Assets</b>   |               |  |
| Current Assets:   |               |  |
| Cash and cash equivalents   | \$ 74,634     | \$ 66,701                                    |
| Restricted cash and cash equivalents  | 14,525        | 11,563                                       |
| Marketable securities   | 114,113       | 107,250                                      |
| Restricted marketable securities  | 135,232       | 135,207                                      |
| Accounts receivable, less allowance for doubtful<br>accounts of \$3,223 and \$3,166, respectively | 76,511        | 76,959                                       |
| Inventories   | 6,349         | 6,660  |
| Prepaid expenses and other assets   | 2,397         | 1,132  |
| Notes receivable  | 5,664         | 5,840  |
| Federal income tax receivable   | -             | 5,933  |
| Total current assets  | 429,425       | 417,245                                      |
| Property and Equipment:   |               |  |
| Property and equipment, at cost   | 695,485       | 675,455                                      |
| Accumulated depreciation and amortization   | (268,410)     | (254,548)                                    |
| Net property and equipment  | 427,075       | 420,907                                      |
| Other Assets:   |               |  |
| Deposits  | 174           | 143  |
| Goodwill  | 17,600        | 17,600                                       |
| Notes receivable  | 15,547        | 15,949                                       |
| Deferred income taxes   | 14,984        | 12,817                                       |
| Investments in limited liability companies  | 37,655        | 40,039                                       |
| Total other assets  | 85,960        | 86,548                                       |
| Total assets  | \$ 942,460    | \$ 924,700                                   |



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

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

|  | June 30,<br>2013 | December 31,<br>2012<br><i>(as adjusted)</i> |
|--|------------------|--|
| <b>Liabilities and Stockholders' Equity</b>  |                  |  |
| Current Liabilities:   |                  |  |
| Trade accounts payable   | \$ 11,251        | \$ 10,555                                    |
| Accrued payroll  | 39,199           | 37,243                                       |
| Amounts due to third party payors  | 20,754           | 19,267                                       |
| Accrued risk reserves  | 114,863          | 110,331                                      |
| Deferred income taxes  | 25,168           | 24,474                                       |
| Other current liabilities  | 13,291           | 20,411                                       |
| Dividends payable  | 6,723            | 6,480  |
| Total current liabilities  | 231,249          | 228,761                                      |
| Long-term debt   | 10,000           | 10,000                                       |
| Refundable entrance fees   | 10,640           | 10,680                                       |
| Obligation to provide future services  | 1,791            | 1,791  |
| Other noncurrent liabilities   | 15,044           | 13,890                                       |
| Deferred revenue   | 4,913            | 3,430  |
| Stockholders' Equity:  |                  |  |
| Series A Convertible Preferred Stock; \$.01 par value;<br>25,000,000 shares authorized; 10,838,305 and 10,838,412<br>shares, respectively, issued and outstanding; stated at<br>liquidation of \$15.75 per share | 170,512          | 170,514                                      |
| Common stock, \$.01 par value; 30,000,000 shares<br>authorized; 14,065,302 and 14,158,127 shares,<br>respectively, issued and outstanding  | 140              | 141  |
| Capital in excess of par value   | 151,399          | 154,692                                      |
| Retained earnings  | 295,086          | 279,993                                      |
| Accumulated other comprehensive income   | 51,686           | 50,808                                       |
| Total stockholders' equity   | 668,823          | 656,148                                      |
| Total liabilities and stockholders' equity   | \$ 942,460       | \$ 924,700                                   |

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

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## NATIONAL HEALTHCARE CORPORATION

## Interim Condensed Consolidated Statements of Cash Flows

*(unaudited – in thousands)*

|   | Six Months Ended |   |
|---|------------------|---|
|   | 2013             | June 30<br>2012<br><i>(as adjusted)</i> |
| <b>Cash Flows From Operating Activities:</b>                                      |                  |   |
| Net income  | \$ 28,147        | \$ 26,209                               |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |   |
| Depreciation and amortization   | 13,928           | 14,766                                  |
| Provision for doubtful accounts receivable  | 1,522            | 1,141                                   |
| Equity in earnings of unconsolidated investments                                  | (7,595)          | (6,016)                                 |
| Distributions from unconsolidated investments                                     | 9,979            | 4,394                                   |
| Gains on sale of marketable securities  | (384)            | (987)                                   |
| Deferred income taxes   | (2,368)          | (1,571)                                 |
| Stock-based compensation  | 1,359            | 1,398                                   |
| Changes in operating assets and liabilities:                                      |                  |   |
| Restricted cash and cash equivalents  | (5,602)          | (3,420)                                 |
| Accounts receivable   | (1,074)          | 3,076                                   |
| Income tax receivable   | 5,933            | 3,779                                   |
| Inventories   | 311              | 625                                     |
| Prepaid expenses and other assets   | (1,265)          | (1,230)                                 |
| Trade accounts payable  | 696              | (3,556)                                 |
| Accrued payroll   | 1,956            | (14,640)                                |
| Amounts due to third party payors   | 1,487            | (125)                                   |
| Other current liabilities and accrued risk reserves                               | (2,588)          | 5,222                                   |
| Other noncurrent liabilities  | 1,154            | 343                                     |
| Deferred revenue  | 1,483            | 1,867                                   |
| Net cash provided by operating activities   | 47,079           | 31,275                                  |
| <b>Cash Flows From Investing Activities:</b>                                      |                  |   |
| Additions to property and equipment   | (20,096)         | (6,242)                                 |
| Acquisition of non-controlling interest in hospice business                       | -                | (7,500)                                 |
| Collections of notes receivable, net  | 578              | 20                                      |
| Change in restricted cash and cash equivalents                                    | 2,640            | 1,070                                   |
| Purchase of marketable securities   | (42,881)         | (36,228)                                |
| Sale of marketable securities   | 38,150           | 33,871                                  |
| Net cash used in investing activities   | (21,609)         | (15,009)                                |
| <b>Cash Flows From Financing Activities:</b>                                      |                  |   |
| Tax expense from stock-based compensation   | (225)            | (270)                                   |
| Dividends paid to preferred stockholders  | (4,336)          | (4,336)                                 |
| Dividends paid to common stockholders   | (8,475)          | (8,348)                                 |
| Issuance of common shares   | 270              | 5,583                                   |

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|   |                  |                  |
|---|------------------|------------------|
| Repurchase of common shares                           | (4,700)          | -                |
| Entrance fee refunds                                  | (40)             | (790)            |
| Change in deposits                                    | (31)             | 96               |
| Net cash used in financing activities                 | (17,537)         | (8,065)          |
| <b>Net Increase in Cash and Cash Equivalents</b>      | <b>7,933</b>     | <b>8,201</b>     |
| <b>Cash and Cash Equivalents, Beginning of Period</b> | <b>66,701</b>    | <b>61,008</b>    |
| <b>Cash and Cash Equivalents, End of Period</b>       | <b>\$ 74,634</b> | <b>\$ 69,209</b> |

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

**NATIONAL HEALTHCARE CORPORATION**

**Interim Condensed Consolidated Statements of Stockholders' Equity**

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

*(unaudited)*

|  | Preferred Stock |            | Common Stock |        | Capital<br>in<br>Excess<br>of<br>Par<br>Value | ( <i>as<br/>adjusted</i> )<br>Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | ( <i>as adjusted</i> )<br>Total<br>Stockholders'<br>Equity |            |
|--|-----------------|------------|--------------|--------|---|--|---|--|------------|
|  | Shares          | Amount     | Shares       | Amount |   |  |   |  |            |
| Balance at<br>January 1,<br>2012   | 10,838,490      | \$ 170,515 | 13,862,738   | \$     | 138   | \$ 139,183   | \$ 260,331                                      | \$ 36,702  | \$ 606,869 |
| Net income   | –               | –          | –            | –      | –   | –  | 26,209  | –  | 26,209     |
| Other<br>comprehensive<br>income   | –               | –          | –            | –      | –   | –  | –   | 7,961  | 7,961      |
| Stock-based<br>compensation  | –               | –          | –            | –      | –   | 1,398  | –   | –  | 1,398      |
| Tax<br>expense<br>from<br>exercise of<br>stock<br>options                        | –               | –          | –            | –      | –   | –  | –   | –  | –          |
| Shares sold<br>– options<br>exercised  | –               | –          | 120,150      | –      | 1   | (270)  | –   | –  | (270)      |
| Shares<br>issued in<br>conversion<br>of preferred<br>stock to<br>common<br>stock | (78)            | (1)        | 18           | –      | –   | 1  | –   | –  | –          |
| Dividends<br>declared to<br>preferred<br>stockholders<br>(\$0.40 per             | –               | –          | –            | –      | –   | –  | (4,336)   | –  | (4,336)    |

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|  |            |            |            |    |     |            |            |           |         |
|--|------------|------------|------------|----|-----|------------|------------|-----------|---------|
| share)   |            |            |            |    |     |            |            |           |         |
| Dividends<br>declared to<br>common<br>stockholders<br>(\$0.60 per<br>share)      |            |            |            |    |     |            | (8,390)    |           | (8,390) |
| Balance at<br>June 30, 2012  | 10,838,412 | \$ 170,514 | 13,982,906 | \$ | 139 | \$ 145,894 | \$ 273,814 | \$ 44,663 | 635,024 |
| Balance at<br>January 1,<br>2013   | 10,838,412 | \$ 170,514 | 14,158,127 | \$ | 141 | \$ 154,692 | \$ 279,993 | \$ 50,808 | 656,148 |
| Net income   |            |            |            |    |     |            | 28,147     |           | 28,147  |
| Other<br>comprehensive<br>income   |            |            |            |    |     |            |            | 878       | 878     |
| Stock-based<br>compensation  |            |            |            |    |     | 1,359      |            |           | 1,359   |
| Tax<br>expense<br>from<br>exercise of<br>stock<br>options                        |            |            |            |    |     | (225)      |            |           | (225)   |
| Shares sold<br>– options<br>exercised  |            |            | 7,150      |    |     | 270        |            |           | 270     |
| Repurchase<br>of common<br>stock   |            |            | (100,000)  |    | (1) | (4,699)    |            |           | (4,700) |
| Shares<br>issued in<br>conversion<br>of preferred<br>stock to<br>common<br>stock | (107)      | (2)        | 25         |    |     | 2          |            |           |         |
| Dividends<br>declared to<br>preferred<br>stockholders<br>(\$0.40 per<br>share)   |            |            |            |    |     |            | (4,336)    |           | (4,336) |
| Dividends<br>declared to<br>common<br>stockholders<br>(\$0.62 per<br>share)      |            |            |            |    |     |            | (8,718)    |           | (8,718) |
|  | 10,838,305 | \$ 170,512 | 14,065,302 | \$ | 140 | \$ 151,399 | \$ 295,086 | \$ 51,686 | 668,823 |

Balance at  
June 30, 2013

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



**NATIONAL HEALTHCARE CORPORATION**

Notes to Interim Condensed Consolidated Financial Statements

June 30, 2013

*(unaudited)*

**Note 1 – Description of Business**

National HealthCare Corporation (“NHC” or the “Company”) is a leading provider of senior health care services. We operate or manage, through certain affiliates, 68 skilled nursing centers with 8,803 beds in nine states and provide other services in one additional state. These operations are provided by separately funded and maintained subsidiaries. We provide health care services to patients in a variety of settings including skilled nursing centers, managed care specialty units, sub–acute care units, Alzheimer’s care units, homecare programs, assisted living centers and independent living centers. We also have a non-controlling ownership interest in a hospice care business that services NHC owned health care centers and others. In addition, we provide insurance services, management and accounting services, and lease properties to operators of skilled nursing centers.

