

OMEGA HEALTHCARE INVESTORS INC  
Form 10-Q  
November 05, 2007

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2007

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-11316

OMEGA HEALTHCARE  
INVESTORS, INC.

(Exact name of Registrant as specified in its charter)

Maryland  
(State of incorporation)

38-3041398  
(IRS Employer  
Identification No.)

9690 Deereco Road, Suite 100, Timonium, MD 21093  
(Address of principal executive offices)

(410) 427-1700  
(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 is a large accelerated filer, an accelerated filer, or non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the

Exchange Act. (Check one:)

Large accelerated filer   
filer

Non-accelerated filer   
Accelerated

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of October 19, 2007.

Common Stock, \$.10 par value	68,004,832
(Class)	(Number of shares)

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**OMEGA HEALTHCARE INVESTORS, INC.**  
**FORM 10-Q**  
**September 30, 2007**

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**OMEGA HEALTHCARE INVESTORS, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands)

	<b>September 30, 2007 (Unaudited)</b>	<b>December 31, 2006</b>
<b>ASSETS</b>		
Real estate properties		
Land and buildings at cost	\$ 1,273,657	\$ 1,235,679
Less accumulated depreciation	(212,634)	(187,769)
Real estate properties – net	1,061,023	1,047,910
Mortgage notes receivable – net	31,849	31,886
	1,092,872	1,079,796
Other investments – net	16,464	22,078
	1,109,336	1,101,874
Assets held for sale – net	3,550	4,635
Total investments – net	1,112,886	1,106,509
Cash and cash equivalents	608	729
Restricted cash	3,698	4,117
Accounts receivable – net	61,768	51,194
Other assets	11,933	12,821
Total assets	\$ 1,190,893	\$ 1,175,370
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Revolving line of credit	\$ 52,000	\$ 150,000
Unsecured borrowings – net	484,718	484,731
Other long-term borrowings	40,995	41,410
Accrued expenses and other liabilities	26,567	28,037
Income tax liabilities	3,441	5,646
Operating liabilities for owned properties	—	92
Total liabilities	607,721	709,916
Stockholders' equity:		
Preferred stock	118,488	118,488
Common stock and additional paid-in-capital	825,495	700,177
Cumulative net earnings	344,824	292,766
Cumulative dividends paid	(662,568)	(602,910)
Cumulative dividends – redemption	(43,067)	(43,067)
Total stockholders' equity	583,172	465,454
Total liabilities and stockholders' equity	\$ 1,190,893	\$ 1,175,370

See notes to consolidated financial statements.



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**OMEGA HEALTHCARE INVESTORS, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**Unaudited**  
**(in thousands, except per share amounts)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>Revenues</b>				
Rental income	\$ 37,113	\$ 33,016	\$ 114,092	\$ 92,643
Mortgage interest income	999	1,054	2,896	3,392
Other investment income – net	962	994	2,336	2,878
Miscellaneous	150	42	640	483
Total operating revenues	39,224	35,106	119,964	99,396
<b>Expenses</b>				
Depreciation and amortization	9,131	8,314	26,740	23,288
General and administrative	2,742	5,669	8,080	10,331
Provision for impairment on real estate properties	1,636	-	1,636	-
Provision for uncollectible mortgages, notes and accounts receivable	-	27	-	27
Total operating expenses	13,509	14,010	36,456	33,646
<b>Income before other income and expense</b>	<b>25,715</b>	<b>21,096</b>	<b>83,508</b>	<b>65,750</b>
<b>Other income (expense):</b>				
Interest and other investment income	36	189	134	371
Interest	(10,071)	(11,190)	(31,988)	(30,246)
Interest – amortization of deferred financing costs	(500)	(439)	(1,459)	(1,513)
Interest – refinancing costs	-	-	-	(3,485)
Gain on sale of equity securities	-	2,709	-	2,709
Change in fair value of derivatives	-	1,764	-	9,672
Total other expense	(10,535)	(6,967)	(33,313)	(22,492)
<b>Income before gain on assets sold</b>	<b>15,180</b>	<b>14,129</b>	<b>50,195</b>	<b>43,258</b>
Gain on assets sold - net	-	1,188	-	1,188
<b>Income from continuing operations before income taxes</b>	<b>15,180</b>	<b>15,317</b>	<b>50,195</b>	<b>44,446</b>
Provision for income taxes	132	(600)	132	(1,739)
<b>Income from continuing operations</b>	<b>15,312</b>	<b>14,717</b>	<b>50,327</b>	<b>42,707</b>
Discontinued operations	37	(94)	1,731	(419)

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<b>Net income</b>	<b>15,349</b>	<b>14,623</b>	<b>52,058</b>	<b>42,288</b>
Preferred stock dividends	(2,480)	(2,480)	(7,442)	(7,442)
<b>Net income available to common</b>	<b>\$ 12,869</b>	<b>\$ 12,143</b>	<b>\$ 44,616</b>	<b>\$ 34,846</b>
<b>Income per common share:</b>				
<b>Basic:</b>				
Income from continuing operations	\$ 0.19	\$ 0.21	\$ 0.66	\$ 0.61
Net income	\$ 0.19	\$ 0.21	\$ 0.69	\$ 0.60
<b>Diluted:</b>				
Income from continuing operations	\$ 0.19	\$ 0.21	\$ 0.66	\$ 0.60
Net income	\$ 0.19	\$ 0.20	\$ 0.69	\$ 0.60
Dividends declared and paid per common share	\$ 0.28	\$ 0.24	\$ 0.81	\$ 0.71
Weighted-average shares outstanding, basic	67,952	59,021	65,094	58,203
Weighted-average shares outstanding, diluted	67,965	59,446	65,114	58,407
<b>Components of other comprehensive income:</b>				
Net income	\$ 15,349	\$ 14,623	\$ 52,058	\$ 42,288
Unrealized gain on common stock investment	-	-	-	1,580
Reclassification adjustment for gain on common stock investment	-	(1,740)	-	(1,740)
Unrealized loss on preferred stock investment	-	(172)	-	(763)
Total comprehensive income	\$ 15,349	\$ 12,711	\$ 52,058	\$ 41,365

See notes to consolidated financial statements.

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**OMEGA HEALTHCARE INVESTORS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**Unaudited (in thousands)**

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Cash flows from operating activities</b>		
Net income	\$ 52,058	\$ 42,288
Adjustment to reconcile net income to cash provided by operating activities:		
Depreciation and amortization (including amounts in discontinued operations)	26,768	23,432
Provision for impairment on real estate properties (including amounts in discontinued operations)	1,636	121
Provision for uncollectible mortgages, notes and accounts receivable (including amounts in discontinued operations)	—	179
Refinancing costs	—	3,485
Amortization of deferred financing costs	1,459	1,513
Gains on assets sold and equity securities – net	(1,595)	(3,516)
Restricted stock amortization expense	880	4,224
Change in fair value of derivatives	—	(9,672)
Income from accretion of marketable securities to redemption value	(155)	(1,155)
Other	(259)	(35)
Change in operating assets and liabilities:		
Accounts receivable	(178)	(20,104)
Straight-line rent	(11,746)	(4,546)
Lease inducement	1,349	—
Other assets	28	1,941
Tax liabilities	(2,206)	1,739
Other liabilities	(1,065)	6,929
Net cash provided by operating activities	66,974	46,823
<b>Cash flows from investing activities</b>		
Acquisition of real estate	(39,503)	(178,906)
Placement of mortgage loans	(345)	—
Proceeds from sale of stock	—	7,573
Proceeds from sale of real estate investments	6,254	1,527
Capital improvements and funding of other investments	(5,463)	(5,416)
Proceeds from other investments	14,829	27,092
Investments in other investments	(8,978)	(29,238)
Collection of mortgage principal – net	559	10,588
Net cash used in investing activities	(32,647)	(166,780)
<b>Cash flows from financing activities</b>		
Proceeds from credit facility borrowings	99,400	234,200
Payments on credit facility borrowings	(197,400)	(134,700)
Receipts from other long-term borrowings	—	39,000
Payments of other long-term borrowings	(415)	(390)
Prepayment of re-financing penalty	—	(755)
Receipts from dividend reinvestment plan	12,222	29,161
Receipts/(payments) from exercised options and taxes on restricted stock – net	(780)	225
Dividends paid	(59,658)	(49,356)



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Net proceeds from common stock offering	112,878	—
Payment on common stock offering	—	(178)
Financing costs paid	(695)	(2,390)
Other	—	1,192
Net cash (used in) provided by financing activities	(34,448)	116,009
Decrease in cash and cash equivalents	(121)	(3,948)
Cash and cash equivalents at beginning of period	729	3,948
Cash and cash equivalents at end of period	\$ 608	\$ —
Interest paid during the period	\$ 27,684	\$ 21,442

See notes to consolidated financial statements.

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**OMEGA HEALTHCARE INVESTORS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**Unaudited**  
**September 30, 2007**

**NOTE 1 – BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES**

**Business Overview:**

We have one reportable segment consisting of investments in real estate. Our business is to provide financing and capital to the long-term healthcare industry with a particular focus on skilled nursing facilities located in the United States. Our core portfolio consists of long-term lease and mortgage agreements. All of our leases are “triple-net” leases, which require the tenants to pay all property-related expenses. Our mortgage revenue derives from fixed-rate mortgage loans, which are secured by first mortgage liens on the underlying real estate and personal property of the mortgagor. Substantially all depreciation expenses reflected in the consolidated statements of operations relate to the ownership of our investment in real estate.

**Basis of Presentation:**

The accompanying unaudited consolidated financial statements for Omega Healthcare Investors, Inc. (“Omega” or the “Company”) have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission regarding interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles (“GAAP”) in the United States for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. These unaudited consolidated financial statements should be read in conjunction with the financial statements and the footnotes thereto included in our latest Annual Report on Form 10-K.

Our consolidated financial statements include the accounts of Omega, all direct and indirect wholly owned subsidiaries and one variable interest entity (“VIE”) for which we are the primary beneficiary. All inter-company accounts and transactions have been eliminated in consolidation of the financial statements.

**Reclassifications:**

Certain amounts in the prior year have been reclassified to conform to the current year presentation and to reflect the results of discontinued operations. See Note 9 – Discontinued Operations for a discussion of discontinued operations. Such reclassifications have no effect on previously reported earnings or equity.

**Accounts Receivables:**

Accounts receivable includes: contractual receivables, straight-line rent receivables, lease inducements, net of an estimated provision for losses related to uncollectible and disputed accounts. Contractual receivables relate to the amounts currently owed to us under the terms of the lease agreement. Straight-line receivables relates to the difference between the rental revenue recognized on a straight-line basis and the amounts due to us contractually. Lease inducements result from value provided by us to the lessee at the inception of the lease and will be amortized as a reduction of rental revenue over the lease term. On a quarterly basis, we review the collection of our contractual payments and determine the appropriateness of our allowance for uncollectible contractual rents. In the case of a lease recognized on a straight-line basis, we generally provide an allowance for straight-line accounts receivable when certain conditions or indicators of adverse collectibility are present.



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A summary of our net receivables by type is as follows:

	<b>September 30, 2007</b>	<b>December 31, 2006</b>
	(in thousands)	
Contractual receivables	\$ 3,618	\$ 4,803
Straight-line receivables	33,670	27,252
Lease inducements	28,783	30,133
Allowance	(4,303)	(10,994)
Accounts receivable – net	\$ 61,768	\$ 51,194

We continuously evaluate the payment history and financial strength of our operators and have historically established allowance reserves for straight-line rent adjustments for operators that do not meet our requirements. We consider factors such as payment history, the operator's financial condition as well as current and future anticipated operating trends when evaluating whether to establish allowance reserves.

During the first quarter of 2007, we reversed approximately \$5.0 million of allowance for straight-line rent previously established, as a result of the improvement in one of our operator's financial condition. We record allowances for straight-line rent receivables as an adjustment to revenue. Accordingly, the reversal of this allowance increased revenue for the three months ended March 31, 2007. The change in estimate resulted in an additional \$0.08 per share of income from continuing operations and net income for the first quarter of 2007 and for the nine months ended September 30, 2007.