**Note 2 – Summary of Significant Accounting Policies**

The listing below is not intended to be a comprehensive list of all of our significant accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles, with limited need for management’s judgment in their application. There are also areas in which management’s judgment in selecting any available alternative would not produce a materially different result. See our audited December 31, 2012 consolidated financial statements and notes thereto which contain accounting policies and other disclosures required by generally accepted accounting principles. Our audited December 31, 2012 consolidated financial statements are available at our web site: [www.nhccare.com](http://www.nhccare.com).

*Basis of Presentation*

The unaudited condensed consolidated financial statements to which these notes are attached include all normal, recurring adjustments which are necessary to fairly present the financial position, results of operations and cash flows of NHC. All significant intercompany transactions and balances have been eliminated in consolidation. We assume that users of these interim financial statements have read or have access to the audited December 31, 2012 consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies, may be determined in that context. Accordingly, footnotes and other disclosures which would substantially duplicate the disclosure contained in our most recent annual report to stockholders have been omitted. This interim financial information is not necessarily indicative of the results that may be expected for a full year for a variety of reasons.

#### *Estimates and Assumptions*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and could cause our reported net income to vary significantly from period to period.

#### *Change in Accounting Principle*

Effective January 1, 2013, the Company recorded the cumulative effect of a change in accounting principle related to the adoption of ASU No. 2012-01, *Continuing Care Retirement Communities — Refundable Advance Fees*. This standard is intended to clarify the accounting for advance fees ("entrance fees") received by a continuing care retirement community ("CCRC"). The updated guidance states that entrance fees should be accounted for as deferred revenue when the refund of the fee is both contingent upon the resale of the contract holder's unit and limited to the proceeds received by the resale. If the refund is simply contingent upon re-occupancy, but not limited

to the proceeds of the resale, then the fees should be accounted for as a liability (“refundable entrance fees”). Previously, we accounted for both the 10% non-refundable and 90% refundable portions of the entrance fees as deferred revenue, amortizing the deferred revenue over the life expectancy of the resident and the estimated useful life of the building, respectively, in accordance with ASC Topic 954-430, *Health Care Entities-Deferred Revenue*. The Company believes recording the 90% refundable entrance fees as a liability and not amortizing the balance over the estimated useful life of the building more clearly aligns how we have historically operated the CCRC. Also, with the adoption of ASU No. 2012-01, our future service obligation calculation for the CCRC was modified. Because the future service obligation calculation includes an offset for unamortized deferred revenue, the reclassification of refundable entrance fee amounts from deferred revenue to a liability has a direct impact on the future revenues input of the calculation. With the loss of deferred revenue, the present value of the CCRC’s expenses exceeds the present value of the CCRC’s revenues, which creates the recording of a future service obligation.

As described in the guidance for accounting changes, the comparative interim consolidated financial statements of prior periods are adjusted to apply the new accounting method retrospectively. The following tables present the effect on the interim condensed consolidated financial statements of the accounting change that was retrospectively adopted on January 1, 2013:

#### Consolidated Balance Sheet

(in thousands)

|  |    | As Previously<br>Reported | December 31, 2012<br>Effect of<br>Accounting<br>Change | As Adjusted |
|--|----|---------------------------|--|-------------|
| Deferred tax asset                         | \$ | 10,564                    | \$ 2,253   | \$ 12,817   |
| Total assets                               |    | 920,181                   | 2,253  | 922,434     |
| Refundable entrance fees                   |    | –                         | 10,680   | 10,680      |
| Deferred revenue                           |    | 10,124                    | (6,694)  | 3,430       |
| Future service obligation                  |    | –                         | 1,791  | 1,791       |
| Retained earnings                          |    | 283,517                   | (3,524)  | 279,993     |
| Total stockholders' equity                 |    | 659,672                   | (3,524)  | 656,148     |
| Total liabilities and stockholders' equity | \$ | 920,181                   | \$ 2,253   | \$ 922,434  |

#### Interim Condensed Consolidated Statement of Income

(in thousands, except share and per share amounts)

|                | Three Months Ended June 30, 2012 |                                   |                | Six Months Ended June 30, 2012 |                                   |                |
|----------------|----------------------------------|-----------------------------------|----------------|--------------------------------|-----------------------------------|----------------|
|                | As<br>Previously<br>Reported     | Effect of<br>Accounting<br>Change | As<br>Adjusted | As<br>Previously<br>Reported   | Effect of<br>Accounting<br>Change | As<br>Adjusted |
| Other revenues | \$ 14,028                        | \$ (97)                           | \$ 13,931      | \$ 28,001                      | \$ (133)                          | \$ 27,868      |

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|   |           |           |           |           |           |           |
|---|-----------|-----------|-----------|-----------|-----------|-----------|
| Net operating revenues                      | 187,765   | (97)      | 187,668   | 377,851   | (133)     | 377,718   |
| Income Before Non-Operating Income          | 16,487    | (97)      | 16,390    | 31,229    | (133)     | 31,096    |
| Income Before Income Taxes                  | 22,394    | (97)      | 22,297    | 43,004    | (133)     | 42,871    |
| Income Tax Provision                        | (8,780)   | 38        | (8,742)   | (16,714)  | 52        | (16,662)  |
| Net Income                                  | 13,614    | (59)      | 13,555    | 26,290    | (81)      | 26,209    |
| Net Income Available to Common Shareholders | \$ 11,446 | \$ (59)   | \$ 11,387 | \$ 21,954 | (81)      | \$ 21,873 |
| Basic Earnings Per Share                    | \$ 0.83   | \$ (0.01) | \$ 0.82   | \$ 1.59   | \$ (0.01) | \$ 1.58   |
| Diluted Earnings Per Share                  | \$ 0.82   | \$ (0.01) | \$ 0.81   | \$ 1.57   | \$ -      | \$ 1.57   |

Interim Condensed Consolidated Statement of Comprehensive Income

(in thousands)

|                      | Three Months Ended June 30, 2012 |                             |             | Six Months Ended June 30, 2012 |                             |             |
|----------------------|----------------------------------|-----------------------------|-------------|--------------------------------|-----------------------------|-------------|
|                      | As Previously Reported           | Effect of Accounting Change | As Adjusted | As Previously Reported         | Effect of Accounting Change | As Adjusted |
| Net Income           | \$ 13,614                        | \$ (59)                     | \$ 13,555   | \$ 26,290                      | \$ (81)                     | \$ 26,209   |
| Comprehensive Income | \$ 16,716                        | \$ (59)                     | \$ 16,657   | \$ 34,251                      | \$ (81)                     | \$ 34,170   |

Interim Condensed Consolidated Statement of Cash Flows

(in thousands)

|  | As Previously Reported | Effect of Accounting Change | As Adjusted |
|--|------------------------|-----------------------------|-------------|
| <i>Cash Flows From Operating Activities:</i> |                        |                             |             |
| Net income                                   | \$ 26,290              | \$ (81)                     | \$ 26,209   |
| Deferred income taxes                        | (1,519)                | (52)                        | (1,571)     |
| Deferred revenue                             | 1,930                  | (63)                        | 1,867       |
| Net cash provided by operating activities    | 31,471                 | (196)                       | 31,275      |
| <i>Cash Flows From Financing Activities:</i> |                        |                             |             |
| Entrance fee refunds                         | (986)                  | 196                         | (790)       |
| Net cash used in financing activities        | \$ (8,261)             | \$ 196                      | \$ (8,065)  |

Interim Condensed Consolidated Statements of Stockholders' Equity

*(in thousands)*

|                            |    | As Previously<br>Reported | Six Months Ended June 30, 2012<br>Effect of<br>Accounting<br>Change | As Adjusted |
|----------------------------|----|---------------------------|---|-------------|
| <i>Retained Earnings</i>   |    |                           |   |             |
| Balance at January 1, 2012 | \$ | 265,198                   | \$ (4,867)  | \$ 260,331  |

*Revenue Recognition – Third Party Payors*

Approximately 67% of our net patient revenues are derived from Medicare, Medicaid, and other government programs. Amounts earned under these programs are subject to review by the Medicare and Medicaid intermediaries or their agents. In our opinion, adequate provision has been made for any adjustments that may result from these reviews. Any differences between our original estimates of reimbursements and subsequent revisions are reflected in operations in the period in which the revisions are made often due to final determination or the period of payment no longer being subject to audit or review. We have made provisions of approximately \$20,754,000 and \$19,267,000 as of June 30, 2013 and December 31, 2012, respectively, for various Medicare and Medicaid current and prior year cost reports and claims reviews.

*Revenue Recognition – Private Pay*

For private pay patients in skilled nursing or assisted living facilities, we bill room and board in advance with payment being due in the month the services are performed. Charges for ancillary, pharmacy, therapy and other services to private patients are billed in the month following the performance of services; however, all billings are recognized as revenue when the services are performed.

*Revenue Recognition – Subordination of Fees and Uncertain Collections*

We provide management services to certain long-term care facilities and to others we provide accounting and financial services. We generally charge 6% to 7% of net operating revenues for our management services and a predetermined fixed rate per bed for the accounting and financial services. Our policy is to recognize revenues associated with both management services and accounting and financial services on an accrual basis as the services are provided.

However, under the terms of our management contracts, payments for our management services are subject to subordination to other expenditures of the long-term care center being managed. Furthermore, for certain of the third parties with whom we have contracted to provide services and which we have determined that collection is not reasonably assured, our policy is to recognize income only in the period in which the amounts are realized. We may receive payment for the unpaid and unrecognized management fees in whole or in part in the future only if cash flows from the operating and investing activities of the centers or proceeds from the sale of the centers are sufficient to pay the fees. There can be no assurance that such future cash flows will occur. The realization of such previously unrecognized revenue could cause our reported net income to vary significantly from period to period.

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

*Accrued Risk Reserves*

We are principally self-insured for risks related to employee health insurance, workers' compensation and professional and general liability claims. Our accrued risk reserves primarily represent the accrual for self-insured risks associated with employee health insurance, workers' compensation and professional and general liability claims. The accrued risk reserves include a liability for reported claims and estimates for incurred but unreported claims. Our policy with respect to our workers' compensation and professional and general liability claims is to use an external, independent actuary to estimate our exposure for claims obligations (for both asserted and unasserted claims). Our health insurance reserve is based on our known claims incurred and an estimate of incurred but unreported claims determined by our analysis of historical claims paid. We reassess our accrued risk reserves on a quarterly basis.

Professional liability remains an area of particular concern to us. The entire long term care industry has seen an increase in personal injury/wrongful death claims based on alleged negligence by nursing homes and their employees in providing care to residents. As of June 30, 2013, we and/or our managed centers are defendants in 32 such claims inclusive of years 2005 through June 30, 2013. It remains possible that those pending matters plus potential unasserted claims could exceed our reserves, which could have a material adverse effect on our consolidated financial

position, results of operations and cash flows. It is also possible that future events could cause us to make significant adjustments or revisions to these reserve estimates and cause our reported net income to vary significantly from period to period.

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

*Continuing Care Contracts and Refundable Entrance Fees*

We have one continuing care retirement center (“CCRC”) within our operations. Residents at this retirement center may enter into continuing care contracts with us. The contract provides that 10% of the resident entry fee becomes non-refundable upon occupancy, and the remaining refundable portion of the entry fee is calculated using the lesser of the price at which the apartment is re-assigned or 90% of the original entry fee, plus 40% of any appreciation if the apartment exceeds the original resident’s entry fee. In each case, we amortize the non-refundable part of these fees into revenue over the actuarially determined remaining life of the resident, which is the expected period of occupancy by the resident. We pay the refundable portion of our entry fees when residents

relocate from our community and the apartment is re-occupied. Refundable entrance fees are classified as non-current liabilities and non-refundable entrance fees are classified as deferred revenue in the Company's consolidated balance sheets. The balances of refundable entrance fees as of June 30, 2013 and December 31, 2012 were \$10,640,000 and \$10,680,000, respectively.

#### *Obligation to Provide Future Services*

The CCRC annually calculates the present value of the net cost of future services and the use of facilities to be provided to the current residents and compares that amount with the balance of non-refundable deferred revenue from entrance fees received. If the present value of the net cost of future services exceeds the related anticipated revenues, a liability is recorded (obligation to provide future services) with a corresponding charge to income. With the recent adoption of ASU No. 2012-01, our future service obligation calculation was modified and we now have a liability recorded in the amount of \$1,791,000 as of June 30, 2013 and December 31, 2012.

#### *Deferred Revenue*

Deferred revenue includes the deferred gain on the sale of assets to National, the non-refundable portion (10%) of CCRC entrance fees being amortized over the remaining life expectancies of the residents, and premiums received within our workers' compensation and professional liability companies that are not yet earned.

#### *New Accounting Pronouncements*

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standard Update ("ASU") No. 2013-02, which is included in Codification under ASC 220, "Comprehensive Income". The objective of this updated standard is to improve the reporting of reclassifications out of accumulated other comprehensive income. The standard states that disclosure of reclassification amounts required by U.S. GAAP to be reclassified out of accumulated other comprehensive income to net income in their entirety in the same reporting period, should be provided in one location, by component of other comprehensive income. Presentation of such amounts is permitted on either the face of the financial statement where net income is presented or as a separate tabular disclosure in the notes to the financial statements, and should be disclosed by respective line item of net income affected. This accounting standard update became effective beginning in our first quarter of fiscal 2013. The adoption of this accounting standard update resulted in financial statement presentation changes only. The Company has reclassified realized gains on the sale of marketable securities out of accumulated other comprehensive income; as such, these investment gains are classified as "non-operating income" in our consolidated statements of income.

In July 2012, the FASB issued ASU No. 2012-01, which is included in the Codification under ASC subtopic 954-430, "Health Care Entities—Deferred Revenue". This revised standard is intended to clarify the accounting for refundable



advance fees (“refundable entrance fees”) received by a continuing care retirement community. The guidance states that refundable portion of entrance fees should be accounted for as deferred revenue when the refund of the fee is contingent upon the resale of the contract holder’s unit, limited to the proceeds received by the resale, and the legal environment and management’s policy and practice support the withholding of refunds under said conditions. In the event that the refund is contingent upon reoccupancy, but not limited to the proceeds of the resale, then the fees should be accounted for and reported as a liability. This accounting standard update became effective beginning in our first quarter of fiscal 2013. The adoption of this accounting standard resulted in a change of accounting principle which was applied retrospectively, including the cumulative effect of this change recognized through beginning retained earnings. See the beginning of Note 2 under “*Change in Accounting Principle*” for further discussion on the adoption of ASU No. 2012-01.

*Reclassifications*

Certain prior period amounts have been reclassified to conform to the current financial statement presentation, with no effect on the Company's consolidated financial position or results of operations.

**Note 3 – Other Revenues**

Other revenues are outlined in the table below. Revenues from management and accounting services include management and accounting fees provided to managed and other health care centers. Revenues from rental income include health care real estate properties owned by us and leased to third party operators. Revenues from insurance services include premiums for workers' compensation, health insurance, and professional liability insurance policies that our wholly-owned limited purpose insurance subsidiaries have written for certain health care centers to which we provide management or accounting services. "Other" revenues include miscellaneous health care related earnings.

Other revenues include the following:

| <i>(in thousands)</i>                   | Three Months Ended |           | Six Months Ended |          |
|---|--------------------|-----------|------------------|----------|
|   | June 30            |           | June 30          |          |
|   | 2013               | 2012      | 2013             | 2012     |
| Management and accounting services fees | \$ 4,596           | \$ 5,018  | \$ 9,428         | \$ 9,979 |
| Rental income                           | 4,764              | 4,761     | 9,501            | 9,523    |
| Insurance services                      | 3,936              | 3,906     | 10,063           | 7,831    |
| Other                                   | 314                | 246       | 566              | 535      |
|   | \$ 13,610          | \$ 13,931 | 29,558           | 27,868   |

*Management Fees from National*

We manage five skilled nursing facilities owned by National Health Corporation ("National"). For the three months and six months ended June 30, 2013, we recognized management fees and interest on management fees of \$865,000 and \$1,777,000, respectively, from these centers. For the three months and six months ended June 30, 2012, we recognized management fees and interest on management fees of \$853,000 and \$1,714,000, respectively, from these centers.

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

the proceeds from the sale of the centers are sufficient to pay the fees. There can be no assurance that such future improved cash flows will occur.

*Management Fees from Other Nursing Centers*

For the three months and six months ended June 30, 2013, we recognized \$1,156,000 and \$2,516,000, respectively, of management fees from fourteen skilled nursing facilities owned by two non-profit organizations (ElderTrust and SeniorTrust) where a court-appointed receiver was custodian over the assets of the organizations. For the three months and six months ended June 30, 2012, we recognized management fees of \$1,423,000 and \$2,829,000, respectively, from these centers.

As of June 30, 2013, we are still providing management services to the seven health care centers located in the states of Massachusetts and New Hampshire (ElderTrust), but we have agreed to lease and operate the seven facilities from National Health Investors (“NHI”) at some point during the third quarter of 2013. NHI is purchasing the seven health care centers from ElderTrust and will then subsequently lease the facilities to us. We are expected to lease and operate the facilities as soon we receive court approval and state licensure is obtained. The Massachusetts and New Hampshire health care centers are currently paying approximately \$3,200,000 annually in management fees to NHC. We do not anticipate a material change to our future results of operations and cash flows from the transition of us managing the seven health care centers to us leasing and operating the seven health care facilities.

As of June 30, 2013, we are no longer providing management services to the seven health care centers located in the states of Missouri and Kansas (SeniorTrust). At the time of the separation, the Missouri and Kansas health care centers were paying approximately \$2,200,000 annually in management fees to NHC. We anticipate the loss of management fee revenue from the Missouri and Kansas health care centers to be adverse to our future results of operations and cash flows.

#### *Rental Income and Accounting Services Fees*

As part of the litigation settlement described in Note 16, we have agreed to no longer sublease The Health Center at Standifer Place and Standifer Place Assisted Living facility in Chattanooga, Tennessee to a third party non-profit organization. Effective on approximately October 1, 2013, we expect to terminate the current sublease with the third party non-profit organization and then re-lease the two health care facilities to a third-party for-profit operator. We do not expect the transaction to have a material effect on our future results of operations and cash flows.

#### **Note 4 – Non-Operating Income**

Non-operating income is outlined in the table below. Non-operating income includes equity in earnings of unconsolidated investments, dividends and other realized gains and losses on securities, and interest income. Our most significant equity method investment is a 75.1% non-controlling ownership interest in Caris HealthCare L.P. (“Caris”), a business that specializes in hospice care services.

|  | Three Months Ended |          |    | Six Months Ended |           |  |
|--|--------------------|----------|----|------------------|-----------|--|
|  |                    | June 30  |    |                  | June 30   |  |
| <i>(in thousands)</i>  | 2013               | 2012     |    | 2013             | 2012      |  |
| Equity in earnings of unconsolidated investments                         | \$ 3,789           | \$ 3,212 | \$ | 7,595            | \$ 6,016  |  |
| Dividends and other net realized gains and losses on sales of securities | 1,445              | 1,540    |    | 2,906            | 3,467     |  |
| Interest income  | 1,398              | 1,155    |    | 2,749            | 2,292     |  |
|  | \$ 6,632           | \$ 5,907 | \$ | 13,250           | \$ 11,775 |  |

**Note 5 – Other Operating Expenses**

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

**Note 6 – Earnings per Share**

Basic net income per share is computed based on the weighted average number of common shares outstanding for each period presented. Diluted net income per share reflects the potential dilution that would have occurred if securities to issue common stock were exercised, converted, or resulted in the issuance of common stock that would have then shared in our earnings.

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

| <i>(in thousands, except for share and per share amounts)</i>                              | Three Months Ended June 30 |           | Six Months Ended June 30 |            |
|--|----------------------------|-----------|--------------------------|------------|
|  | 2013                       | 2012      | 2013                     | 2012       |
| <b>Basic:</b>  |                            |           |                          |            |
| Weighted average common shares outstanding   | 13,816,53                  | 13,845,51 | 13,838,93                | 13,842,797 |
| Net income   | \$ 14,342                  | \$ 13,555 | \$ 28,147                | \$ 26,209  |
| Dividends to preferred stockholders  | (2,168)                    | (2,168)   | (4,336)                  | (4,336)    |
| Net income available to common stockholders  | 12,174                     | 11,387    | 23,811                   | 21,873     |
| Earnings per common share, basic   | \$ 0.88                    | \$ 0.82   | \$ 1.72                  | \$ 1.58    |
| <b>Diluted:</b>  |                            |           |                          |            |
| Weighted average common shares outstanding   | 13,816,53                  | 13,845,51 | 13,838,93                | 13,842,797 |
| Dilutive effect of stock options   | 7,421                      | 9,126     | 8,610                    | 9,500      |
| Dilutive effect of restricted stock  | 2,710                      | 3,431     | 5,040                    | 5,805      |
| Dilutive effect of contingent issuable stock   | 233,000                    | 117,000   | 233,000                  | 83,572     |
| Convertible preferred stock  | 2,623,303                  | -         | 2,623,303                | -          |
| Assumed average common shares outstanding  | 16,682,97                  | 13,975,07 | 16,708,88                | 13,941,674 |
| Net income available to common stockholders  | \$ 12,174                  | \$ 11,387 | \$ 23,811                | \$ 21,873  |
| Add dilutive preferred stock dividends for effect of assumed conversion of preferred stock | 2,168                      | -         | 4,336                    | -          |
| Net income for diluted earnings per common share   | \$ 14,342                  | \$ 11,387 | \$ 28,147                | \$ 21,873  |
| Earnings per common share, diluted   | \$ 0.86                    | \$ 0.81   | \$ 1.68                  | \$ 1.57    |

In the above table, options to purchase 997,828 and 1,282,271 shares of our common stock have been excluded for 2013 and 2012, respectively, due to their anti-dilutive impact. Also for the 2012 periods presented, we have excluded 2,623,329 of common shares issuable upon the conversion of preferred stock due to their anti-dilutive impact.

**Note 7 – Investments in Marketable Securities**

Our investments in marketable securities are classified as available for sale securities. Realized gains and losses from securities sales are recognized in results of operations upon disposition of the securities using the specific identification method on a trade date basis. Refer to Note 8 for a description of the Company's methodology for determining the fair value of marketable securities.