**Implementation of New Accounting Pronouncement:**FIN 48 Evaluation

In July 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes," an interpretation of FASB Statement No. 109, "Accounting for Income Taxes." FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, by defining a criterion that an individual tax position must meet for any part of that position to be recognized in an enterprise's financial statements. The interpretation requires a review of all tax positions accounted for in accordance with FASB Statement No. 109 and applies a more-likely-than-not recognition threshold. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with the taxing authority that has full knowledge of all relevant information. Subsequent recognition, derecognition, and measurement is based on management's judgment given the facts, circumstances and information available at the reporting date. We are subject to the provisions of FIN 48 beginning January 1, 2007. We evaluated FIN 48 and determined that the adoption of FIN 48 had no impact on our financial statements.

**Recent Accounting Pronouncement:**FAS 157 Evaluation

In September 2006, the FASB issued FASB Statement No. 157, "Fair Value Measurements" ("FAS No. 157"). This standard defines fair value, establishes a methodology for measuring fair value and expands the required disclosure for fair value measurements. FAS No. 157 emphasizes that fair value is a market-based measurement, not an

entity-specific measurement, and states that a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. This statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those pronouncements that fair value is the relevant measurement attribute. Accordingly, this statement does not require any new fair value measurements. FAS No. 157 is effective for fiscal years beginning after November 15, 2007, and we intend to adopt the standard on January 1, 2008. We are currently evaluating the impact, if any, that FAS No. 157 will have on our financial statements.

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FAS 159 Evaluation

In February 2007, the FASB issued Statement of Financial Accounting Standards (“SFAS”) No. 159, “*The Fair Value Option for Financial Assets and Financial Liabilities*” (“SFAS No. 159”). SFAS No. 159 permits entities to choose to measure certain financial assets and liabilities at fair value, with the change in unrealized gains and losses on items for which the fair value option has been elected and reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact, if any, that SFAS No. 159 will have on our financial statements.

**NOTE 2 –PROPERTIES**

In the ordinary course of our business activities, we periodically evaluate investment opportunities and extend credit to customers. We also regularly engage in lease and loan extensions and modifications. Additionally, we actively monitor and manage our investment portfolio with the objectives of improving credit quality and increasing investment returns. In connection with portfolio management, we may engage in various collection and foreclosure activities.

If we acquire real estate pursuant to a foreclosure, lease termination or bankruptcy proceeding and do not immediately re-lease or sell the properties to new operators, the assets will be included on the balance sheet as “foreclosed real estate properties,” and the value of such assets is reported at the lower of cost or estimated fair value.

**Leased Property**

Our leased real estate properties, represented by 227 long-term care facilities and two rehabilitation hospitals at September 30, 2007, are leased under provisions of single leases and master leases with initial terms typically ranging from 5 to 15 years, plus renewal options. Substantially all of our leases contain provisions for specified annual increases over the rents of the prior year and are generally computed in one of three methods depending on specific provisions of each lease as follows: (i) a specific annual increase over the prior year’s rent, generally 2.5%; (ii) an increase based on the change in pre-determined formulas from year to year (i.e., such as increases in the Consumer Price Index (“CPI”)); or (iii) specific dollar increases over prior years. Under the terms of the leases, the lessee is responsible for all maintenance, repairs, taxes and insurance on the leased properties.

During the third quarter of 2007, we completed a transaction with Litchfield Investment Company, LLC and its affiliates to purchase five (5) skilled nursing facilities (“SNFs”) for a total investment of \$39.5 million. The facilities total 645 beds and are located in Alabama (1), Georgia (2), Kentucky (1) and Tennessee (1). We also provided a \$2.5 million loan in the form of a subordinated note as part of the transaction. Simultaneously with the close of the purchase transaction, the facilities were combined into an Amended and Restated Master Lease with Home Quality Management (“HQM”). The Amended and Restated Master Lease was extended until July 31, 2017. The investment allocated to land, building and personal property is \$6.3 million, \$32.1 million and \$1.1 million, respectively.

During the third quarter of 2007, we continued our restructure of a 5 facility master lease with one of our existing tenants whereby we and tenant have agreed to sell three (3) facilities and reduce the overall annual rent on the master lease by \$0.4 million. Two (2) of the facilities are under contract to be sold, pending licensure, for approximately \$2.8 million in cash proceeds. The tenant will continue to pay full rent pursuant to the master lease until the completion of the sale of the two facilities. Upon completion, the overall annual rent on the master lease will be reduced by \$0.4 million. We have and will continue to maintain a personal guarantee from the tenant.

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During the second quarter of 2007, we purchased the land, building and existing improvements of a former medical office building in Toledo, Ohio for \$1.4 million. The building is located adjacent to one of our SNFs. We are in the process of renovating the building into a 40 bed long- term acute care hospital (“LTACH”).

During the first quarter of 2007, we consolidated and extended two master lease agreements with one of our operators, increasing the lease terms by two and four years, respectively.

**Acquisitions**

The five (5) SNFs acquired from Litchfield during the quarter are included in our results of operations from the respective date of acquisition. The following unaudited pro forma results of operations reflect these transactions as if each had occurred on January 1 of the year presented. According to management, all significant adjustments necessary to reflect the effects of the acquisitions have been made.

	<b>Pro Forma</b>			
	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	<b>(in thousands, except per share amounts)</b>			
Revenues	\$ 39,602	\$ 37,849	\$ 122,607	\$ 113,782
Net income	\$ 15,361	\$ 14,821	\$ 52,144	\$ 43,560
Earnings per share available to common – basic	0.19	\$ 0.21	\$ 0.69	\$ 0.62
Earnings per share available to common – diluted	\$ 0.19	\$ 0.21	\$ 0.69	\$ 0.62

In the third quarter of 2006, we completed two transactions: (i) the purchase of Litchfield Investment Company, LLC and its affiliates (“Litchfield”), which included 30 SNFs and one independent living center; and (ii) an additional facility located in Pennsylvania for a combined total investment of \$178.9 million. We have substantially finalized the purchase price allocation of the \$178.9 million. The amount allocated to land, building and personal property is \$15.4 million, \$154.4 million and \$7.5 million, respectively, including \$1.8 million land and building classified as held for sale. We also allocated \$1.6 million to a below-market lease.

**Assets Sold or Held for Sale***Assets Sold*

- On January 31, 2007, we sold two assisted living facilities (“ALFs”) in Indiana for approximately \$3.6 million resulting in a gain of approximately \$1.7 million.
- On February 1, 2007, we sold a closed SNF in Illinois for approximately \$0.1 million resulting in a loss of \$35 thousand.

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- On March 30, 2007, we sold a SNF in Arkansas for approximately \$0.7 million resulting in a loss of \$15 thousand.
- On May 18, 2007, we sold two SNFs in Texas for their net book values, generating cash proceeds of approximately \$1.8 million.

*Held for Sale*

During the three months ended September 30, 2007, a \$1.6 million provision for impairment charge was recorded to reduce the carrying value on one facility to its estimated fair value. At September 30, 2007, we had four assets classified as held-for-sale with a net book value of approximately \$3.6 million.

**Mortgage Notes Receivable**

Mortgage notes receivable relate to nine (9) long-term care facilities. The mortgage notes are secured by first mortgage liens on the borrowers' underlying real estate and personal property. The mortgage notes receivable relate to facilities located in four (4) states, operated by five (5) independent healthcare operating companies. We monitor compliance with mortgages and when necessary have initiated collection, foreclosure and other proceedings with respect to certain outstanding loans. As of September 30, 2007, we had no foreclosed property, and none of our mortgages were in foreclosure proceedings.

Mortgage interest income is recognized as earned over the terms of the related mortgage notes. Allowances are provided against earned revenues from mortgage interest when collection of amounts due becomes questionable or when negotiations for restructurings of troubled operators lead to lower expectations regarding ultimate collection. When collection is uncertain, mortgage interest income on impaired mortgage loans is recognized as received after taking into account application of security deposits.

**NOTE 3 – CONCENTRATION OF RISK**

As of September 30, 2007, our portfolio of investments consisted of 238 healthcare facilities, located in 27 states and operated by 29 third-party operators. Our gross investment in these facilities, net of impairments and before reserve for uncollectible loans, totaled approximately \$1.3 billion at September 30, 2007, with approximately 98% of our real estate investments related to long-term care facilities. This portfolio is made up of 223 long-term healthcare facilities, two rehabilitation hospitals owned and leased to third parties, fixed rate mortgages on nine long-term healthcare facilities and four long-term healthcare facilities that are currently held for sale. At September 30, 2007, we also held miscellaneous investments of approximately \$16 million, consisting primarily of secured loans to third-party operators of our facilities.

At September 30, 2007, approximately 29% of our real estate investments were operated by two public companies: Sun Healthcare Group (“Sun”) (18%) and Advocat Inc. (“Advocat”) (11%). Our largest private company operators (by investment) were CommuniCare Health Services, Inc. (“CommuniCare”) (15%), HQM (11%), Haven Eldercare, LLC (“Haven”) (9%), Guardian LTC Management, Inc. (“Guardian”) (7%), Nexion Health Inc. (“Nexion”) (6%) and Essex Healthcare Corporation (6%). No other operator represents more than 4% of our investments. The three states in which we had our highest concentration of investments were Ohio (21%), Florida (13%) and Pennsylvania (8%) at September 30, 2007.

For the three-month period ended September 30, 2007, our revenues from operations totaled \$39.2 million, of which approximately \$7.7 million were from Sun (20%), \$5.2 million from Advocat (13%) and \$5.1 million from CommuniCare (13%). For the nine-month period ended September 30, 2007, our revenues from operations totaled \$120.0 million, of which approximately \$22.9 million were from Sun (19%), \$20.4 million from Advocat (17%) and



\$15.4 million from CommuniCare (13%). No other operator generated more than 9% of our revenues from operations for the three- and nine- month periods ended September 30, 2007.

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Sun and Advocat are subject to the reporting requirements of the SEC and are required to file with the SEC annual reports containing audited financial information and quarterly reports containing unaudited interim financial information. Sun and Advocat's filings with the SEC can be found at the SEC's website at [www.sec.gov](http://www.sec.gov). We are providing this data for information purposes only, and you are encouraged to obtain Sun and Advocat's publicly available filings from the SEC.

**NOTE 4 –DIVIDENDS**

*Common Dividends*

On October 16, 2007, the Board of Directors declared a common stock dividend of \$0.28 per share, an increase of \$0.01 per common share compared to the prior quarter. The common dividend will be paid November 15, 2007 to common stockholders of record on October 31, 2007.

On July 17, 2007, the Board of Directors declared a common stock dividend of \$0.27 per share that was paid August 15, 2007 to common stockholders of record on July 31, 2007.

On April 18, 2007, the Board of Directors declared a common stock dividend of \$0.27 per share, an increase of \$0.01 per common share compared to the prior quarter. The common dividend was paid May 15, 2007 to common stockholders of record on April 30, 2007.

On January 16, 2007, the Board of Directors declared a common stock dividend of \$0.26 per share, an increase of \$0.01 per common share compared to the prior quarter. The common dividend was paid February 15, 2007 to common stockholders of record on January 31, 2007.

*Series D Preferred Dividends*

On October 16, 2007, the Board of Directors declared the regular quarterly dividends for the 8.375% Series D Cumulative Redeemable Preferred Stock ("Series D Preferred Stock") to stockholders of record on October 31, 2007. The stockholders of record of the Series D Preferred Stock on October 31, 2007 will be paid dividends in the amount of \$0.52344 per preferred share on November 15, 2007. The liquidation preference for our Series D Preferred Stock is \$25.00 per share. Regular quarterly preferred dividends for the Series D Preferred Stock represent dividends for the period August 1, 2007 through October 31, 2007.

On July 17, 2007, the Board of Directors declared the regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D preferred stock that were paid August 15, 2007 to preferred stockholders of record on July 31, 2007.

On April 18, 2007, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid May 15, 2007 to preferred stockholders of record on April 30, 2007.

On January 16, 2007, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D preferred stock that were paid February 15, 2007 to preferred stockholders of record on January 31, 2007.

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**NOTE 5 – TAXES**

So long as we qualify as a REIT and, among other things, we distribute 90% of our taxable income, we will not be subject to Federal income taxes on our income, except as described below. We are permitted to own up to 100% of a “taxable REIT subsidiary” (“TRS”). Currently, we have one TRS that is taxable as a corporation and that pays federal, state and local income tax on its net income at the applicable corporate rates. The TRS had a net operating loss carry-forward as of September 30, 2007 of \$1.1 million. The loss carry-forward was fully reserved with a valuation allowance due to uncertainties regarding realization.