Marketable securities and restricted marketable securities consist of the following:

|  | June 30, 2013 |            | December 31, 2012 |            |
|--|---------------|------------|-------------------|------------|
|  | Amortized     | Fair       | Amortized         | Fair       |
| <i>(in thousands)</i>                      | Cost          | Value      | Cost              | Value      |
| Investments available for sale:            |               |            |                   |            |
| Marketable equity securities               | \$ 30,176     | \$ 114,113 | \$ 30,176         | \$ 107,250 |
| Restricted investments available for sale: |               |            |                   |            |
| Corporate debt securities                  | 65,956        | 64,491     | 61,453            | 62,876     |
| Commercial mortgage-backed securities      | 49,605        | 48,824     | 47,194            | 48,063     |
| U.S. Treasury securities                   | 13,473        | 13,533     | 16,218            | 16,604     |
| State and municipal securities             | 8,159         | 8,384      | 7,213             | 7,664      |
|  | \$ 167,369    | \$ 249,345 | \$ 162,254        | \$ 242,457 |

Included in the available for sale marketable equity securities are the following (*in thousands, except share amounts*):

|                  | June 30, 2013 |           |            | December 31, 2012 |           |            |
|------------------|---------------|-----------|------------|-------------------|-----------|------------|
|                  | Shares        | Cost      | Fair Value | Shares            | Cost      | Fair Value |
| NHI Common Stock | 1,630,642     | \$ 24,734 | \$ 97,610  | 1,630,642         | \$ 24,734 | \$ 92,180  |

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

| <i>(in thousands)</i> | June 30, 2013 |            | December 31, 2012 |            |
|-----------------------|---------------|------------|-------------------|------------|
|                       | Cost          | Fair Value | Cost              | Fair Value |
| Maturities:           |               |            |                   |            |
| Within 1 year         | \$ 9,201      | \$ 9,258   | \$ 8,868          | \$ 8,918   |
| 1 to 5 years          | 75,895        | 76,127     | 80,910            | 82,801     |
| 6 to 10 years         | 49,481        | 47,275     | 40,670            | 41,856     |
| Over 10 years         | 2,616         | 2,572      | 1,630             | 1,632      |
|                       | \$ 137,193    | \$ 135,232 | \$ 132,078        | \$ 135,207 |

Gross unrealized gains related to available for sale securities are \$85,273,000 and \$80,296,000 as of June 30, 2013 and December 31, 2012, respectively. Gross unrealized losses related to available for sale securities are \$3,297,000 and \$93,000 as of June 30, 2013 and December 31, 2012, respectively. For the marketable securities in gross unrealized loss positions, (a) it is more likely than not that the Company will not be required to sell the investment securities before recovery of the unrealized losses, and (b) the Company expects that the contractual principal and interest will be received on the investment securities. These securities have also been in an unrealized loss position for a period of less than twelve months. As a result, the Company recognized no other-than-temporary impairment during the six months ended June 30, 2013 or the year ended December 31, 2012.

Proceeds from the sale of investments in restricted marketable securities during the six months ended June 30, 2013 and 2012 were \$38,150,000 and \$33,871,000, respectively. Investment gains of \$154,000 and \$384,000 were realized on these sales during the three months and six months ended June 30, 2013, respectively. Investment gains of \$300,000 and \$987,000 were realized on these sales during the three months and six months ended June 30, 2012, respectively.



**Note 8 – Fair Value Measurements**

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

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

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

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

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

#### *Valuation of Marketable Securities*

The Company determines fair value for marketable securities with Level 1 inputs through quoted market prices. The Company determines fair value for marketable securities with Level 2 inputs through broker or dealer quotations or alternative pricing sources with reasonable levels of price transparency. Our Level 2 marketable securities have been initially valued at the transaction price and subsequently valued, at the end of each month, typically utilizing third party pricing services or other market observable data. The pricing services utilize industry standard valuation models, including both income and market based approaches and observable market inputs to determine value. These observable market inputs include reportable trades, benchmark yields, credit spreads, broker/dealer quotes, bids, offers, and other industry and economic events.

We validated the prices provided by our broker by reviewing their pricing methods, obtaining market values from other pricing sources, analyzing pricing data in certain instances and confirming that the relevant markets are active.

After completing our validation procedures, we did not adjust or override any fair value measurements provided by our broker as of June 30, 2013. We did not have any transfers of assets between Level 1 and Level 2 of the fair value measurement hierarchy during the six months ended June 30, 2013.

#### *Other*

The carrying amounts of cash and cash equivalents, restricted cash and cash equivalents, accounts receivable, and accounts payable approximate fair value due to their short-term nature. The estimated fair value of notes receivable approximates the carrying value based principally on their underlying interest rates and terms, maturities, collateral and credit status of the receivables. Our long-term debt approximates fair value due to variable interest rates, but fair value is also determined using Level 2 inputs through alternative pricing sources. At June 30, 2013, there were no material differences between the carrying amounts and fair values of NHC's financial instruments.

The following table summarizes fair value measurements by level at June 30, 2013 and December 31, 2012 for assets and liabilities measured at fair value on a recurring basis (*in thousands*):

#### Fair Value Measurements Using

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|                                       | Fair Value | Quoted Prices in Active Markets |   |   |
|---------------------------------------|------------|---------------------------------|---|---|
|                                       |            | For Identical Assets (Level 1)  | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| June 30, 2013                         |            |                                 |   |   |
| Cash and cash equivalents             | \$ 74,634  | \$ 74,634                       | \$ —  | \$ —                                      |
| Restricted cash and cash equivalents  | 14,525     | 14,525                          | —   | —   |
| Marketable equity securities          | 114,113    | 114,113                         | —   | —   |
| Corporate debt securities             | 64,491     | —                               | 64,491  | —   |
| Commercial mortgage-backed securities | 48,824     | —                               | 48,824  | —   |
| U.S. Treasury securities              | 13,533     | 13,533                          | —   | —   |
| State and municipal securities        | 8,384      | —                               | 8,384   | —   |
| Total financial assets                | \$ 338,504 | \$ 216,805                      | \$ 121,699                                    | \$ —                                      |

|                                       | Fair Value | Fair Value Measurements Using Quoted Prices in Active Markets |   |   |
|---------------------------------------|------------|---|---|---|
|                                       |            | For Identical Assets (Level 1)                                | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| December 31, 2012                     |            |   |   |   |
| Cash and cash equivalents             | \$ 66,701  | \$ 66,701   | \$ —  | \$ —                                      |
| Restricted cash and cash equivalents  | 11,563     | 11,563  | —   | —   |
| Marketable equity securities          | 107,250    | 107,250   | —   | —   |
| Corporate debt securities             | 62,876     | —   | 62,876  | —   |
| Commercial mortgage-backed securities | 48,063     | —   | 48,063  | —   |
| U.S. Treasury securities              | 16,604     | 16,604  | —   | —   |
| State and municipal securities        | 7,664      | —   | 7,664   | —   |
| Total financial assets                | \$ 320,721 | \$ 202,118  | \$ 118,603                                    | \$ —                                      |

**Note 9 – Long-Term Debt**

Long-term debt consists of the following:

|   | Weighted<br>Average | Interest Rate | Maturities | 6/30/13                       | 12/31/12         |
|---|---------------------|---------------|------------|-------------------------------|------------------|
|   |                     |               |            | <i>(dollars in thousands)</i> |                  |
| Revolving Credit Facility,<br>interest payable monthly  | Variable,<br>0.9%   |               | 2013       | \$ —                          | \$ —             |
| Unsecured term note payable to<br>National, interest payable<br>quarterly, principal payable at<br>maturity | Variable,<br>2.8%   |               | 2018       | 10,000<br>10,000              | 10,000<br>10,000 |
| Less current portion  |                     |               |            | —<br>\$ 10,000                | —<br>\$ 10,000   |

#### Note 10 – \$75,000,000 Revolving Credit Facility

Effective October 24, 2012, we extended the maturity of our Credit Agreement (the "Credit Agreement") with Bank of America, N.A., as lender (the "Lender"). The Credit Agreement provides for a \$75,000,000 revolving credit facility (the "Credit Facility"), of which up to \$5,000,000 may be utilized for letters of credit.

Borrowings bear interest at either, (i) the Eurodollar rate plus 0.70% or (ii) the prime rate. Letter of credit fees are equal to 0.70% times the maximum amount available to be drawn under outstanding letters of credit.

Commitment fees are payable on the daily unused portion of the Credit Facility at a rate of fifteen (15) basis points per annum. NHC is permitted to prepay the loans outstanding under the Credit Facility at any time, without penalty.

The Credit Facility matures on October 23, 2013. We currently anticipate renewing the credit agreement at that time and while we have had no indication from the lender there is any question about renewal, there has been no commitment at this time. If the Lender elects to consent to such extension, subject to certain conditions, the maturity date will be extended to the date which is 364 days after the then maturity date.



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

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

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

#### **Note 11 - Stock Repurchase Program**

On August 1, 2012, the Board of Directors of the Company approved a stock repurchase program authorizing the Company to repurchase up to \$25 million of its outstanding shares of common stock. During the six months ended June 30, 2013, the Company repurchased 100,000 shares for a total cost of \$4.7 million. These were the first shares repurchased pursuant to the program's authorization. The shares were funded from cash on hand and were cancelled and returned to the status of authorized but unissued. This program may be suspended or discontinued at any time without prior notice.

#### **Note 12 – Stock-Based Compensation**

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

*The 2005 and 2010 Stock-Based Compensation Plans*

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

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

In May 2005, our stockholders approved the 2005 Stock Option, Employee Stock Purchase, Physician Stock Purchase and Stock Appreciation Rights Plan (“the 2005 Plan”) pursuant to which 1,200,000 shares of our common stock were available to grant as stock-based payments to key employees, directors, and non-employee consultants. At June 30, 2013, 235,620 shares were available for future grants under the 2005 Plan.

In May 2010, our stockholders approved the 2010 Omnibus Equity Incentive Plan (“the 2010 Plan”) pursuant to which 1,200,000 shares of our common stock were available to grant as stock-based payments to key employees, directors, and non-employee consultants. The shares granted during the six months ended June 30, 2013 consisted of 45,000 shares to the directors of the Company and 15,828 shares through the Employee Stock Purchase Plan. At June 30, 2013, 409,904 shares were available for future grants under the 2010 Plan.

Compensation expense is recognized only for the awards that ultimately vest. Stock-based compensation totaled \$861,000 and \$1,359,000 for the three months and six months ended June 30, 2013, respectively. Stock-based compensation totaled \$855,000 and \$1,398,000 for the three months and six months ended June 30, 2012, respectively. At June 30, 2013, we had \$4,953,000 of unrecognized compensation cost related to unvested stock-based compensation awards, which consisted of \$4,570,000 for stock options and \$383,000 for restricted stock. This expense will be recognized over the remaining weighted average vesting period, which is approximately 2.7

years for stock options and 1.3 years for restricted stock. Stock-based compensation is included in “Salaries, wages and benefits” in the interim condensed consolidated statements of income.

### Stock Options

The following table summarizes the significant assumptions used to value the options granted for the six months ended June 30, 2013 and for the year ended December 31, 2012.

|                         |           |           |
|-------------------------|-----------|-----------|
|                         | 2013      | 2012      |
| Risk-free interest rate | 0.25%     | 0.28%     |
| Expected volatility     | 31.1%     | 38.8%     |
| Expected life, in years | 2.1 years | 2.1 years |
| Expected dividend yield | 2.81%     | 2.91%     |

The following table summarizes our outstanding stock options for the six months ended June 30, 2013 and for the year ended December 31, 2012.

|  | Number of | Weighted       | Aggregate    |
|--|-----------|----------------|--------------|
|  | Shares    | Average        | Intrinsic    |
|  |           | Exercise Price | Value        |
| Options outstanding at January 1, 2012   | 1,482,077 | \$ 46.92       | \$ —         |
| Options granted                          | 63,516    | 44.24          | —            |
| Options exercised                        | (295,371) | 45.41          | —            |
| Options cancelled                        | (115,620) | 50.99          | —            |
| Options outstanding at December 31, 2012 | 1,134,602 | 46.75          | —            |
| Options granted                          | 60,928    | 47.98          | —            |
| Options exercised                        | (7,150)   | 37.70          | —            |
| Options cancelled                        | (90,000)  | 51.50          | —            |
| Options outstanding at June 30, 2013     | 1,098,380 | \$ 46.49       | \$ 1,471,000 |
| Options exercisable at June 30, 2013     | 145,552   | \$ 44.84       | \$ 431,000   |

| Options         | Weighted Average      |
|-----------------|-----------------------|
| Outstanding     | Remaining Contractual |
| June 30, 2013   | Life in Years         |
| Exercise Prices | Exercise Price        |



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|           |                   |    |       |     |
|-----------|-------------------|----|-------|-----|
| 21,750    | \$37.70           | \$ | 37.70 | 0.8 |
| 1,060,802 | \$44.80 – \$47.45 |    | 46.62 | 2.8 |
| 15,828    | \$49.50           |    | 49.50 | 0.5 |
| 1,098,380 |                   | \$ | 46.49 | 2.7 |

*Restricted Stock*

The following table summarizes our restricted stock activity for the six months ended June 30, 2013 and for the year ended December 31, 2012.

|   | Number of | Weighted      |                 | Aggregate  |
|---|-----------|---------------|-----------------|------------|
|   | Shares    | Average Grant | Date Fair Value | Intrinsic  |
|   |           |               |                 | Value      |
| Non-vested restricted shares at January 1, 2012   | 24,000    | \$            | 34.46           | \$ –       |
| Award shares granted                              | –         |               | –               | –          |
| Award shares vested                               | 6,000     |               | 34.46           | –          |
| Non-vested restricted shares at December 31, 2012 | 18,000    |               | 34.46           | –          |
| Award shares granted                              | –         |               | –               | –          |
| Award shares vested                               | 6,000     |               | 34.46           | –          |
| Non-vested restricted shares at June 30, 2013     | 12,000    | \$            | 34.46           | \$ 160,000 |

The weighted average remaining contractual life of restricted stock at June 30, 2013 is 1.3 years.

### **Note 13 – Accounting for Uncertainty in Income Taxes**

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

At June 30, 2013, we had \$12,777,000 of unrecognized tax benefits, composed of \$9,073,000 of deferred tax assets and \$3,704,000 of permanent differences. Accrued interest and penalties of \$2,267,000 relate to unrecognized tax benefits at June 30, 2013. Unrecognized tax benefits of \$3,704,000, net of federal benefit, at June 30, 2013, attributable to permanent differences, would favorably impact our effective tax rate if recognized. Accrued interest and penalties of \$1,870,000 relate to these permanent differences at June 30, 2013. We do not expect to recognize significant increases or decreases in unrecognized tax benefits within the twelve months beginning June 30, 2013, except for the effect of decreases related to the lapse of statute of limitations estimated at \$2,707,000, composed of temporary differences of \$1,722,000, and permanent tax differences of \$985,000. Interest and penalties of \$621,000 relate to these temporary and permanent difference changes within 12 months beginning June 30, 2013.

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

The Company is no longer subject to U.S. federal and state examinations by tax authorities for years before 2009 (with certain state exceptions). Currently, there are no U.S. federal or state returns under examination.

Our deferred tax assets have been evaluated for realization based on historical taxable income, tax planning strategies, the expected timing of reversals of existing temporary differences and future taxable income anticipated. Our deferred tax assets are more likely than not to be realized in full due to the existence of sufficient taxable income of the appropriate character under the tax law. As such, there is no need for a valuation allowance.

**Note 14 – Guarantees and Contingencies**

*Accrued Risk Reserves*

We are self-insured for risks related to health insurance and have wholly-owned limited purpose insurance companies that insure risks related to workers' compensation and general and professional liability insurance claims both for our owned or leased entities and certain of the entities to which we provide management or accounting services. The liability we have recognized for reported claims and estimates for incurred but unreported claims totals \$114,863,000 and \$110,331,000 at June 30, 2013 and December 31, 2012, respectively. This liability is classified as a current liability based on the uncertainty regarding the timing of potential payments. The liability is included in accrued risk reserves in the interim condensed consolidated balance sheets and is subject to adjustment for actual claims incurred. It is possible that these claims plus unasserted claims could exceed our insurance coverages and our reserves, which could have a material adverse effect on our consolidated financial position, results of operations and cash flows.

As a result of the terms of our insurance policies and our use of wholly-owned limited purpose insurance companies, we have retained significant insurance risk with respect to workers' compensation and general and professional liability. We use independent actuaries to estimate our exposures for claims obligations (for both asserted and unasserted claims) related to deductibles and exposures in excess of coverage limits, and we maintain

reserves for these obligations. Such estimates are based on many variables including historical and statistical information and other factors.

#### *Workers' Compensation*

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

For these workers' compensation insurance operations, the premium revenues reflected in the interim condensed consolidated statements of income within "Other Revenues" for the three months and six months ended June 30, 2013 are \$1,781,000 and \$5,390,000, respectively. During the 2013 year, there was a non-recurring positive insurance settlement reached with one of the states in which we provide workers' compensation insurance. This event helped increase other revenues in the amount of \$502,000 and \$2,769,000 for the three months and six months ended June 30, 2013, respectively. For the three months and six months ended June 30, 2012, workers' compensation premium revenues reflected within "Other Revenues" were \$1,336,000 and \$2,685,000, respectively. Associated losses and expenses are reflected in the interim condensed consolidated statements of income as "Salaries, wages and benefits."

#### *General and Professional Liability Lawsuits and Insurance*

The senior care industry has experienced increases in both the number of personal injury/wrongful death claims and in the severity of awards based upon alleged negligence by nursing facilities and their employees in providing care to residents. As of June 30, 2013, we and/or our managed centers are currently defendants in 32 such claims covering the years 2005 through June 30, 2013.

In 2002, due to the unavailability and/or prohibitive cost of third-party professional liability insurance coverage, we established and capitalized a wholly-owned licensed liability insurance company incorporated in the Cayman Island, for the purpose of managing our losses related to these risks. Thus, since 2002, insurance coverage for incidents occurring at all NHC owned providers, and most providers managed by us, is provided through this wholly-owned insurance company.

Insurance coverage for all years includes both primary policies and excess policies. Beginning in 2003, both primary and excess coverage is provided through our wholly-owned insurance company. The primary coverage is in the

amount of \$1.0 million per incident, \$3.0 million per location with an annual primary policy aggregate limit that is adjusted on an annual basis. The excess coverage is \$7.5 million annual excess in the aggregate applicable to years 2005–2007, \$9.0 million annual excess in the aggregate for years 2008–2010 and \$4.0 million excess per occurrence for 2011–2013.

Beginning in 2008 and continuing through June 30, 2013, additional insurance is purchased through third party providers that serve to supplement the coverage provided through our wholly-owned captive insurance company.

For these professional liability insurance operations, the premium revenues reflected in the interim condensed consolidated statements of income as "Other Revenues" for the three months and six months ended June 30, 2013 are \$923,000 and \$1,885,000, respectively. For the three months and six months ended June 30, 2012, professional liability premium revenues reflected within "Other Revenues" were \$1,051,000 and \$2,101,000, respectively. Associated losses and expenses including those for self-insurance are included in the interim condensed consolidated statements of income as "Other operating costs and expenses".

#### **Note 15 – Asset Purchase Commitment**

On December 26, 2012, we entered into a Purchase and Sale Agreement to purchase six skilled health care centers from NHI. The six centers, which are located in Columbia (2), Knoxville and Springfield, Tennessee; Madisonville, Kentucky and Rossville, Georgia, have been leased by NHC since 1991 and have a total of 650 beds.

The purchase price is \$21 million and the transaction is expected to close in September 2013; which has been accelerated from the December 2013 date disclosed in our annual December 31, 2012 Form 10-K. With the purchase of the six skilled health care centers, NHC's master lease payment will decrease annually by \$2.95 million.

#### **Note 16 – Settlement of SeniorTrust of Florida, Inc. and ElderTrust of Florida, Inc. Litigation**

On April 26, 2013, the Company entered into a settlement agreement concerning litigation with two management services clients, ElderTrust of Florida, Inc. (“ElderTrust”), and SeniorTrust of Florida, Inc. (“SeniorTrust”), both Tennessee nonprofit corporations. NHC's transactions with these entities have been previously disclosed in NHC's Forms 10-Q and Forms 10-K and were the subject of a Civil Investigative Demand by the Office of the Tennessee Attorney General issued in July, 2009. As part of the negotiated settlement, NHC paid SeniorTrust \$6,650,000 to resolve the claims. For the six months ended June 30, 2013, we recorded additional other operating expenses in the interim condensed consolidated statement of income of \$4,150,000 due to the settlement of this litigation.

In conjunction with the settlement, which was subject to court approval, NHC will lease and operate ElderTrust's seven skilled nursing facilities in New Hampshire and Massachusetts from National Health Investors, Inc. (“NHI”) after NHI purchases the centers from ElderTrust. The purchase by NHI and subsequent lease to NHC is expected to be completed as soon as court approval and state licensure is obtained. At the time of this settlement agreement, ElderTrust was paying approximately \$3,200,000 annually in management fees to NHC. We do not anticipate a material change to our future results of operations and cash flows from the transition of managing the seven health care facilities to leasing and operating the seven health care facilities.

On April 30, 2013, SeniorTrust sold its five Kansas skilled nursing facilities and terminated their respective NHC management agreements effective May 1, 2013. At the time of this settlement agreement, SeniorTrust was paying approximately \$2,200,000 annually in management and accounting fees for these five skilled nursing facilities and the two Missouri skilled nursing facilities previously sold on February 5, 2013. We anticipate the loss of management fee revenue from the Missouri and Kansas skilled nursing facilities to be adverse to our future results of operations and cash flows.

Effective October 1, 2013 and as part of the negotiated settlement, NHC will terminate its sublease of The Health Center at Standifer Place and Standifer Place Assisted Living facility in Chattanooga, Tennessee with the property's current tenant, MatureCare of Standifer Place, LLC (“MatureCare”), which was scheduled to terminate on December 31, 2016. At the termination of the current sublease, we expect to re-lease the two health care facilities to a third-party for-profit operator. We do not expect this transaction to have a material effect on our future results of operations and cash flows.

In summary and combining all the transactions in the negotiated settlement, we estimate our future results of operations and cash flows will be adversely affected by approximately \$2,200,000 annually, or \$1,350,000 annually net of income taxes. Under the negotiated settlement, we do not admit to any wrongdoing, nor do the opposing parties make any claims as to the validity of their charges.