During the fourth quarter of 2006, we determined that certain terms of the Advocat Series B non-voting, redeemable convertible preferred stock could be interpreted as affecting our compliance with federal income tax rules applicable to REITs regarding related party tenant income. As such, Advocat, one of our lessees, may be deemed to be a “related party tenant” under applicable federal income tax rules. In such event, our rental income from Advocat would not be qualifying income under the gross income tests that are applicable to REITs. In order to maintain qualification as a REIT, we annually must satisfy certain tests regarding the source of our gross income, unless the “savings clause” (which finds that such failure to satisfy the REIT gross income test is due to reasonable cause) that is provided for REITs under federal income tax laws applies. A REIT that qualifies for the savings clause will retain its REIT status but will pay a tax under section 857(b)(5), plus interest, even though the gross income test is not otherwise satisfied. While we believe there were valid arguments that Advocat should not be deemed a “related party tenant,” the matter was not free from doubt, and we believed it was in our best interest to request a closing agreement from the IRS resolving any issues regarding whether the rents received from Advocat were considered related party tenant income, which affected our ability to satisfy the gross income test. Accordingly, on December 15, 2006, we submitted a request for a closing agreement to the IRS in order to resolve the “related party tenant” issue. Since that time, we have had additional conversations with the IRS and submitted additional documentation requested by the IRS in support of the issuance of a closing agreement with respect to this matter. While we have not yet entered into a formal closing agreement with the IRS with respect to the Advocat matter, after its initial review, the IRS has not raised any objections to the request. If obtained, a closing agreement will establish that any failure to satisfy the gross income tests was due to reasonable cause. In the event that it is determined that the “savings clause” described above does not apply, we could be treated as having failed to qualify as a REIT for one or more taxable years.

As a result of the potential related party tenant issue described above, we have recorded approximately \$5.5 million in income tax provisions for the tax years 2002-2006. This amount represents the estimated liability and interest, which remains subject to final resolution and acceptance of our request for a closing agreement. On the advice of, and with tax counsel’s assistance, we have amended our relationship with Advocat such that we do believe there is a related party tenant issue with respect to rental income received from Advocat. Accordingly, we do not expect to incur tax expense associated with related party tenant income in future periods commencing January 1, 2007. We recorded interest and penalty charges associated with tax matters as income tax expense. We file U.S. federal income tax returns and state income and franchise tax returns in over 27 state jurisdictions. With few exceptions, we are no longer subject to U.S. federal or state income tax examinations by taxing authorities for years prior to 2003. During the third quarter of 2007, we filed our 2006 tax return and paid approximately \$2.1 million of the \$5.5 million tax liability.

Table of Contents**NOTE 6 – STOCK-BASED COMPENSATION**

Effective January 1, 2006, we adopted FASB Statement No. 123R, *Share-Based Payment*, using the modified prospective method. The following is a summary of our stock based compensation expense for the three- and nine-month periods ended September 30, 2007 and 2006, respectively:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>			
Stock based compensation cost	\$ 545	\$ 3,639	\$ 880	\$ 4,224

**2007 Stock Awards**

In May 2007, we granted 286,908 shares of restricted stock and 247,992 performance restricted stock units (“PRSU”) to five executive officers under the 2004 Plan Stock Incentive Plan (the “2004 Plan”).

***Restricted Stock Award***

The restricted stock award vests one-seventh on December 31, 2007 and two-sevenths on December 31, 2008, December 31, 2009, and December 31, 2010, respectively, subject to continued employment on the vesting date (as defined in the agreements filed with the SEC on May 8, 2007).

***Performance Restricted Stock Units***

We awarded two types of PRSUs (annual and cliff vesting awards) to the five executives. One half of the PRSU awards vest annually in equal increments on December 31, 2008, December 31, 2009, and December 31, 2010, respectively. The other half of the PRSU awards cliff vest on December 31, 2010. Vesting on both types of awards requires achievement of total shareholder return as defined in the agreements filed with the SEC on May 8, 2007.

The following table summarizes our total unrecognized compensation cost associated with the restricted stock awards and PRSUs awarded in May 2007 as of September 30, 2007:

	<b>Shares/ Units</b>	<b>Value Per Unit/ Share</b>	<b>Total Compensation Cost</b>	<b>Weighted Average Period of Expense Recognition (in months)</b>	<b>Unrecognized Compensation Cost</b>
	<b>(in thousands, except per share amounts)</b>				
Restricted stock	286,908	\$ 17.06	\$ 4,895	44	\$ 4,362
2008 Annual performance restricted stock units	41,332	8.78	363	20	272
2009 Annual performance restricted stock units	41,332	8.25	341	32	288
	41,332	8.14	336	44	298

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2010 Annual performance restricted stock  
units

3 year cliff vest performance restricted  
stock units

123,996	6.17	765	44	678	
Total	534,900	\$	6,700	\$	5,898

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A Monte-Carlo model was used to estimate the fair value and derived service periods for PRSUs granted to the executives. The following are some of the significant assumptions used in estimating the value of the awards:

Closing stock price on date of grant	\$17.06
20-day-average stock price	\$17.27
Risk-free interest rate at time of grant	4.6% to 5.1%
Expected volatility	24.0% to 29.4%

As of September 30, 2007, we had 35,997 stock options and 15,496 shares of restricted stock outstanding to other employees and directors. The stock options were fully vested as of January 1, 2007 and the restricted shares are scheduled to vest over the next three years.

**NOTE 7 – FINANCING ACTIVITIES AND BORROWING ARRANGEMENTS**

**Bank Credit Agreements**

Pursuant to Section 2.01 of our Credit Agreement, dated as of March 31, 2006 (the “Credit Agreement”), we were permitted under certain circumstances to increase our available borrowing base under the Credit Agreement from \$200 million up to an aggregate of \$300 million. Effective February 22, 2007, we exercised our right to increase the available revolving commitment under Section 2.01 of the Credit Agreement from \$200 million to \$255 million and we consented to add 18 of our properties to the borrowing base assets under the Credit Agreement. We paid approximately \$0.7 million in fees and expenses associated with increasing the available revolving commitment.

At September 30, 2007, we had \$52.0 million outstanding under our \$255 million revolving senior secured credit facility and \$2.1 million was utilized for the issuance of letters of credit, leaving availability of \$200.9 million. The \$52.0 million of outstanding borrowings had a blended interest rate of 6.40% at September 30, 2007.

Our long-term borrowings require us to meet certain property level financial covenants and corporate financial covenants, including prescribed leverage, fixed charge coverage, minimum net worth, limitations on additional indebtedness and limitations on dividend payouts. As of September 30, 2007, we were in compliance with all property level and corporate financial covenants.

**Other Long-Term Borrowings**

As previously reported, during the three months ended March 31, 2006, Haven Eldercare, LLC (“Haven”), an existing operator for us, entered into a \$39 million first mortgage loan with General Electric Capital Corporation (“GE Capital”). Haven used the \$39 million of proceeds from the GE Loan to partially repay a portion of a \$62 million mortgage it has with us. Simultaneously, we subordinated the payment of its remaining \$23 million mortgage note to that of the GE Loan. In conjunction with the above transactions and the application of Financial Accounting Standards Board Interpretation No. 46R, *Consolidation of Variable Interest Entities*, (“FIN 46R”), we consolidated the financial statements and real estate of the Haven entity into our financial statements. The impact of consolidating the Haven entity resulted in the following adjustments to our consolidated balance sheet as of September 30, 2007: (1) an increase in total gross investments of \$39.0 million; (2) an increase in accumulated depreciation of \$2.7 million; (3) an increase in accounts receivable of \$0.3 million; (4) an increase in other long-term borrowings of \$39.0 million; (5) and a reduction of \$2.4 million in cumulative net earnings primarily due to increased depreciation expense. Our results of operation reflect the impact of the consolidation of the Haven entity for the three- and nine- month periods ended September 30, 2007 and 2006, respectively. The loan has an interest rate of approximately 7% and is due

2012. The lender of the \$39 million does not have recourse to our assets.

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Table of Contents**Issuance of Common Stock**

On April 3, 2007, we completed an underwritten public offering of 7,130,000 shares of Omega common stock at \$16.75 per share, less underwriting discounts. The sale included 930,000 shares sold in connection with the exercise of an over-allotment option granted to the underwriters. We received approximately \$112.9 million in net proceeds from the sale of the shares, after deducting underwriting discounts and offering expenses. UBS Investment Bank acted as sole book-running manager for the offering. Banc of America Securities LLC, Deutsche Bank Securities and Stifel Nicolaus acted as co-managers for the offering. The net proceeds were used to repay indebtedness under our Credit Agreement.

**NOTE 8 – LITIGATION**

We are subject to various legal proceedings, claims and other actions arising out of the normal course of business. While any legal proceeding or claim has an element of uncertainty, management believes that the outcome of each lawsuit, claim or legal proceeding that is pending or threatened, or all of them combined, will not have a material adverse effect on our consolidated financial position or results of operations.

We and several of our wholly-owned subsidiaries have been named as defendants in professional liability claims related to our former owned and operated facilities. Other third-party managers responsible for the day-to-day operations of these facilities have also been named as defendants in these claims. In these suits, patients of certain previously owned and operated facilities have alleged significant damages, including punitive damages against the defendants. The majority of these lawsuits representing the most significant amount of exposure were settled in 2004. There currently is one lawsuit pending that is in the discovery stage, and we are unable to predict the likely outcome of this lawsuit at this time.

**NOTE 9 – DISCONTINUED OPERATIONS**

Statement of Financial Accounting Standards (“SFAS”) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, requires the presentation of the net operating results of facilities sold during 2006 and 2007 or currently classified as held-for-sale as income from discontinued operations for all periods presented.

The following table summarizes the results of operations of facilities sold or held-for-sale during the three and nine months ended September 30, 2007 and 2006, respectively.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>			
<b>Revenues</b>				
Rental income	\$ 45	\$ 138	\$ 167	\$ 413
<b>Expenses</b>				
Depreciation and amortization	7	49	28	144
General and administrative	—	31	3	34
Provision for impairment	—	—	—	121
Allowance for uncollectible loans	—	152	—	152
Subtotal expenses	7	232	31	451



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Income (loss) before gain (loss) on sale of assets	38		(94)		136		(38)
(Loss) gain on assets sold – net	(1)		—		1,595		(381)
<b>Discontinued operations</b>	<b>\$ 37</b>	<b>\$</b>	<b>(94)</b>	<b>\$</b>	<b>1,731</b>	<b>\$</b>	<b>(419)</b>

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During the third quarter of 2007, we classified one held-for-sale facility in California as a discontinued operations and reported its net operating results as discontinued operations. The facility's net book value was approximately \$1.1 million at September 30, 2007 and December 31, 2006. The facility generated approximately \$0.2 million in revenues in fiscal year 2006.

During the second quarter of 2007, we sold two properties in Texas for their net book values. The facilities generated no revenue in fiscal year 2006.

During the first quarter of 2007, we sold four properties (two in Indiana, one in Arkansas and one in Illinois) for approximately \$4.4 million and recorded a gain of \$1.6 million. The facilities generated approximately \$0.4 million in revenues in fiscal year 2006.

**NOTE 10 – EARNINGS PER SHARE**

We calculate basic and diluted earnings per common share (“EPS”) in accordance with FAS No. 128, *Earnings Per Share*. The computation of basic EPS is computed by dividing net income available to common stockholders by the weighted-average number of shares of common stock outstanding during the relevant period. Diluted EPS is computed using the treasury stock method, which is net income divided by the total weighted-average number of common outstanding shares plus the effect of dilutive common equivalent shares during the respective period. Dilutive common shares reflect the assumed issuance of additional common shares pursuant to certain of our share-based compensation plans, including stock options, restricted stock and performance restricted stock units.