**Item 2.**

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

Overview

National HealthCare Corporation (“NHC” or the “Company”) is a leading provider of senior health care services. We operate or manage, through certain affiliates, 68 skilled nursing facilities with 8,803 beds in nine states and provide other services in one additional state. These operations are provided by separately funded and maintained subsidiaries. We provide health care services to patients in a variety of settings including skilled nursing centers, managed care specialty units, sub–acute care units, Alzheimer's care units, homecare programs, assisted living centers and independent living centers. We also have a non-controlling ownership interest in a hospice care business that services NHC owned health care centers and others. In addition, we provide insurance services, management and accounting services, and lease properties to operators of skilled nursing health care centers.

Summary of Goals and Areas of Focus

*Earnings*

To monitor our earnings, we have developed budgets and management reports to monitor labor, census, and the composition of revenues.

*Medicare Reimbursement Rate Changes*

In July 2012, CMS released its skilled nursing facility PPS update for the fiscal year 2013, which began October 1, 2012. The notice provided for a 1.8% rate update, which reflects a 2.5% market basket increase that is reduced under the Affordable Care Act by a 0.7% multifactor productivity adjustment. CMS estimates the update will increase overall payments to skilled nursing facilities in fiscal year 2013 by \$670 million compared to fiscal year 2012 levels. The notice also provided an update to certain fiscal year 2012 policy changes involving recalibration of the parity adjustment, reallocation of group therapy time, and changes to the MDS 3.0 patient assessment instrument. The effect of the 2013 PPS rate update on our revenues is dependent upon our census and the mix of our patients at the PPS pay rates.

On April 1, 2013, the automatic 2% cuts (known as "sequestration") began for Medicare providers. We anticipate that, assuming other factors remain constant, the resulting decrease in revenue on our 2013 consolidated statement of income to range from approximately \$2,500,000 to \$3,250,000 for the remaining six months of the 2013 calendar year, or \$1,250,000 to \$1,625,000 per quarter. We are unable to predict the financial impact of other cuts Congress may implement. However, such impact may be adverse and material to our future results of operations and cash flows.

*Development and Growth*

We are undertaking to expand our senior care operations while protecting our existing operations and markets. The following table lists our recent construction and purchase activities.

| Type of Operation | Description | Size | Location      | Placed in Service |
|-------------------|-------------|------|---------------|-------------------|
| Hospice           | Acquisition |      | Knoxville, TN | June, 2012        |



|     |              |   |               |                    |
|-----|--------------|---|---------------|--------------------|
|     |              | Additional 7.5%<br>interest in Caris<br>HealthCare LP |               |                    |
| SNF | New Facility | 90 Beds   | Tullahoma, TN | Under construction |
| SNF | Addition     | 50 bed  | Lexington, SC | Under construction |

In the fourth quarter of 2013, we will open the 90-bed skilled nursing facility in Tullahoma, Tennessee and begin construction on a 92-bed skilled nursing facility and 60-unit assisted living community in Sumner County, Tennessee.

In addition, we entered into limited liability partnerships with RSF Partners, Inc., and Flournoy Development, Inc. to build and operate an 85-unit assisted living community ("Camellia Walk") in Augusta, Georgia. Camellia Walk is currently under construction and plans to open in the first quarter of 2014.

We also entered into a partnership with Reliant Healthcare, LLC to develop and operate a 14-bed psychiatric hospital focusing on geriatric care in Osage Beach, Missouri. This project is projected to open in 2014.

In the second quarter of 2013, we applied for a CON that would be used to build a replacement center (SNF) that would combine the 92 beds of NHC Hillview with 20 beds from the existing skilled nursing unit at Maury Regional Medical Center. The resulting replacement center would be a partnership between NHC and Maury Regional Medical Center.

During 2013 we will apply for Certificates of Need for additional beds in our markets and also evaluate the feasibility of expansion into new markets by building private pay health care centers or by the purchase of existing health care centers. We will also evaluate the feasibility of construction of new assisted living facilities in select markets.

### *Accrued Risk Reserves*

Our accrued professional liability reserves, workers' compensation reserves and health insurance reserves totaled \$114,863,000 at June 30, 2013 and are a primary area of management focus. We have set aside restricted cash and cash equivalents and marketable securities to fund all of our professional liability and workers' compensation liabilities.

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

### Application of Critical Accounting Policies

Effective January 1, 2013, the Company recorded the cumulative effect of a change in accounting principle related to the adoption of ASU No. 2012-01, *Continuing Care Retirement Communities — Refundable Advance Fees*. This standard is intended to clarify the accounting for advance fees ("entrance fees") received by a continuing care retirement community ("CCRC"). The updated guidance states that entrance fees should be accounted for as deferred revenue when the refund of the fee is both contingent upon the resale of the contract holder's unit and limited to the proceeds received by the resale. If the refund is simply contingent upon re-occupancy, but not limited to the proceeds of the resale, then the fees should be accounted for as a liability ("refundable entrance fees"). Previously, we accounted for both the 10% non-refundable and 90% refundable portions of the entrance fees as deferred revenue, amortizing the deferred revenue over the life expectancy of the resident and the estimated useful life of the building, respectively, in accordance with ASC Topic 954-430, *Health Care Entities-Deferred Revenue*. The Company believes recording the refundable entrance fees as a liability and not amortizing the balance over the estimated useful life of the building more clearly aligns how we have historically operated the CCRC. Also, with the adoption of ASU No. 2012-01, our future service obligation calculation for the CCRC was modified. Because the future service obligation calculation includes an offset for unamortized deferred revenue, the reclassification of refundable entrance fee amounts from deferred revenue to a liability has a direct impact on the future revenues input of the calculation. With the loss of deferred revenue, the present value of the CCRC's expenses exceeds the present value of the CCRC's revenues, which creates the recording of a future service obligation. As described in the guidance for accounting changes, the comparative interim consolidated financial statements of prior periods are adjusted to apply the new accounting method retrospectively.

There were no other significant changes during the six month period ended June 30, 2013 to the items we disclosed as our critical accounting policies and estimates in our discussion and analysis of financial condition and results of

operations in our December 31, 2012 Annual Report on Form 10-K filed with the SEC.

### Government Program Financial Changes

#### *Federal Health Care Reform*

In March 2010, President Obama signed into law the Patient Protection and Affordable Care Act ("PPACA" or, commonly, "ACA") and the Health Care and Education Reconciliation Act of 2010 ("HCERA"), which represents significant changes to the current U.S. health care system (collectively the "Acts"). The primary goals of the Acts are to: (1) expand coverage to Americans without health insurance, (2) reform the delivery system to improve quality and drive efficiency, (3) and to lower the overall costs of providing health care. The timeline of the enacted provisions span over several years – some of the provisions were effective immediately in 2010 and others will be phased in through 2020.

The U.S. Supreme Court has since issued its ruling on the constitutionality of a key provision in the ACA, which is the requirement that every American maintain a minimum level of health coverage or pay a penalty beginning in 2014. The Supreme Court upheld the constitutionality of the "individual mandate", holding that the penalty for not doing so could reasonably be interpreted as a tax, which the Constitution permits. The ruling also

permits the federal government to pursue a broad expansion of the Medicaid program, but the ruling gives the states the maximum flexibility on whether to do so. In preparation for the Medicaid coverage expansion to occur in 2014, the current Administration is expected to release a host of regulations and an array of new taxes and fees. It is uncertain at this time the effect the Acts, their modifications, or Medicaid expansion will have on our future results of operations or cash flows.

In August 2011 and pursuant to the Budget Control Act of 2011, Congress created a 12-member bipartisan committee called the Joint Select Committee on Deficit Reduction, or the Joint Committee. The Joint Committee was charged with issuing a formal recommendation by November 23, 2011 on how to reduce the federal deficit by at least \$1.5 trillion over the next ten years. The Committee concluded their work in November 2011 and was not able to reach a bipartisan agreement before the Committee's deadline period. This failure by the Committee has triggered automatic reductions in discretionary and mandatory spending that started April 1, 2013, including reductions of not more than 2% to payments to Medicare providers.

We anticipate that, assuming other factors remain constant, the resulting decrease in revenue on our 2013 consolidated statement of income from the 2% Medicare cuts to range from approximately \$2,500,000 to \$3,250,000 for the six months of the 2013 calendar year, or \$1,250,000 to \$1,625,000 per quarter. We are unable to predict the financial impact of other cuts Congress may implement. However, such impact may be adverse and material to our future results of operations and cash flows.

#### *Medicare – Skilled Nursing Facilities*

In July 2012, CMS released its skilled nursing facility PPS update for the fiscal year 2013, which began October 1, 2012. The notice provided for a 1.8% rate update, which reflects a 2.5% market basket increase that is reduced under the ACA by a 0.7% multifactor productivity adjustment. CMS estimates the update will increase overall payments to skilled nursing facilities in fiscal year 2013 by \$670 million compared to fiscal year 2012 levels. The notice also provides an update to certain fiscal year 2012 policy changes involving recalibration of the parity adjustment, reallocation of group therapy time, and changes to the MDS 3.0 patient assessment instrument. The effect of the 2013 PPS rate update on our revenues is dependent upon our census and the mix of our patients at the PPS pay rates.

On April 1, 2013, the automatic 2% Medicare cuts began for skilled nursing facility providers. We anticipate the resulting decrease in revenue to our skilled nursing facilities to range from approximately \$2,000,000 to \$2,750,000 for the remaining six months of the 2013 calendar year, or \$1,000,000 to \$1,375,000 per quarter.

For the first six months of 2013, our average Medicare per diem rate for skilled nursing facilities decreased 0.4% compared to the same period in 2012.

*Medicaid – Skilled Nursing Facilities*

Effective July 1, 2012 and for the fiscal year 2013, the state of Tennessee implemented specific individual nursing facility rate increases. We estimate the resulting increase in revenue beginning July 1, 2012 will be approximately \$3,500,000 annually, or \$875,000 per quarter. During the second quarter of 2013, the state of Tennessee paid a non-recurring acuity based rate adjustment to help account for the higher acuity of patients served as a result of the level of care changes implemented in fiscal year 2013. This one-time rate adjustment increased revenues \$1,635,000 for the three months and six months ended June 30, 2013.

Effective October 1, 2012 and for the fiscal year 2013, South Carolina implemented specific individual nursing facility rate increases. We estimate the resulting increase in revenue beginning October 1, 2012 will be approximately \$1,660,000 annually, or \$415,000 per quarter.

There was no rate increase or decrease implemented as of October 1, 2012 (for the fiscal year 2013) for the Medicaid program in the state of Missouri.

For the first six months of 2013, our average Medicaid per diem increased 4.0% compared to same period in 2012. We face challenges with respect to states' Medicaid payments, because many currently do not cover the total costs incurred in providing care to those patients. States will continue to control Medicaid expenditures and also look for adequate funding sources, including provider assessments. There are several pieces of legislation that

include provisions designed to reduce Medicaid spending. These provisions include, among others, provisions strengthening the Medicaid asset transfer restrictions for persons seeking to qualify for Medicaid long-term care coverage, which could, due to the timing of the penalty period, increase facilities' exposure to uncompensated care. Other provisions could increase state funding for home and community-based services, potentially having an impact on funding for nursing facilities.