The following tables set forth the computation of basic and diluted earnings per share:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	(in thousands, except per share amounts)			
Numerator:				
Income from continuing operations	\$ 15,312	\$ 14,717	\$ 50,327	\$ 42,707
Preferred stock dividends	(2,480)	(2,480)	(7,442)	(7,442)
Numerator for income available to common from continuing operations - basic and diluted	12,832	12,237	42,885	35,265
Discontinued operations	37	(94)	1,731	(419)
Numerator for net income available to common per share - basic and diluted	\$ 12,869	\$ 12,143	\$ 44,616	\$ 34,846
Denominator:				
Denominator for basic earnings per share	67,952	59,021	65,094	58,203
Effect of dilutive securities:				
Unvested restricted stock	—	404	3	184
Stock option incremental shares	13	21	17	20
Denominator for diluted earnings per share	67,965	59,446	65,114	58,407
Earnings per share - basic:				
Income available to common from continuing operations	\$ 0.19	\$ 0.21	\$ 0.66	\$ 0.61
Income (loss) from discontinued operations	—	—	0.03	(0.01)
Net income available to common	\$ 0.19	\$ 0.21	\$ 0.69	\$ 0.60
Earnings per share - diluted:				
Income available to common from continuing operations	\$ 0.19	\$ 0.21	\$ 0.66	\$ 0.60

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Income (loss) from discontinued operations		—	(0.01)		0.03		—	
Net income available to common	\$	0.19	\$	0.20	\$	0.69	\$	0.60

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**NOTE 11 – SUBSEQUENT EVENT**

**Reinstatement of Optional Cash Purchases Under the Plan**

On October 16, 2007, we announced the reinstatement of the optional cash purchase component of our Dividend Reinvestment and Common Stock Purchase Plan, effective immediately for investments beginning November 15, 2007. We reset the per share purchase discount for both optional cash purchases and dividend reinvestments under the Plan to 1% for shares purchased from us. All participants at the date of the Plan's suspension on August 1, 2007 will be receiving a letter from us discussing enrollment status and procedures.

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**Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Forward-looking Statements, Reimbursement Issues and Other Factors Affecting Future Results**

*The following discussion should be read in conjunction with the financial statements and notes thereto appearing elsewhere in this document. This document contains forward-looking statements within the meaning of the federal securities laws, including statements regarding potential financings and potential future changes in reimbursement. These statements relate to our expectations, beliefs, intentions, plans, objectives, goals, strategies, future events, performance and underlying assumptions and other statements other than statements of historical facts. In some cases, you can identify forward-looking statements by the use of forward-looking terminology including, but not limited to, terms such as “may,” “will,” “anticipates,” “expects,” “believes,” “intends,” “should” or comparable terms or the negative thereof. These statements are based on information available on the date of this filing and only speak as to the date hereof and no obligation to update such forward-looking statements should be assumed. Our actual results may differ materially from those reflected in the forward-looking statements contained herein as a result of a variety of factors, including, among other things:*

- (i) those items discussed under “Risk Factors” in Item 1A to our annual report on Form 10-K for the year ended December 31, 2006;
- (ii) uncertainties relating to the business operations of the operators of our assets, including those relating to reimbursement by third-party payors, regulatory matters and occupancy levels;
- (iii) the ability of any operators in bankruptcy to reject unexpired lease obligations, modify the terms of our mortgages and impede our ability to collect unpaid rent or interest during the process of a bankruptcy proceeding and retain security deposits for the debtors’ obligations;
- (iv) our ability to sell closed assets on a timely basis and on terms that allow us to realize the carrying value of these assets;
  - (v) our ability to negotiate appropriate modifications to the terms of our credit facility;
  - (vi) our ability to manage, re-lease or sell any owned and operated facilities;
  - (vii) the availability and cost of capital;
  - (viii) competition in the financing of healthcare facilities;
  - (ix) regulatory and other changes in the healthcare sector;
- (x) the effect of economic and market conditions generally and, particularly, in the healthcare industry;
  - (xi) changes in interest rates;
  - (xii) the amount and yield of any additional investments;
  - (xiii) changes in tax laws and regulations affecting real estate investment trusts;
  - (xiv) our ability to maintain our status as a real estate investment trust; and
  - (xv) changes in the ratings of our debt and preferred securities.

**Overview**

Our portfolio of investments at September 30, 2007, consisted of 238 healthcare facilities, located in 27 states and operated by 29 third-party operators. Our gross investment in these facilities totaled approximately \$1.3 billion at September 30, 2007, with 98% of our real estate investments related to long-term healthcare facilities. This portfolio is made up of 223 long-term healthcare facilities, two rehabilitation hospitals owned and leased to third parties, fixed rate mortgages on nine long-term healthcare facilities and four long-term healthcare facilities that are currently held for sale. At September 30, 2007, we also held other investments of approximately \$16 million, consisting primarily of secured loans to third-party operators of our facilities.



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**Medicare Reimbursement**

All of our properties are used as healthcare facilities; therefore, we are directly affected by the risk associated with the healthcare industry. Our lessees and mortgagors, as well as any facilities that may be owned and operated for our own account from time to time, derive a substantial portion of their net operating revenues from third-party payors, including the Medicare and Medicaid programs. These programs are highly regulated by federal, state and local laws, rules and regulations and are subject to frequent and substantial change.

In 1997, the Balanced Budget Act significantly reduced spending levels for the Medicare and Medicaid programs, in part because the legislation modified the payment methodology for skilled nursing facilities (“SNFs”) by shifting payments for services provided to Medicare beneficiaries from a reasonable cost basis to a prospective payment system. Under the prospective payment system, SNFs are paid on a per diem prospective case-mix adjusted basis for all covered services. Implementation of the prospective payment system has affected each long-term care facility to a different degree, depending upon the amount of revenue such facility derives from Medicare patients.

Legislation adopted in 1999 and 2000 provided for a few temporary increases to Medicare payment rates, but these temporary increases have since expired. Specifically, in 1999 the Balanced Budget Refinement Act included a 4% across-the-board increase of the adjusted federal per diem payment rates for all patient acuity categories (known as “Resource Utilization Groups” or “RUGs”) that were in effect from April 2000 through September 30, 2002. In 2000, the Benefits Improvement and Protection Act included a 16.7% increase in the nursing component of the case-mix adjusted federal periodic payment rate, which was implemented in April 2000 and also expired October 1, 2002. The October 1, 2002 expiration of these temporary increases has had an adverse impact on the revenues of the operators of SNFs and has negatively impacted some operators’ ability to satisfy their monthly lease or debt payments to us.

The Balanced Budget Refinement Act and the Benefits Improvement and Protection Act also established temporary increases, beginning in April 2001, to Medicare payment rates to SNFs that were designated to remain in place until the Centers for Medicare and Medicaid Services (“CMS”), implemented refinements to the existing RUG case-mix classification system to more accurately estimate the cost of non-therapy ancillary services. The Balanced Budget Refinement Act provided for a 20% increase for 15 RUG categories until CMS modified the RUG case-mix classification system. The Benefits Improvement and Protection Act modified this payment increase by reducing the 20% increase for three of the 15 RUGs to a 6.7% increase and instituting an additional 6.7% increase for eleven other RUGs.

On August 4, 2005, CMS published a final rule, effective October 1, 2005, establishing Medicare payments for SNFs under the prospective payment system for federal fiscal year 2006 (October 1, 2005 to September 30, 2006). The final rule modified the RUG case-mix classification system and added nine new categories to the system, expanding the number of RUGs from 44 to 53. The implementation of the RUG refinements triggered the expiration of the temporary payment increases of 20% and 6.7% established by the Balanced Budget Refinement Act and the Benefits Improvement and Protection Act, respectively.

Additionally, CMS announced updates in the final rule to reimbursement rates for SNFs in federal fiscal year 2006 based on an increase in the “full market-basket” of 3.1%. In the August 4, 2005 notice, CMS estimated that the increases in Medicare reimbursements to SNFs arising from the refinements to the prospective payment system and the market basket update under the final rule would offset the reductions stemming from the elimination of the temporary increases during federal fiscal year 2006. CMS estimated that there would be an overall increase in Medicare payments to SNFs totaling \$20 million in fiscal year 2006 compared to 2005.

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On July 27, 2006, CMS posted a notice updating the payment rates to SNFs for fiscal year 2007 (October 1, 2006 to September 30, 2007). The market basket increase factor for 2007 was 3.1 %. CMS estimated that the payment update would increase aggregate payments to SNFs nationwide by approximately \$560 million in fiscal year 2007 compared to 2006.

On August 3, 2007, CMS published its final rule for updating the payment rates used under the prospective payment system for SNFs for federal fiscal year 2008 (October 1, 2007 to September 30, 2008). The market basket increase for fiscal year 2008 is 3.3%. Under the final rule, aggregate Medicare payments for nursing homes would increase by approximately \$690 million for fiscal year 2008. In addition, the rule revises and rebases the SNF market basket, which is used in calculating SNF payment rates.

In August 2007, the United States House of Representatives passed a bill, the Children's Health and Medicare Protection (CHAMP) Act (H.R. 3162), which proposed significant cuts to the Medicare program. The Act would have limited the SNF market basket increase for 2008 to the first quarter of fiscal year 2008. After the first quarter, the bill would have decreased the update to zero. Although the House of Representatives subsequently dropped these and all other Medicare provisions from the legislation, it remains possible that such Medicare provisions will be considered by the full Congress in the future.

A 128% temporary increase in the per diem amount paid to SNFs for residents who have AIDS took effect on October 1, 2004. This temporary payment increase arose from the Medicare Prescription Drug Improvement and Modernization Act of 2003, or the Medicare Modernization Act. Although CMS also noted that the AIDS add-on was not intended to be permanent, the increase remained in effect through fiscal year 2007 and the final rule updating payment rates for SNFs for fiscal year 2008 indicated that the increase will continue to remain in effect for fiscal year 2008.

A significant change enacted under the Medicare Modernization Act is the creation of a new prescription drug benefit, Medicare Part D, which went into effect January 1, 2006. The significant expansion of benefits for Medicare beneficiaries arising under the expanded prescription drug benefit could result in financial pressures on the Medicare program that might result in future legislative and regulatory changes with impacts for our operators. As part of this new program, the prescription drug benefits for patients who are dually eligible for both Medicare and Medicaid are being transitioned from Medicaid to Medicare, and many of these patients reside in long-term care facilities. The Medicare program experienced significant operational difficulties in transitioning prescription drug coverage for this population when the benefit went into effect on January 1, 2006. Although it is unclear whether or how issues involving Medicare Part D might have any direct financial impacts on our operators, a June 2007 report by the Medicare Payment Advisory Commission (MedPAC, which is an independent body that advises Congress on Medicare payment policies) examined how Part D is affecting pharmacy services for residents of nursing facilities and other stakeholders and considered alternative approaches for delivering Part D benefits in nursing facilities. MedPAC did not make recommendations, although the report indicated that MedPAC will continue monitoring the delivery of Part D benefits to residents of long-term care facilities.

On February 8, 2006, the President signed into law a \$39.7 billion budget reconciliation package called the Deficit Reduction Act of 2005 ("Deficit Reduction Act"), to lower the federal budget deficit. The Deficit Reduction Act included estimated net savings of \$8.3 billion from the Medicare program over 5 years.

The Deficit Reduction Act contained a provision reducing payments to SNFs for allowable bad debts. Previously, Medicare reimbursed SNFs for 100% of beneficiary bad debt arising from unpaid deductibles and coinsurance amounts. In 2003, CMS released a proposed rule seeking to reduce bad debt reimbursement rates for certain providers, including SNFs, by 30% over a three-year period. Subsequently, in early 2006 the Deficit Reduction Act reduced payments to SNFs for allowable bad debts by 30% effective October 1, 2005 for those individuals not dually eligible for both Medicare and Medicaid. Bad debt payments for the dually eligible population will remain at



100%. Consistent with this legislation, CMS finalized its 2003 proposed rule on August 18, 2006, and the regulations became effective on October 1, 2006. CMS estimates that implementation of this bad debt provision will result in a savings to the Medicare program of \$490 million from FY 2006 to FY 2010. These reductions in Medicare payments for bad debt could have a material adverse effect on our operators' financial condition and operations, which could adversely affect their ability to meet their payment obligations to us.

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The Deficit Reduction Act also contained a provision governing the therapy caps that went into place under Medicare on January 1, 2006. The therapy caps limit the physical therapy, speech-language therapy and occupation therapy services that a Medicare beneficiary can receive during a calendar year. The therapy caps were in effect for calendar year 1999 and then suspended by Congress for three years. An inflation-adjusted therapy limit (\$1,590 per year) was implemented in September of 2002, but then once again suspended in December of 2003 by the Medicare Modernization Act. Under the Medicare Modernization Act, Congress placed a two-year moratorium on implementation of the caps, which expired at the end of 2005.

The inflation-adjusted therapy caps are set at \$1,780 for calendar year 2007. These caps do not apply to therapy services covered under Medicare Part A in a SNF, although the caps apply in most other instances involving patients in SNFs or long-term care facilities who receive therapy services covered under Medicare Part B. The Deficit Reduction Act permitted exceptions in 2006 for therapy services to exceed the caps when the therapy services are deemed medically necessary by the Medicare program. The Tax Relief and Health Care Act of 2006, signed into law on December 20, 2006, extends these exceptions through December 31, 2007. Future and continued implementation of the therapy caps could have a material adverse effect on our operators' financial condition and operations, which could adversely affect their ability to meet their payment obligations to us.

In general, we cannot be assured that federal reimbursement will remain at levels comparable to present levels or that such reimbursement will be sufficient for our lessees or mortgagors to cover all operating and fixed costs necessary to care for Medicare and Medicaid patients. We also cannot be assured that there will be any future legislation to increase Medicare payment rates for SNFs, and if such payment rates for SNFs are not increased in the future, some of our lessees and mortgagors may have difficulty meeting their payment obligations to us.

### **Medicaid and Other Third-Party Reimbursement**

Each state has its own Medicaid program that is funded jointly by the state and federal government. Federal law governs how each state manages its Medicaid program, but there is wide latitude for states to customize Medicaid programs to fit the needs and resources of their citizens. Currently, Medicaid is the single largest source of financing for long-term care in the United States. Rising Medicaid costs and decreasing state revenues caused by recent economic conditions have prompted an increasing number of states to cut or consider reductions in Medicaid funding as a means of balancing their respective state budgets. Existing and future initiatives affecting Medicaid reimbursement may reduce utilization of (and reimbursement for) services offered by the operators of our properties.

In recent years, many states have announced actual or potential budget shortfalls. As a result of these budget shortfalls, many states have announced that they are implementing or considering implementing "freezes" or cuts in Medicaid reimbursement rates, including rates paid to SNF and long-term care providers, or reductions in Medicaid enrollee benefits, including long-term care benefits. We cannot predict the extent to which Medicaid rate freezes, cuts or benefit reductions ultimately will be adopted, the number of states that will adopt them or the impact of such adoption on our operators. However, extensive Medicaid rate cuts, freezes or benefit reductions could have a material adverse effect on our operators' liquidity, financial condition and operations, which could adversely affect their ability to make lease or mortgage payments to us.

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The Deficit Reduction Act included \$4.7 billion in estimated savings from Medicaid and the State Children's Health Insurance Program over five years. The Deficit Reduction Act gave states the option to increase Medicaid cost-sharing and reduce Medicaid benefits, accounting for an estimated \$3.2 billion in federal savings over five years. The remainder of the Medicaid savings under the Deficit Reduction Act comes primarily from changes to prescription drug reimbursement (\$3.9 billion in savings over five years) and tightened policies governing asset transfers (\$2.4 billion in savings over five years).

Asset transfer policies, which determine Medicaid eligibility based on whether a Medicaid applicant has transferred assets for less than fair value, became more restrictive under the Deficit Reduction Act, which extended the look-back period to five years, moved the start of the penalty period and made individuals with more than \$500,000 in home equity ineligible for nursing home benefits (previously, the home was excluded as a countable asset for purposes of Medicaid eligibility). These changes could have a material adverse effect on our operators' financial condition and operations, which could adversely affect their ability to meet their payment obligations to us.

Private payors, including managed care payors, increasingly are demanding discounted fee structures and the assumption by healthcare providers of all or a portion of the financial risk of operating a healthcare facility. Efforts to impose greater discounts and more stringent cost controls are expected to continue. Any changes in reimbursement policies that reduce reimbursement levels could adversely affect the revenues of our lessees and mortgagors, thereby adversely affecting those lessees' and mortgagors' abilities to make their monthly lease or debt payments to us.

In May of 2007, CMS awarded 13 states and the District of Columbia grants totaling over \$547 million to build Medicaid long-term care programs that provide alternatives to nursing home care and keep people at home. Similarly, individual states have been promoting alternatives to nursing homes to cope with the aging population through laws and the development and promotion of community-based systems of care. CMS' grants and the activities of states evidence a shift from a focus on institutional care to a system that offers more choices, including home and community-based services. This trend could have potential adverse effects on our operators' financial conditions, which could affect their ability to meet their payment obligations to us.

### **Fraud and Abuse Laws and Regulations**

There are various extremely complex and largely uninterpreted federal and state laws governing a wide array of referrals, relationships and arrangements and prohibiting fraud by healthcare providers, including criminal provisions that prohibit filing false claims or making false statements to receive payment or certification under Medicare and Medicaid, and failing to refund overpayments or improper payments. The federal and state governments are devoting increasing attention and resources to anti-fraud initiatives against healthcare providers. Penalties for healthcare fraud have been increased and expanded over recent years, including broader provisions for the exclusion of providers from the Medicare and Medicaid programs. The Office of the Inspector General for the U.S. Department of Health and Human Services ("OIG-HHS"), has described a number of ongoing and new initiatives for 2007 to study instances of potential overbilling and/or fraud in SNFs and nursing homes under both Medicare and Medicaid. The OIG-HHS, in cooperation with other federal and state agencies, also continues to focus on the activities of SNFs in certain states in which we have properties.

In addition, the federal False Claims Act allows a private individual with knowledge of fraud to bring a claim on behalf of the federal government and earn a percentage of the federal government's recovery. Because of these monetary incentives, these so-called "whistleblower" suits have become more frequent. Some states currently have statutes that are analogous to the federal False Claims Act. The Deficit Reduction Act encourages additional states to enact such legislation and may encourage increased enforcement activity by permitting states to retain 10% of any recovery for that state's Medicaid program if the enacted legislation is at least as rigorous as the federal False Claims Act. The violation of any of these laws or regulations by an operator may result in the imposition of fines or other penalties that could jeopardize that operator's ability to make lease or mortgage payments to us or to continue

operating its facility.

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**Legislative and Regulatory Developments**

Each year, legislative and regulatory proposals are introduced or proposed in Congress and state legislatures as well as by federal and state agencies that, if implemented, could result in major changes in the healthcare system, either nationally or at the state level. In addition, regulatory proposals and rules are released on an ongoing basis that may have major impacts on the healthcare system generally and the industries in which our operators do business. Legislative and regulatory developments can be expected to occur on an ongoing basis at the local, state and federal levels that have direct or indirect impacts on the policies governing the reimbursement levels paid to our facilities by public and private third-party payors, the costs of doing business and the threshold requirements that must be met for facilities to continue operation or to expand.

The Medicare Modernization Act, which is one example of such legislation, was enacted in December 2003. The significant expansion of other benefits for Medicare beneficiaries under this Act, such as the prescription drug benefit, could create financial pressures on the Medicare program that might result in future legislative and regulatory changes with impacts on our operators. Although the creation of a prescription drug benefit for Medicare beneficiaries was expected to generate fiscal relief for state Medicaid programs, the structure of the benefit and costs associated with its implementation may mitigate the relief for states that originally was anticipated.

The Deficit Reduction Act is another example of such legislation. The provisions in the legislation designed to create cost savings from both Medicare and Medicaid could diminish reimbursement for our operators under both Medicare and Medicaid.

CMS also launched, in 2002, the Nursing Home Quality Initiative program in 2002, which requires nursing homes participating in Medicare to provide consumers with comparative information about the quality of care at the facility. In the fall of 2007, CMS plans to initiate a new quality campaign, Advancing Excellence for America's Nursing Home Residents, to be conducted over the next two years with the ultimate goal being improvement in quality of life and efficiency of care delivery. In the event any of our operators do not maintain the same or superior levels of quality care as their competitors, patients could choose alternate facilities, which could adversely impact our operators' revenues. In addition, the reporting of such information could lead to reimbursement policies that reward or penalize facilities on the basis of the reported quality of care parameters.

In late 2005, CMS began soliciting public comments regarding a demonstration to examine pay-for-performance approaches in the nursing home setting that would offer financial incentives for facilities delivering high quality care. In June 2006, Abt Associates published recommendations for CMS on how to design this demonstration project. The two-year demonstration is slated to begin in October 2007 and will run through September 2009. Other proposals under consideration include efforts by individual states to control costs by decreasing state Medicaid reimbursements in the current or future fiscal years and federal legislation addressing various issues, such as improving quality of care and reducing medical errors throughout the health care industry. We cannot accurately predict whether specific proposals will be adopted or, if adopted, what effect, if any, these proposals would have on operators and, thus, our business.

**Taxation**

The following is a general summary of the material U.S. federal income tax considerations applicable to us and to the holders of our securities and our election to be taxed as a real estate investment trust ("REIT"). It is not tax advice. The summary is not intended to represent a detailed description of the U.S. federal income tax consequences applicable to a particular stockholder in view of any person's particular circumstances, nor is it intended to represent a detailed description of the U.S. federal income tax consequences applicable to stockholders subject to special treatment under the federal income tax laws such as insurance companies, tax-exempt organizations, financial institutions, securities broker-dealers, investors in pass-through entities, expatriates and taxpayers subject to alternative minimum taxation.



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The following discussion, to the extent it constitutes matters of law or legal conclusions (assuming the facts, representations, and assumptions upon which the discussion is based are accurate), accurately represents some of the material U.S. federal income tax considerations relevant to ownership of our securities. The sections of the Internal Revenue Code (the “Code”) relating to the qualification and operation as a REIT are highly technical and complex. The following discussion sets forth the material aspects of the Code sections that govern the federal income tax treatment of a REIT and its stockholders. The information in this section is based on the Code; current, temporary, and proposed Treasury regulations promulgated under the Code; the legislative history of the Code; current administrative interpretations and practices of the Internal Revenue Service (“IRS”); and court decisions, in each case, as of the date of this report. In addition, the administrative interpretations and practices of the IRS include its practices and policies as expressed in private letter rulings, which are not binding on the IRS, except with respect to the particular taxpayers who requested and received those rulings.

## *Taxation of Omega*

*General.* We have elected to be taxed as a REIT, under Sections 856 through 860 of the Code, beginning with our taxable year ended December 31, 1992. Except with respect to the Advocat Inc. (“Advocat”) “related party tenant” issue described elsewhere in this report, we believe that we have been organized and operated in such a manner as to qualify for taxation as a REIT under the Code and we intend to continue to operate in such a manner, but no assurance can be given that we have operated or will be able to continue to operate in a manner so as to qualify or remain qualified as a REIT.

The sections of the Code that govern the federal income tax treatment of a REIT are highly technical and complex. The following sets forth the material aspects of those sections. This summary is qualified in its entirety by the applicable Code provisions, rules and regulations promulgated thereunder, and administrative and judicial interpretations thereof.

If we qualify for taxation as a REIT, we generally will not be subject to federal corporate income taxes on our net income that is currently distributed to stockholders. However, we will be subject to federal income tax as follows: First, we will be taxed at regular corporate rates on any undistributed REIT taxable income, including undistributed net capital gains; provided, however, that if we have a net capital gain, we will be taxed at regular corporate rates on our undistributed REIT taxable income, computed without regard to net capital gain and the deduction for capital gains dividends, plus a 35% tax on undistributed net capital gain, if our tax as thus computed is less than the tax computed in the regular manner. Second, under certain circumstances, we may be subject to the “alternative minimum tax” on our items of tax preference that we do not distribute or allocate to our stockholders. Third, if we have (i) net income from the sale or other disposition of “foreclosure property,” which is held primarily for sale to customers in the ordinary course of business, or (ii) other nonqualifying income from foreclosure property, we will be subject to tax at the highest regular corporate rate on such income. Fourth, if we have net income from prohibited transactions (which are, in general, certain sales or other dispositions of property (other than foreclosure property) held primarily for sale to customers in the ordinary course of business by us, i.e., when we are acting as a dealer), such income will be subject to a 100% tax. Fifth, if we should fail to satisfy the 75% gross income test or the 95% gross income test (as discussed below), but have nonetheless maintained our qualification as a REIT because certain other requirements have been met, we will be subject to a 100% tax on an amount equal to (a) the gross income attributable to the greater of the amount by which we fail the 75% or 95% test, multiplied by (b) a fraction intended to reflect our profitability. Sixth, if we should fail to distribute by the end of each year at least the sum of (i) 85% of our REIT ordinary income for such year, (ii) 95% of our REIT capital gain net income for such year, and (iii) any undistributed taxable income from prior periods, we will be subject to a 4% excise tax on the excess of such required distribution over the amounts actually distributed. Seventh, we will be subject to a 100% excise tax on transactions with a taxable REIT subsidiary (“TRS”) that are not conducted on an arm’s-length basis. Eighth, if we acquire any asset, which is defined as a “built-in gain asset” from a C corporation that is not a REIT (i.e., generally a corporation subject to full corporate-level tax) in a transaction in which the basis of the built-in gain asset in our hands is determined by

reference to the basis of the asset (or any other property) in the hands of the C corporation, and we recognize gain on the disposition of such asset during the 10-year period, which is defined as the “recognition period,” beginning on the date on which such asset was acquired by us, then, to the extent of the built-in gain (i.e., the excess of (a) the fair market value of such asset on the date such asset was acquired by us over (b) our adjusted basis in such asset on such date), our recognized gain will be subject to tax at the highest regular corporate rate. The results described above with respect to the recognition of built-in gain assume that we will not make an election pursuant to Treasury Regulations Section 1.337(d)-7(c)(5).