#### *Medicare – Homecare Programs*

In November 2012, CMS issued a final rule to update and revise reimbursement rates for the calendar year 2013. The final rule includes a 2.3% market basket increase, a 1% reduction mandated by the ACA, and a negative 1.32% case-mix adjustment. The net effect of these changes is a 0.04% decrease in the base rate. Additionally, the wage index was updated which impacts providers differently depending on their geographic location. In total, CMS estimates the effect of these changes will result in a 0.01% reduction in reimbursement to home health providers.

On April 1, 2013, the automatic 2% Medicare cuts began for homecare providers. We anticipate the resulting decrease in revenue to our homecare programs to be approximately \$500,000 for the remaining six months of the 2013 calendar year, or \$250,000 per quarter.

#### Litigation Settlement

See Note 16 to the Interim Condensed Consolidated Financial Statements regarding the details of the SeniorTrust and ElderTrust litigation settlement.

#### Results of Operations

##### *Three Months Ended June 30, 2013 Compared to Three Months Ended June 30, 2012*

Results for the three month period ended June 30, 2013 include a 2.3% increase in net operating revenues and a 6.0% increase in income before income taxes compared to the same period in 2012.

The total census at owned and leased skilled nursing facilities for the quarter averaged 89.2% compared to an average of 89.9% for the same quarter a year ago.

Medicare and managed care per diem rates at our owned and leased skilled nursing facilities decreased 0.8% and 3.7%, respectively, compared to the quarter a year ago. Medicaid and private pay per diem rates at our owned and leased skilled nursing facilities increased 3.0% and 3.3%, respectively, compared to the quarter a year ago.

Net patient revenues increased \$4,664,000 or 2.7% compared to the same period last year. In combination with our overall average skilled nursing facility per diem increasing, we had a favorable skilled patient mix change compared to the quarter a year ago that helped increase net patient revenues. Also during the second quarter of 2013, the Tennessee Medicaid program paid a non-recurring acuity based rate adjustment to help account for the higher acuity of patients served as a result of the level of care changes implemented in fiscal year 2013. This one-time rate adjustment increased revenues \$1,635,000 for the 2013 three month period compared to the quarter a year ago.

Other revenues decreased \$321,000 or 2.3% in the three month 2013 period to \$13,610,000 from \$13,931,000 in the 2012 three-month period. The decrease in other revenues is primarily due to the decreased collection of management fees and insurance service revenue (\$893,000) from the discontinuation of our relationship with the SeniorTrust non-profit organization. We discontinued providing management and insurance services in February 2013 for two of SeniorTrusts' skilled healthcare facilities and April 2013 for the remaining five skilled healthcare facilities.

Other revenues are further detailed in Note 3 of our interim condensed consolidated financial statements. As discussed in Note 3 and Note 16 of this Form 10-Q, we are discontinuing our relationship with certain non-profit organizations and we estimate our future results of operations and cash flows to be adversely affected by

approximately \$2,200,000 annually, or \$1,350,000 net of income taxes annually, due to the loss of management fees and insurance services from the discontinuation of these relationships.

Total costs and expenses for the 2013 second quarter compared to the 2012 second quarter increased \$3,732,000 or 2.2% to \$175,010,000 from \$171,278,000. Salaries, wages and benefits, the largest operating costs of our company, increased \$4,645,000 to \$109,358,000 from \$104,713,000. Other operating expenses decreased \$496,000 or 1.0% to \$48,728,000 for the 2013 period compared to \$49,224,000 for the 2012 period. Facility rent expense increased \$23,000 or 0.2% to \$9,870,000. Depreciation and amortization decreased 5.6% to \$6,972,000.

The increase in salaries, wages and benefits is primarily due to the increased costs for therapist services of \$1,160,000 and inflationary wage increases for our partners. The decrease in other operating expenses is primarily due to the continued cost saving measurements implemented in our skilled nursing facilities, which reflected a decrease of \$382,000 in the 2013 three month period compared to the quarter a year ago.

Non-operating income increased by \$725,000 to \$6,632,000 in the three month 2013 period in comparison to \$5,907,000 for the three month 2012 period, as further detailed in Note 4 to our interim condensed consolidated financial statements. The increase (\$576,000) is primarily due to our equity method investment in Caris, which includes our increased 7.5% non-controlling ownership interest that was effective June 1, 2012.

The income tax provision for the three months ended June 30, 2013 is \$9,291,000 (an effective income tax rate of 39.3%, which is consistent with management's expectations). The income tax provision and effective tax rate for the three months ended June 30, 2013 were unfavorably impacted by adjustments to unrecognized tax benefits of \$160,000 and permanent differences including nondeductible expenses of \$50,000 resulting in an increase in the provision. The income tax provision for the three months ended June 30, 2012 was \$8,742,000 (an effective income tax rate of 39.2%). The income tax provision and effective tax rate for the three months ended June 30, 2012 were unfavorably impacted by adjustments to unrecognized tax benefits of \$75,000 and permanent differences including nondeductible expenses of \$62,000 resulting in an increase in the provision.

#### *Six Months Ended June 30, 2013 Compared to Six Months Ended June 30, 2012*

Results for the six month period ended June 30, 2013 include a 2.3% increase in net operating revenues and a 7.9% increase in income before income taxes compared to the same period in 2012.



The total census at owned and leased skilled nursing facilities for the six months averaged 89.5% compared to an average of 90.6% for the same period a year ago.

Medicare and managed care per diem rates at our owned and leased skilled nursing facilities decreased 0.4% and 0.1%, respectively, compared to the six months a year ago. Medicaid and private pay per diem rates at our owned and leased skilled nursing facilities increased 4.0% and 3.5%, respectively, compared to the six month period a year ago.

Net patient revenues increased \$6,981,000 or 2.0% compared to the same period last year. In combination with our overall average skilled nursing facility per diem increasing, we had a favorable skilled patient mix change compared to the six month period a year ago that helped increase net patient revenues. Also during the six months ended June 30, 2013, the Tennessee Medicaid program paid a non-recurring acuity based rate adjustment to help account for the higher acuity of patients served as a result of the level of care changes implemented in fiscal year 2013. This one-time rate adjustment increased revenues \$1,635,000 for the 2013 six month period compared to the six month period a year ago.

Other revenues increased \$1,690,000 or 6.1% in the six month 2013 period to \$29,558,000 from \$27,868,000 in the 2012 six month period. The increase in other revenues is primarily due to the increased workers compensation insurance revenue recorded as a result of a positive settlement reached with one of the states in which we insure third party operators of healthcare facilities. The insurance settlement revenue of \$2,769,000 is a nonrecurring item.

Offsetting the increase in revenue from the insurance settlement, management fees and insurance service revenue decreased \$1,088,000 from the discontinuation of our relationship with the SeniorTrust non-profit organization. We discontinued providing management and insurance services in February 2013 for two of SeniorTrusts' healthcare facilities and April 2013 for the remaining five healthcare facilities.

Other revenues are further detailed in Note 3 of our interim condensed consolidated financial statements. As discussed in Note 3 and Note 16 of this Form 10-Q, we are discontinuing our relationship with certain non-profit organizations and we estimate our future results of operations and cash flows to be adversely affected by approximately \$2,200,000 annually, or \$1,350,000 net of income taxes annually, due to the loss of management fees and insurance services from the discontinuation of these relationships.

Total costs and expenses for the 2013 six months compared to the 2012 six months increased \$6,770,000 or 2.0% to \$353,392,000 from \$346,622,000. Salaries, wages and benefits, the largest operating costs of our company, increased \$5,237,000 to \$216,421,000 from \$211,184,000. Other operating expenses increased \$2,387,000 or 2.4% to \$103,139,000 for the 2013 period compared to \$100,752,000 for the 2012 period. Facility rent expense increased \$44,000 or 0.2% to \$19,738,000. Depreciation and amortization decreased 5.7% to \$13,928,000.

The increase in salaries, wages and benefits is primarily due to the increased costs for therapist services of \$1,831,000 and inflationary wage increases for our partners. The increase in other operating expenses is primarily due to the settlement of the SeniorTrust and ElderTrust litigation cases. We recorded additional other operating expenses in the amount of \$4,150,000 due to the settlement of these cases. We continue to implement cost saving measures in our skilled nursing facilities, which helped offset the litigation expense by \$2,295,000.

Non-operating income increased by \$1,475,000 to \$13,250,000 in the six month 2013 period in comparison to \$11,775,000 for the six month 2012 period, as further detailed in Note 4 to our interim condensed consolidated financial statements. The increase is primarily due to our equity method investment in Caris (\$1,596,000), which includes our increased 7.5% non-controlling ownership interest that was effective June 1, 2012.

The income tax provision for the six months ended June 30, 2013 is \$18,100,000 (an effective income tax rate of 39.1%). The income tax provision and effective tax rate for the six months ended June 30, 2013 were unfavorably impacted by adjustments to unrecognized tax benefits of \$313,000 and permanent differences including nondeductible expenses of \$80,000 resulting in an increase in the provision. The income tax provision for the six months ended June 30, 2012 was \$16,662,000 (an effective income tax rate of 38.9 %). The income tax provision and effective tax rate for the six months ended June 30, 2012 were unfavorably impacted by adjustments to unrecognized tax benefits of \$25,000 and permanent differences including nondeductible expenses of \$140,000 resulting in an increase in the provision.

#### Liquidity, Capital Resources, and Financial Condition

Our primary sources of cash include revenues from the operations of our healthcare and senior living facilities, insurance services, management services and accounting services. Our primary uses of cash include salaries, wages and other operating costs of our healthcare and senior living facilities, the cost of additions to and acquisitions of real property, facility rent expenses, and dividend distributions. These sources and uses of cash are reflected in our interim condensed consolidated statements of cash flows and are discussed in further detail below. The following is a summary of our sources and uses of cash flows (*dollars in thousands*):

|  | Six Months Ended |                 |                  |          |
|--|------------------|-----------------|------------------|----------|
|  | 2013             | June 30<br>2012 | Six Month Change |          |
|  |                  |                 | \$               | %        |
| Cash and cash equivalents at beginning of period | \$ 66,701        | \$ 61,008       | \$ 5,693         | 9.3%     |
| Cash provided by operating activities            | 47,079           | 31,275          | 15,804           | 50.5%    |
| Cash used in investing activities                | (21,609)         | (15,009)        | (6,600)          | (44.0)%  |
| Cash used in financing activities                | (17,537)         | (8,065)         | (9,472)          | (117.4)% |
| Cash and cash equivalents at end of period       | \$ 74,634        | \$ 69,209       | \$ 5,425         | 7.8%     |

*Operating Activities*

Net cash provided by operating activities for the six months ended June 30, 2013 was \$47,079,000 as compared to \$31,275,000 in the same period last year. Cash provided by operating activities consisted of net income of \$28,147,000, adjustments for non-cash items of \$16,441,000, and \$2,491,000 provided by working capital.

Cash provided by working capital primarily consisted of an increase in accrued risk reserves (\$4,532,000) and the collection of our 2012 federal income tax receivable (\$5,933,000), but was offset by an increase in restricted cash and cash equivalents (\$5,602,000). The increase in accrued risk reserves is due to the addition of the 2013 fiscal year accrual and the timing of payments. The increase in restricted cash and cash equivalents is from NHC and other healthcare entities paying insurance premiums into NHC insurance companies, which restrict the cash payment.