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*Requirements for qualification.* The Code defines a REIT as a corporation, trust or association: (1) which is managed by one or more trustees or directors; (2) the beneficial ownership of which is evidenced by transferable shares, or by transferable certificates of beneficial interest; (3) which would be taxable as a domestic corporation, but for Sections 856 through 859 of the Code; (4) which is neither a financial institution nor an insurance company subject to the provisions of the Code; (5) the beneficial ownership of which is held by 100 or more persons; (6) during the last half year of each taxable year not more than 50% in value of the outstanding stock of which is owned, actually or constructively, by five or fewer individuals (as defined in the Code to include certain entities); and (7) which meets certain other tests, described below, regarding the nature of its income and assets and the amount of its annual distributions to stockholders. The Code provides that conditions (1) to (4), inclusive, must be met during the entire taxable year and that condition (5) must be met during at least 335 days of a taxable year of twelve months, or during a proportionate part of a taxable year of less than twelve months. For purposes of conditions (5) and (6), pension funds and certain other tax-exempt entities are treated as individuals, subject to a “look-through” exception in the case of condition (6).

*Income tests.* In order to maintain our qualification as a REIT, we annually must satisfy two gross income requirements. First, at least 75% of our gross income (excluding gross income from prohibited transactions) for each taxable year must be derived directly or indirectly from investments relating to real property or mortgages on real property (including generally “rents from real property,” interest on mortgages on real property, and gains on sale of real property and real property mortgages, other than property described in Section 1221(a)(1) of the Code) and income derived from certain types of temporary investments. Second, at least 95% of our gross income (excluding gross income from prohibited transactions) for each taxable year must be derived from such real property investments, dividends, interest and gain from the sale or disposition of stock or securities other than property held for sale to customers in the ordinary course of business.

Rents received by us will qualify as “rents from real property” in satisfying the gross income requirements for a REIT described above only if several conditions are met. First, the amount of the rent must not be based in whole or in part on the income or profits of any person. However, any amount received or accrued generally will not be excluded from the term “rents from real property” solely by reason of being based on a fixed percentage or percentages of receipts or sales. Second, the Code provides that rents received from a tenant will not qualify as “rents from real property” in satisfying the gross income tests if we, or an owner (actually or constructively) of 10% or more of the value of our stock, actually or constructively owns 10% or more of such tenant, which is defined as a related party tenant. Third, if rent attributable to personal property, leased in connection with a lease of real property, is greater than 15% of the total rent received under the lease, then the portion of rent attributable to such personal property will not qualify as “rents from real property.” Finally, for rents received to qualify as “rents from real property,” we generally must not operate or manage the property or furnish or render services to the tenants of such property, other than through an independent contractor from which we derive no revenue. We may, however, directly perform certain services that are “usually or customarily rendered” in connection with the rental of space for occupancy only and are not otherwise considered “rendered to the occupant” of the property. In addition, we may provide a minimal amount of “non-customary” services to the tenants of a property, other than through an independent contractor, as long as our income from the services does not exceed 1% of our income from the related property. Furthermore, we may own up to 100% of the stock of a taxable REIT subsidiary (“TRS”), which may provide customary and non-customary services to our tenants without tainting our rental income from the related properties. For our tax years beginning after 2004, rents for customary services performed by a TRS or that are received from a TRS and are described in Code Section 512(b)(3) no longer need to meet the 100% excise tax safe harbor. Instead, such payments avoid the excise tax if we pay the TRS at least 150% of its direct cost of furnishing such services.

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The term “interest” generally does not include any amount received or accrued (directly or indirectly) if the determination of such amount depends in whole or in part on the income or profits of any person. However, an amount received or accrued generally will not be excluded from the term “interest” solely by reason of being based on a fixed percentage or percentages of gross receipts or sales. In addition, an amount that is based on the income or profits of a debtor will be qualifying interest income as long as the debtor derives substantially all of its income from the real property securing the debt from leasing substantially all of its interest in the property, but only to the extent that the amounts received by the debtor would be qualifying “rents from real property” if received directly by a REIT.

If a loan contains a provision that entitles us to a percentage of the borrower’s gain upon the sale of the real property securing the loan or a percentage of the appreciation in the property’s value as of a specific date, income attributable to that loan provision will be treated as gain from the sale of the property securing the loan, which generally is qualifying income for purposes of both gross income tests.

Interest on debt secured by mortgages on real property or on interests in real property generally is qualifying income for purposes of the 75% gross income test. However, if the highest principal amount of a loan outstanding during a taxable year exceeds the fair market value of the real property securing the loan as of the date we agreed to originate or acquire the loan, a portion of the interest income from such loan will not be qualifying income for purposes of the 75% gross income test, but will be qualifying income for purposes of the 95% gross income test. The portion of the interest income that will not be qualifying income for purposes of the 75% gross income test will be equal to the portion of the principal amount of the loan that is not secured by real property.

*Prohibited transactions.* We will incur a 100% tax on the net income derived from any sale or other disposition of property, other than foreclosure property, that we hold primarily for sale to customers in the ordinary course of a trade or business. We believe that none of our assets is primarily held for sale to customers and that a sale of any of our assets would not be in the ordinary course of our business. Whether a REIT holds an asset primarily for sale to customers in the ordinary course of a trade or business depends, however, on the facts and circumstances in effect from time to time, including those related to a particular asset. Nevertheless, we will attempt to comply with the terms of safe-harbor provisions in the federal income tax laws prescribing when an asset sale will not be characterized as a prohibited transaction. We cannot assure you, however, that we can comply with the safe-harbor provisions or that we will avoid owning property that may be characterized as property that we hold primarily for sale to customers in the ordinary course of a trade or business.

*Foreclosure property.* We will be subject to tax at the maximum corporate rate on any income from foreclosure property, other than income that otherwise would be qualifying income for purposes of the 75% gross income test, less expenses directly connected with the production of that income. However, gross income from foreclosure property is treated as qualifying for purposes of the 75% and 95% gross income tests. Foreclosure property is any real property, including interests in real property, and any personal property incident to such real property:

that is acquired by a REIT as the result of the REIT having bid on such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was a default or default was imminent on a lease of such property or on indebtedness that such property secured;

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for which the related loan or lease was acquired by the REIT at a time when the default was not imminent or anticipated; and

- for which the REIT makes a proper election to treat the property as foreclosure property.

Property generally ceases to be foreclosure property at the end of the third taxable year following the taxable year in which the REIT acquired the property, or longer if an extension is granted by the Secretary of the Treasury. This grace period terminates and foreclosure property ceases to be foreclosure property on the first day:

• on which a lease is entered into for the property that, by its terms, will give rise to income that does not qualify for purposes of the 75% gross income test, or any amount is received or accrued, directly or indirectly, pursuant to a lease entered into on or after such day that will give rise to income that does not qualify for purposes of the 75% gross income test;

• on which any construction takes place on the property, other than completion of a building or any other improvement, where more than 10% of the construction was completed before default became imminent; or

• which is more than 90 days after the day on which the REIT acquired the property and the property is used in a trade or business which is conducted by the REIT, other than through an independent contractor from whom the REIT itself does not derive or receive any income.

After the year 2000, the definition of foreclosure property was amended to include any “qualified health care property,” as defined in Code Section 856(e)(6) acquired by us as the result of the termination or expiration of a lease of such property. We have operated qualified healthcare facilities acquired in this manner for up to two years (or longer if an extension was granted). However, we do not currently own any property with respect to which we have made foreclosure property elections. Properties that we had taken back in a foreclosure or bankruptcy and operated for our own account were treated as foreclosure properties for income tax purposes, pursuant to Internal Revenue Code Section 856(e). Gross income from foreclosure properties was classified as “good income” for purposes of the annual REIT income tests upon making the election on the tax return. Once made, the income was classified as “good” for a period of three years, or until the properties were no longer operated for our own account. In all cases of foreclosure property, we utilized an independent contractor to conduct day-to-day operations in order to maintain REIT status. In certain cases we operated these facilities through a taxable REIT subsidiary. For those properties operated through the taxable REIT subsidiary, we utilized an eligible independent contractor to conduct day-to-day operations to maintain REIT status. As a result of the foregoing, we do not believe that our participation in the operation of nursing homes increased the risk that we would fail to qualify as a REIT. Through our 2005 taxable year, we had not paid any tax on our foreclosure property because those properties had been producing losses. We cannot predict whether, in the future, our income from foreclosure property will be significant and/or whether we could be required to pay a significant amount of tax on that income.

*Hedging transactions.* From time to time, we enter into hedging transactions with respect to one or more of our assets or liabilities. Our hedging activities may include entering into interest rate swaps, caps and floors, options to purchase these items, and futures and forward contracts. To the extent that we enter into an interest rate swap or cap contract, option, futures contract, forward rate agreement, or any similar financial instrument to hedge our indebtedness incurred to acquire or carry “real estate assets,” any periodic income or gain from the disposition of that contract should be qualifying income for purposes of the 95% gross income test, but not the 75% gross income test. Accordingly, our income and gain from our interest rate swap agreements generally is qualifying income for purposes of the 95% gross income test, but not the 75% gross income test. To the extent that we hedge with other types of financial instruments, or in other situations, it is not entirely clear how the income from those transactions will be treated for purposes of the gross income tests. We have structured and intend to continue to structure any hedging transactions in a manner that does not jeopardize our status as a REIT. For tax years beginning after 2004, we were no longer required to include

income from hedging transactions in gross income (i.e., not included in either the numerator or the denominator) for purposes of the 95% gross income test.

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*TRS income.* A TRS may earn income that would not be qualifying income if earned directly by the parent REIT. Both the subsidiary and the REIT must jointly elect to treat the subsidiary as a TRS. A corporation of which a TRS directly or indirectly owns more than 35% of the voting power or value of the stock will automatically be treated as a TRS. Overall, no more than 20% of the value of a REIT's assets may consist of securities of one or more TRSs. However, a TRS does not include a corporation which directly or indirectly (i) operates or manages a health care (or lodging) facility, or (ii) provides to any other person (under a franchise, license, or otherwise) rights to any brand name under which a health care (or lodging) facility is operated. A TRS will pay income tax at regular corporate rates on any income that it earns. In addition, the new rules limit the deductibility of interest paid or accrued by a TRS to its parent REIT to assure that the TRS is subject to an appropriate level of corporate taxation. The rules also impose a 100% excise tax on transactions between a TRS and its parent REIT or the REIT's tenants that are not conducted on an arm's-length basis. We have made a TRS election with respect to Bayside Street II, Inc. That entity will pay corporate income tax on its taxable income and its after-tax net income will be available for distribution to us.

*Failure to satisfy income tests.* If we fail to satisfy one or both of the 75% or 95% gross income tests for any taxable year, we may nevertheless qualify as a REIT for such year if we are entitled to relief under certain provisions of the Code. These relief provisions will be generally available if our failure to meet such tests was due to reasonable cause and not due to willful neglect, we attach a schedule of the sources of our income to our tax return, and any incorrect information on the schedule was not due to fraud with intent to evade tax. It is not possible, however, to state whether in all circumstances we would be entitled to the benefit of these relief provisions. Even if these relief provisions apply, we would incur a 100% tax on the gross income attributable to the greater of the amounts by which we fail the 75% and 95% gross income tests, multiplied by a fraction intended to reflect our profitability and we would file a schedule with descriptions of each item of gross income that caused the failure.

*Related Party Tenant Issue.* In the fourth quarter of 2006, we were advised by tax counsel that, due to certain provisions of the Series B preferred stock issued to us by Advocat in 2000 in connection with a restructuring, Advocat may be considered to be a "related party tenant" under the rules applicable to REITs and, in such event, rental income received by us from Advocat would not be qualifying income for purposes of the REIT gross income tests. The applicable federal income tax rules provide a "savings clause" for REITs that fail to satisfy the REIT gross income tests if such a failure is due to reasonable cause.