*Investing Activities*

Cash used in investing activities totaled \$21,609,000 and \$15,009,000 for the six months ended June 30, 2013 and 2012, respectively. Cash used for property and equipment additions was \$20,096,000 for the six months ended June 30, 2013 and \$6,242,000 in the comparable period in 2012. Cash provided by net collections of notes receivable was \$578,000 in 2013 compared to \$20,000 in 2012. Purchases and sales of restricted marketable securities resulted in a net use of cash of \$2,091,000 for the 2013 period compared to \$1,287,000 for the 2012 period.

Construction costs included in additions to property and equipment in 2013 include \$5,493,000 for the construction of the 90 bed skilled nursing facility in Tullahoma, Tennessee, \$2,642,000 for the 50 bed addition to our skilled nursing facility in Lexington, South Carolina, and \$2,813,000 for the land and acquisition costs of a future development site in Nashville, Tennessee.

*Financing Activities*

Net cash used in financing activities totaled \$17,537,000 and \$8,065,000 for the six months ended June 30, 2013 and 2012, respectively. Attributable to the increase during the first six months of 2013 was the use of cash of \$4,700,000 to purchase outstanding common stock under our current stock repurchase program, as compared to \$-0- for the same period in 2012. Cash used for dividend payments to common and preferred stockholders totaled \$12,811,000 in the current year period compared to \$12,684,000 for the same period a year ago. In the prior period, cash of \$5,583,000 was provided by the issuance of common stock.

Table of Contractual Cash Obligations

Our contractual cash obligations for periods subsequent to June 30, 2013 are as follows (*in thousands*):

|                                      |            |           | 1-3       | 3-5       | After      |
|--------------------------------------|------------|-----------|-----------|-----------|------------|
|                                      | Total      | 1 year    | Years     | Years     | 5 Years    |
| Long-term debt – principal           | \$ 10,000  | \$ –      | \$ –      | \$ 10,000 | \$ –       |
| Long-term debt – interest            | 1,243      | 276       | 553       | 414       | –          |
| Operating leases                     | 454,950    | 33,700    | 67,400    | 67,400    | 286,450    |
| Asset purchase commitment            | 21,000     | 21,000    | –         | –         | –          |
| Obligations to complete construction | 3,843      | 3,843     | –         | –         | –          |
| Total contractual cash obligations   | \$ 491,036 | \$ 58,819 | \$ 67,953 | \$ 77,814 | \$ 286,450 |

Other noncurrent liabilities for uncertain tax positions of \$3,704,000, attributable to permanent differences, at June 30, 2013 has not been included in the above table because of the inability to estimate the period in which the tax payment is expected to occur. See Note 13 of the interim condensed consolidated financial statements for a discussion on income taxes.

We started paying quarterly dividends on our common shares outstanding in 2004 and our preferred shares outstanding in 2007. We anticipate the continuation of both the common and preferred dividend payments as approved quarterly by the Board of Directors.

*Short-term liquidity*

We expect to meet our short-term liquidity requirements primarily from our cash flows from operating activities. In addition to cash flows from operations, our current cash on hand of \$74,634,000 at June 30, 2013, marketable securities of \$114,113,000 at June 30, 2013 and as needed, our borrowing capacity, are expected to be adequate to meet our contractual obligations and to finance our operating requirements and our growth and development plans in the next twelve months. We currently do not have any funds drawn against our revolving credit agreement and the amount of \$75,000,000 is available to be drawn for general corporate purposes, including working capital and acquisitions.

*Long-term liquidity*

Our \$75,000,000 revolving credit agreement matures on October 23, 2013. We currently anticipate renewing the credit agreement at that time and while we have had no indication from the lender that there is any question about renewal, there has been no commitment at this time. We entered into this loan originally on October 30, 2007, and have renewed the loan five times with one year maturities. At the inception and at each renewal, the lender offered longer maturities, but the Company chose a one-year maturity because of the terms. If we are not able to refinance our debt as it matures, we will be required to use our cash and marketable securities to meet our debt and contractual obligations and will be limited in our ability to fund future growth opportunities.

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

Commitment and Contingencies

*Governmental Regulations*

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

investigation underway or threatened involving allegations of potential wrongdoing.

### *Acquisitions*

We have acquired and will continue to acquire businesses with prior operating histories. Acquired companies may have unknown or contingent liabilities, including liabilities for failure to comply with healthcare laws and regulations, such as billing and reimbursement, anti-kickback and physician self-referral laws. Although we institute policies designed to conform practices to our standards following completion of acquisitions and attempts to structure our acquisitions as asset acquisitions in which we do not assume liability for seller wrongful actions, there can be no assurance that we will not become liable for past activities that may later be alleged to be improper by private plaintiffs or government agencies. Although we obtain general indemnifications from sellers covering such matters, there can be no assurance that any specific matter will be covered by such indemnifications, or if covered, that such indemnifications will be adequate to cover potential losses and fines.

### *Inflation*

We have historically derived a substantial portion of our revenue from the Medicare and Medicaid programs, along with similar reimbursement programs. Payments under these programs generally provide for reimbursement levels that are adjusted for inflation annually based upon the state's fiscal year for the Medicaid programs and in each October for the Medicare program. The adjustments may not continue in the future, and even if received, such adjustments may not reflect the actual increase in our costs for providing healthcare services.

New Accounting Pronouncements

See Note 2 to the Interim Condensed Consolidated Financial Statements for the impact of new accounting standards.

Forward-Looking Statements

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

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

Forward-looking statements involve known and unknown risks and uncertainties that may cause our actual results in future periods to differ materially from those projected or contemplated in the forward-looking statements as a result of, but not limited to, the following factors:

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

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



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

.  
liabilities and other claims asserted against us, including patient care liabilities, as well as the resolution of current litigation (see Note 13: Guarantees and Contingencies);

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

.  
the ability to attract and retain qualified personnel;

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

.  
the ability to refinance existing debt on favorable terms;

.  
the competitive environment in which we operate;

.  
the ability to maintain and increase census levels; and

demographic changes.

See the notes to the quarterly financial statements, and “Item 1. Business” in our 2012 Annual Report on Form 10-K for a discussion of various governmental regulations and other operating factors relating to the

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

### **Item 3.**

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

Market risk represents the potential economic loss arising from adverse changes in the fair value of financial instruments. Currently, our exposure to market risk relates primarily to our fixed-income and equity portfolios. These investment portfolios are exposed primarily to, but not limited to, interest rate risk, credit risk, equity price risk, and concentration risk. We also have exposure to market risk that includes our cash and cash equivalents, notes receivable, revolving credit facility, and long-term debt. The Company's senior management has established comprehensive risk management policies and procedures to manage these market risks.

##### *Interest Rate Risk*

The fair values of our fixed-income investments fluctuate in response to changes in market interest rates. Increases and decreases in prevailing interest rates generally translate into decreases and increases, respectively, in the fair values of those instruments. Additionally, the fair values of interest rate sensitive instruments may be affected by the creditworthiness of the issuer, prepayment options, the liquidity of the instrument and other general market conditions.

At June 30, 2013, we have available for sale debt securities in the amount of \$135,232,000. The fixed maturity portfolio is comprised of investments with primarily short-term and intermediate-term maturities. The portfolio composition allows flexibility in reacting to fluctuations of interest rates. The fixed maturity portfolio allows our insurance company subsidiaries to achieve an adequate risk-adjusted return while maintaining sufficient liquidity to meet obligations.

As of June 30, 2013, both our long-term debt and revolving credit facility bear interest at variable interest rates. Currently, we have long-term debt outstanding of \$10.0 million and the revolving credit facility is zero. However, we do intend to borrow funds on our credit facility in the future. Based on a hypothetical credit facility borrowing of \$75.0 million and our outstanding long-term debt, a 1% change in interest rates would change our annual interest cost by approximately \$850,000.

Approximately \$5.3 million of our notes receivable bear interest at variable rates (generally at the prime rate plus 2%). Because the interest rates of these instruments are variable, a hypothetical 1% change in interest rates would result in a related increase or decrease in interest income of approximately \$53,000.

Our cash and cash equivalents consist of highly liquid investments with a maturity of less than three months when purchased. As a result of the short-term nature of our cash instruments, a hypothetical 1% change in interest rates would have minimal impact on our future earnings and cash flows related to these instruments.

We do not currently use any derivative instruments to hedge our interest rate exposure. We have not used derivative instruments for trading purposes and the use of such instruments in the future would be subject to approvals by the Investment Committee of the Board.

#### *Credit Risk*

Credit risk is managed by diversifying the fixed maturity portfolio to avoid concentrations in any single industry group or issuer and by limiting investments in securities with lower credit ratings.

#### *Equity Price and Concentration Risk*

Our available for sale equity securities are recorded at their fair market value based on quoted market prices. Thus, there is exposure to equity price risk, which is the potential change in fair value due to a change in

quoted market prices. At June 30, 2013, the fair value of our equity marketable securities is approximately \$114,113,000. Of the \$114.1 million equity securities portfolio, our investment in National Health Investors, Inc. (“NHI”) comprises approximately \$97.6 million, or 85.5%, of the total fair value. We manage our exposure to NHI by closely monitoring the financial condition, performance, and outlook of the company. Hypothetically, a 10% change in quoted market prices would result in a related increase or decrease in the fair value of our equity investments of approximately \$11.4 million. At June 30, 2013, our equity securities had unrealized gains of \$83.9 million. Of the \$83.9 million of unrealized gains, \$72.9 million is related to our investment in NHI.

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

As of June 30, 2013, an evaluation was performed under the supervision and with the participation of the Company’s management, including the Chief Executive Officer (“CEO”) and Principal Accounting Officer (“PAO”), of the effectiveness of the design and operation of the Company’s disclosure controls and procedures. Based on that evaluation, the Company’s management, including the CEO and PAO, concluded that the Company’s disclosure controls and procedures were effective as of June 30, 2013. There have been no changes in the Company’s internal control over financial reporting during the quarter ended June 30, 2013 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

## **PART II. OTHER INFORMATION**

#### **Item 1. Legal Proceedings.**

For a discussion of prior, current and pending litigation of material significance to NHC, please see Note 14 and Note 16 of this Form 10-Q.

#### **Item 1A. Risk Factors.**

During the six months ended June 30, 2013, there were no material changes to the risk factors that were disclosed in Item 1A of National HealthCare Corporation's Annual Report on Form 10-K for the year ended December 31, 2012.

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

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

**Item 5. Other Information.**

**Item 6. Exhibits.**

(a)

List of exhibits

| <u>Exhibit No.</u> | <u>Description</u>   |
|--------------------|--|
| 31.1               | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer  |
| 31.2               | Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer                                      |
| 32                 | Certification pursuant to 18 U.S.C. Section 906 by Chief Executive Officer and Principal Financial Officer |
| 101.INS            | XBRL Instance Document   |
| 101.SCH            | XBRL Taxonomy Extension Schema Document  |
| 101.CAL            | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF            | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB            | XBRL Taxonomy Extension Label Linkbase Document  |

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

**SIGNATURES**

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

NATIONAL HEALTHCARE  
CORPORATION

(Registrant)

Date: August 1, 2013

/ s / Robert G. Adams

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

Date: August 1, 2013

/ s / Donald K. Daniel

\_\_\_\_\_  
Donald K. Daniel  
Senior Vice President and Controller  
(Principal Financial Officer)