While we believe that there are valid arguments that Advocat should not be a "related party tenant," if Advocat were so treated, we would have failed to satisfy the 95% gross income tests during certain prior taxable years. Such a failure could have prevented us from maintaining REIT tax status during such years and from re-electing REIT tax status for a number of taxable years thereafter. Any such failure to satisfy the REIT gross income tests, however, would not result in the loss of REIT status, if the failure was due to reasonable cause and not to willful neglect, and we pay a tax on the non-qualifying income. Accordingly, on the advice of tax counsel in order to resolve the matter, minimize potential penalties, and obtain assurances regarding our continued REIT tax status, we submitted to the IRS a request for a closing agreement on December 15, 2006, which agreement would conclude that any failure to satisfy the gross income tests would be due to reasonable cause and not to willful neglect. Since that time, we have had ongoing conversations with the IRS and we have submitted additional documentation in furtherance of the issuance of a closing agreement. We have been in discussions toward finalization of the closing agreement, however, we have not as yet entered into a closing agreement with respect to the related party tenant issue with the IRS. Based on these discussions, we have no reason to believe that a closing agreement will not be entered into with the IRS once administrative review of the closing agreement by the appropriate levels at the IRS has been completed. We intend to continue to proceed with this course of action until a closing agreement with the IRS is obtained. In the event that it is determined that the "savings clause" described above does not apply, we could be treated as having failed to qualify as a REIT for one or more taxable years. If we fail to qualify for taxation as a REIT for any taxable year, our income will be taxed at regular corporate rates, and we could be disqualified as a REIT for the following four taxable years.



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As a result of the related party tenant issue described above, we have recorded income tax provision of \$5.5 million for the tax years 2002 through 2006. In the third quarter of 2007, we filed and paid \$2.1 million of the liability relating to the tax year 2006. The amount accrued represents the estimated liability and interest, which remains subject to final resolution and therefore is subject to change. In addition, in October 2006, we restructured our Advocat relationship and have been advised by tax counsel that we will not receive any non-qualifying related party tenant income from Advocat in future fiscal years. Accordingly, we do not expect to incur tax expense associated with related party tenant income in future periods commencing January 1, 2007, assuming we enter into a closing agreement with the IRS that recognizes that reasonable cause existed for any failure to satisfy the REIT gross income tests as explained above.

*Asset tests.* At the close of each quarter of our taxable year, we must also satisfy the following tests relating to the nature of our assets. First, at least 75% of the value of our total assets must be represented by real estate assets (including (i) our allocable share of real estate assets held by partnerships in which we own an interest and (ii) stock or debt instruments held for not more than one year purchased with the proceeds of a stock offering or long-term (at least five years) debt offering of our company), cash, cash items and government securities. Second, of our investments not included in the 75% asset class, the value of our interest in any one issuer's securities may not exceed 5% of the value of our total assets. Third, we may not own more than 10% of the voting power or value of any one issuer's outstanding securities. Fourth, no more than 20% of the value of our total assets may consist of the securities of one or more TRSs. Fifth, no more than 25% of the value of our total assets may consist of the securities of TRSs and other non-TRS taxable subsidiaries and other assets that are not qualifying assets for purposes of the 75% asset test.

For purposes of the second and third asset tests the term "securities" does not include our equity or debt securities of a qualified REIT subsidiary, a TRS, or an equity interest in any partnership, since we are deemed to own our proportionate share of each asset of any partnership of which we are a partner. Furthermore, for purposes of determining whether we own more than 10% of the value of only one issuer's outstanding securities, the term "securities" does not include: (i) any loan to an individual or an estate; (ii) any Code Section 467 rental agreement; (iii) any obligation to pay rents from real property; (iv) certain government issued securities; (v) any security issued by another REIT; and (vi) our debt securities in any partnership, not otherwise excepted under (i) through (v) above, (A) to the extent of our interest as a partner in the partnership or (B) if 75% of the partnership's gross income is derived from sources described in the 75% income test set forth above.

We may own up to 100% of the stock of one or more TRSs. However, overall, no more than 20% of the value of our assets may consist of securities of one or more TRSs, and no more than 25% of the value of our assets may consist of the securities of TRSs and other non-TRS taxable subsidiaries (including stock in non-REIT C corporations) and other assets that are not qualifying assets for purposes of the 75% asset test. If the outstanding principal balance of a mortgage loan exceeds the fair market value of the real property securing the loan, a portion of such loan likely will not be a qualifying real estate asset for purposes of the 75% test. The nonqualifying portion of that mortgage loan will be equal to the portion of the loan amount that exceeds the value of the associated real property.

After initially meeting the asset tests at the close of any quarter, we will not lose our status as a REIT for failure to satisfy any of the asset tests at the end of a later quarter solely by reason of changes in asset values. If the failure to satisfy the asset tests results from an acquisition of securities or other property during a quarter, the failure can be cured by disposition of sufficient nonqualifying assets within 30 days after the close of that quarter.

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For our tax years beginning after 2004, subject to certain *de minimis* exceptions, we may avoid REIT disqualification in the event of certain failures under the asset tests, provided that (i) we file a schedule with a description of each asset that caused the failure, (ii) the failure was due to reasonable cause and not willful neglect, (iii) we dispose of the assets within 6 months after the last day of the quarter in which the identification of the failure occurred (or the requirements of the rules are otherwise met within such period), and (iv) we pay a tax on the failure equal to the greater of (A) \$50,000 per failure, and (B) the product of the net income generated by the assets that caused the failure for the period beginning on the date of the failure and ending on the date we dispose of the asset (or otherwise satisfy the requirements) multiplied by the highest applicable corporate tax rate.

*Annual distribution requirements.* In order to qualify as a REIT, we are required to distribute dividends (other than capital gain dividends) to our stockholders in an amount at least equal to (A) the sum of (i) 90% of our “REIT taxable income” (computed without regard to the dividends paid deduction and our net capital gain) and (ii) 90% of the net income (after tax), if any, from foreclosure property, minus (B) the sum of certain items of noncash income. Such distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before we timely file our tax return for such year and paid on or before the first regular dividend payment after such declaration. In addition, such distributions are required to be made pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that such class is entitled to such a preference. To the extent that we do not distribute all of our net capital gain, or distribute at least 90%, but less than 100% of our “REIT taxable income,” as adjusted, we will be subject to tax thereon at regular ordinary and capital gain corporate tax rates.

Furthermore, if we fail to distribute during a calendar year, or by the end of January following the calendar year in the case of distributions with declaration and record dates falling in the last three months of the calendar year, at least the sum of:

- 85% of our REIT ordinary income for such year;
- 95% of our REIT capital gain income for such year; and
- any undistributed taxable income from prior periods,

we will incur a 4% nondeductible excise tax on the excess of such required distribution over the amounts we actually distribute. We may elect to retain and pay income tax on the net long-term capital gain we receive in a taxable year. If we so elect, we will be treated as having distributed any such retained amount for purposes of the 4% excise tax described above. We have made, and we intend to continue to make, timely distributions sufficient to satisfy the annual distribution requirements. We may also be entitled to pay and deduct deficiency dividends in later years as a relief measure to correct errors in determining our taxable income. Although we may be able to avoid income tax on amounts distributed as deficiency dividends, we will be required to pay interest to the IRS based upon the amount of any deduction we take for deficiency dividends.

The availability to us of, among other things, depreciation deductions with respect to our owned facilities depends upon the treatment by us as the owner of such facilities for federal income tax purposes, and the classification of the leases with respect to such facilities as “true leases” rather than financing arrangements for federal income tax purposes. The questions of whether (1) we are the owner of such facilities and (ii) the leases are true leases for federal tax purposes, are essentially factual matters. We believe that we will be treated as the owner of each of the facilities that we lease, and such leases will be treated as true leases for federal income tax purposes. However, no assurances can be given that the IRS will not successfully challenge our status as the owner of our facilities subject to leases, and the status of such leases as true leases, asserting that the purchase of the facilities by us and the leasing of such facilities merely constitute steps in secured financing transactions in which the lessees are owners of the facilities and we are merely a secured creditor. In such event, we would not be entitled to claim depreciation deductions with



respect to any of the affected facilities. As a result, we might fail to meet the 90% distribution requirement or, if such requirement is met, we might be subject to corporate income tax or the 4% excise tax.

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*Other Failures.* We may avoid disqualification in the event of a failure to meet certain requirements for REIT qualification, other than the 95% and 75% gross income tests, the rules with respect to ownership of securities of more than 10% of a single issuer, and the new rules provided for failures of the asset tests, if the failures are due to reasonable cause and not willful neglect, and if the REIT pays a penalty of \$50,000 for each such failure.

### *Failure to Qualify*

If we fail to qualify as a REIT in any taxable year, and the relief provisions do not apply, we will be subject to tax (including any applicable alternative minimum tax) on our taxable income at regular corporate rates. Distributions to stockholders in any year in which we fail to qualify will not be deductible and our failure to qualify as a REIT would reduce the cash available for distribution by us to our stockholders. In addition, if we fail to qualify as a REIT, all distributions to stockholders will be taxable as ordinary income, to the extent of current and accumulated earnings and profits, and, subject to certain limitations of the Code, corporate distributees may be eligible for the dividends received deduction. Unless entitled to relief under specific statutory provisions, we would also be disqualified from taxation as a REIT for the four taxable years following the year during which qualification was lost. It is not possible to state whether in all circumstances we would be entitled to such statutory relief. Failure to qualify could result in our incurring indebtedness or liquidating investments in order to pay the resulting taxes.

### *Other Tax Matters*

We own and operate a number of properties through qualified REIT subsidiaries, (“QRSs”). The QRSs are treated as qualified REIT subsidiaries under the Code. Code Section 856(i) provides that a corporation which is a qualified REIT subsidiary shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of a qualified REIT subsidiary shall be treated as assets, liabilities and such items (as the case may be) of the REIT. Thus, in applying the tests for REIT qualification described in this prospectus under the heading “Taxation of Omega,” the QRSs will be ignored, and all assets, liabilities and items of income, deduction, and credit of such QRSs will be treated as our assets, liabilities and items of income, deduction, and credit.

In the case of a REIT that is a partner in a partnership, the REIT is treated as owning its proportionate share of the assets of the partnership and as earning its allocable share of the gross income of the partnership for purposes of the applicable REIT qualification tests. Thus, our proportionate share of the assets, liabilities, and items of income of any partnership, joint venture, or limited liability company that is treated as a partnership for federal income tax purposes in which we own an interest, directly or indirectly, will be treated as our assets and gross income for purposes of applying the various REIT qualification requirements.

### **Critical Accounting Policies and Estimates**

Our financial statements are prepared in accordance with generally accepted accounting principles in the United States of America (“GAAP”) and a summary of our significant accounting policies is included in Note 2 – Summary of Significant Accounting Policies to our annual report on Form 10-K for the year ended December 31, 2006. Our preparation of the financial statements requires us to make estimates and assumptions about future events that affect the amounts reported in our financial statements and accompanying footnotes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such difference may be material to the consolidated financial statements. We have described our most critical accounting policies in our 2006 annual report on Form 10-K in Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations. During the first quarter of 2007, we adopted Financial Accounting Standards Board (“FASB”)

Interpretation No. 48 (“FIN 48”), “*Accounting for Uncertainty in Income Taxes*,” an interpretation of FASB Statement No. 109 (“FAS No. 109”), “*Accounting for Income Taxes*.” The following discussion provides additional information about the effect on the consolidated financial statements of judgments and estimates related to our policy regarding uncertainty in income taxes.

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Effective January 1, 2007, we adopted the provisions of FIN 48. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FAS No. 109, by defining a criterion that an individual tax position must meet for any part of that position to be recognized in an enterprise's financial statements. The interpretation requires a review of all tax positions accounted for in accordance with FAS No. 109 and applies a more-likely-than-not recognition threshold. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with the taxing authority that has full knowledge of all relevant information. Subsequent recognition, derecognition, and measurement is based on management's judgment given the facts, circumstances and information available at the reporting date. We evaluated FIN 48 and determined that the adoption of FIN 48 had no impact on our financial statements.

### **Recent Accounting Pronouncement:**

#### FAS 157 Evaluation

In September 2006, the FASB issued FASB Statement No. 157, "*Fair Value Measurements*" ("FAS No. 157"). This standard defines fair value, establishes a methodology for measuring fair value and expands the required disclosure for fair value measurements. FAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and states that a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. This statement applies under other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those pronouncements that fair value is the relevant measurement attribute. Accordingly, this statement does not require any new fair value measurements. FAS No. 157 is effective for fiscal years beginning after November 15, 2007, and we intend to adopt the standard on January 1, 2008. We are currently evaluating the impact, if any, that FAS No. 157 will have on our financial statements.

#### FAS 159 Evaluation

In February 2007, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 159, "*The Fair Value Option for Financial Assets and Financial Liabilities*" ("SFAS No. 159"). SFAS No. 159 permits entities to choose to measure certain financial assets and liabilities at fair value, with the change in unrealized gains and losses on items for which the fair value option has been elected reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact, if any, that SFAS No. 159 will have on our financial statements.

### **Results of Operations**

The following is our discussion of the consolidated results of operations, financial position and liquidity and capital resources, which should be read in conjunction with our unaudited consolidated financial statements and accompanying notes.

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***Three Months Ended September 30, 2007 and 2006***

*Operating Revenues*

Our operating revenues for the three months ended September 30, 2007 totaled \$39.2 million, an increase of \$4.1 million, over the same period in 2006. The \$4.1 million increase was primarily the result of additional rental income due to the third quarter 2006 acquisition of 30 SNFs and one independent living center and third quarter 2007 acquisition of 5 SNFs from Litchfield Investment Company, LLC (“Litchfield”).

*Operating Expenses*

Operating expenses for the three months ended September 30, 2007 totaled \$13.5 million, a decrease of approximately \$0.5 million over the same period in 2006. The decrease was primarily due to a \$3.1 million decrease in restricted stock expense, offset by an increase in depreciation expense of \$0.8 million and a 2007 provision for impairment of \$1.6 million related to an asset we plan to sell. The decrease in restricted stock expense primarily relates to the third quarter 2006 vesting of performance awards granted to executives in 2004. The increase in depreciation expenses primarily relates to the third quarter 2006 acquisitions of 30 SNFs and one independent living center from Litchfield.

*Other Income (Expense)*

For the three months ended September 30, 2007, total other expenses were \$10.5 million, as compared to \$7.0 million for the same period in 2006, an increase of \$3.5 million. The \$3.5 million increase is primarily due to the following:

- Interest expense, excluding amortization of deferred financing costs and refinancing related interest expenses, decreased \$1.1 million to \$10.1 million for the three months ended September 30, 2007, from \$11.2 million for the same period 2006. The decrease of \$1.1 million was primarily due to lower average outstanding debt for the period. In the third quarter of 2006 and 2007, we used proceeds from debt to acquire the aforementioned SNFs from Litchfield.
- For the three months ended September 30, 2006, we sold our remaining 760,000 shares of Sun Healthcare Group (“Sun”) common stock for approximately \$7.6 million, realizing a gain on the sale of these securities of approximately \$2.7 million.
- For the three months ended September 30, 2006, we recorded a \$1.8 million mark-to-market adjustment to reflect the increase in fair value of our derivative instrument (i.e., the conversion feature of the redeemable convertible preferred stock we held in Advocat, a publicly traded company).

*Income from continuing operations*

Income from continuing operations for the three months ended September 30, 2007 was \$15.3 million compared to \$14.7 million for the same period in 2006. The increase in income from continuing operations is the result of the factors described above.

***Nine Months Ended September 30, 2007 and 2006***

*Operating Revenues*

Our operating revenues for the nine months ended September 30, 2007 totaled \$120.0 million, an increase of \$20.6 million, over the same period in 2006. The \$20.6 million increase was primarily the result of additional rental income

due to the third quarter 2006 acquisition of 30 SNFs and one independent living center from Litchfield and a change in accounting estimate related to one of our operators. As more fully disclosed in Note 1 –Basis of Presentation and Significant Accounting Policies, during the first quarter of 2007, we determined that we should reverse approximately \$5.0 million of allowance previously established for straight-line rent, as a result of an improvement in one of our operator’s financial condition.

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*Operating Expenses*

Operating expenses for the nine months ended September 30, 2007 totaled \$36.5 million, an increase of approximately \$2.8 million over the same period in 2006. The increase was primarily due to increased depreciation expenses of \$3.4 million related to the third quarter 2006 acquisition of the Litchfield facilities and \$1.6 million of provision for impairment on real estate properties, offset by a reduction of \$3.3 million of restricted stock expense compared to 2006. The decrease in restricted stock primarily relates to the third quarter 2006 vesting of performance awards.

*Other Income (Expense)*

For the nine months ended September 30, 2007, our total other expenses were \$33.3 million, as compared to \$22.5 million for the same period in 2006, an increase of \$10.8 million. The \$10.8 million increase is primarily due to the following:

- Interest expense, excluding amortization of deferred financing costs and refinancing related interest expenses, increased \$1.7 million to \$32.0 million for the nine months ended September 30, 2007, from \$30.2 million for the same period 2006. The increase of \$1.7 million was primarily due to the higher average debt outstanding in 2007 compared to 2006 as a result of the third quarter 2006 and 2007 acquisition of the Litchfield facilities, offset by the use of proceeds from the issuance of equity in April 2007 to pay down debt.
  - For the nine months ended September 30, 2006, we recorded a charge of approximately \$2.7 million relating to the write-off of deferred financing costs associated with the termination of our old credit facility, and \$0.8 million non-cash charge associated with the redemption of the remaining 20.7% of our \$100 million aggregate principal amount of 6.95% unsecured notes due 2007.
- For the nine months ended September 30, 2006, we sold our remaining 760,000 shares of (“Sun”) common stock for approximately \$7.6 million, realizing a gain on the sale of these securities of approximately \$2.7 million.
- For the nine months ended September 30, 2006, we recorded a \$9.7 million mark-to-market adjustment to reflect the increase in fair value of our derivative instrument (i.e., the conversion feature of the redeemable convertible preferred stock we held in Advocat).

*Taxes*

As more fully disclosed in Note 5 – Taxes and in our December 31, 2006 Form 10-K, filed with the Securities and Exchange Commission (the “SEC”), we identified a related party tenant issue which could have been interpreted as affecting our compliance with federal income tax rules applicable to REITs regarding related party tenant income. During the fourth quarter of 2006, we restructured our agreement with the tenant eliminating the related party tenant income issue. As a result of the related party tenant issue in 2006, we recorded income tax expense of \$1.7 million for the nine months ended September 30, 2006.

So long as we qualify as a REIT and, among other things, we distribute 90% of our taxable income, we will not be subject to Federal income taxes on our income, except as described below. For tax year 2006, preferred and common dividend payments of approximately \$67 million made throughout 2006 satisfy the 2006 REIT requirements relating to qualifying income. We are permitted to own up to 100% of a “taxable REIT subsidiary” (“TRS”). Currently, we have one TRS that is taxable as a corporation and that pays federal, state and local income tax on its net income at the applicable corporate rates. The TRS had a net operating loss carry-forward as of September 30, 2007 of \$1.1 million. The loss carry-forward was fully reserved with a valuation allowance due to uncertainties regarding realization. We recorded interest and penalty charges associated with tax matters as income tax expense.





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*Income from continuing operations*

Income from continuing operations for the nine months ended September 30, 2007 was \$50.3 million compared to \$42.7 million for the same period in 2006. The increase in income from continuing operations is the result of the factors described above.

*Gain/Loss from Discontinued Operations*

For the nine months ended September 30, 2007, we recorded a gain of \$1.7 million compared to a loss of \$0.4 million from the same period in 2006. The gain was primarily related to the sale of two assisted living facilities (“ALFs”) in Indiana during the first quarter of 2007.

*Funds From Operations*

Our funds from operations available to common stockholders (“FFO”), for the three months ended September 30, 2007, was \$22.0 million, compared to \$19.3 million, for the same period in 2006.

We calculate and report FFO in accordance with the definition and interpretive guidelines issued by the National Association of Real Estate Investment Trusts (“NAREIT”), and consequently, FFO is defined as net income available to common stockholders, adjusted for the effects of asset dispositions and certain non-cash items, primarily depreciation and amortization. We believe that FFO is an important supplemental measure of our operating performance. Because the historical cost accounting convention used for real estate assets requires depreciation (except on land), such accounting presentation implies that the value of real estate assets diminishes predictably over time, while real estate values instead have historically risen or fallen with market conditions. The term FFO was designed by the real estate industry to address this issue. FFO herein is not necessarily comparable to FFO of other real estate investment trusts (“REITs”) that do not use the same definition or implementation guidelines or interpret the standards differently from us.

We use FFO as one of several criteria to measure operating performance of our business. We further believe that by excluding the effect of depreciation, amortization and gains or losses from sales of real estate, all of which are based on historical costs and which may be of limited relevance in evaluating current performance, FFO can facilitate comparisons of operating performance between periods and between other REITs. We offer this measure to assist the users of our financial statements in analyzing our financial performance; however, this is not a measure of financial performance under GAAP and should not be considered a measure of liquidity, an alternative to net income or an indicator of any other performance measure determined in accordance with GAAP. Investors and potential investors in our securities should not rely on this measure as a substitute for any GAAP measure, including net income.

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The following table presents our FFO results reflecting the impact of asset impairment charges (the SEC's interpretation) for the three- and nine- months ended September 30, 2007 and 2006:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	(in thousands)			
<b>Net income available to common</b>	\$ 12,869	\$ 12,143	\$ 44,616	\$ 34,846
Add back loss (deduct gain) from real estate dispositions	1	(1,188)	(1,595)	(807)
Sub-total	12,870	10,955	43,021	34,039
Elimination of non-cash items included in net income:				
Depreciation and amortization	9,138	8,362	26,768	23,432
<b>Funds from operations available to common stockholders</b>	\$ 22,008	\$ 19,317	\$ 69,789	\$ 57,471

### **Portfolio Developments, New Investments and Recent Developments**

Below is a brief description, by third-party operator, of our re-leasing, restructuring or new investment transactions that occurred during the nine months ended September 30, 2007.

#### *Home Quality Management, Inc.*

On July 31, 2007, we completed a transaction with Litchfield Investment Company, LLC and its affiliates to purchase five (5) SNFs for a total investment of \$39.5 million. The facilities total 645 beds and are located in Alabama (1), Georgia (2), Kentucky (1) and Tennessee (1). We also provided a \$2.5 million loan in the form of a subordinated note as part of the transaction. Simultaneously with the close of the purchase transaction, the facilities were combined into an Amended and Restated Master Lease with Home Quality Management ("HQM"). The Amended and Restated Master Lease was extended until July 31, 2017. The investment allocated to land, building and personal property is \$6.3 million, \$32.1 million and \$1.1 million, respectively.

#### *Advocat*

We continuously evaluate the payment history and financial strength of our operators and have historically established allowance reserves for straight-line rent adjustments for operators that do not meet our internal revenue requirements. We consider factors such as payment history, the operator's financial condition as well as current and future anticipated operating trends and regulatory impacts on our operators when evaluating whether to establish allowances.

We have reviewed Advocat's financial statements annually and noted that since 2000 Advocat's external auditors issued Advocat a "going concern" opinion. We reviewed Advocat's 2006 annual report and noted that Advocat was issued a "clean" opinion by its external auditors (i.e., the auditors removed the going concern qualification). We also reviewed Advocat's financial statements and noted an improvement in its financial condition. As a result, we reversed approximately \$5.0 million of allowance previously established for straight line rent in the first quarter of 2007. This change in estimate resulted in an additional \$0.08 per share of income from continuing operations and net income for the first quarter of 2007 and for the nine months ended September 30, 2007.

#### *Haven Eldercare, LLC*

In conjunction with the application of *Consolidation of Variable Interest Entities* (“FIN 46R”), we consolidated the financial statements and related real estate of this Haven entity into our financial statements. The impact of consolidating the Haven entity resulted in the following adjustments to our consolidated balance sheet as of September 30, 2007: (1) an increase in total gross investments of \$39.0 million; (2) an increase in accumulated depreciation of \$2.7 million; (3) an increase in accounts receivable of \$0.3 million; (4) an increase in other long-term borrowings of \$39.0 million; (5) and a reduction of \$2.4 million in cumulative net earnings primarily due to increased depreciation expense. Our results of operation reflect the impact of the consolidation of the Haven entity for the three- and nine- month periods ended September 30, 2007 and 2006, respectively.

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Table of Contents*Assets Sold*

- On January 31, 2007, we sold two assisted living facilities (“ALFs”) in Indiana for approximately \$3.6 million resulting in a gain of approximately \$1.7 million.
- On February 1, 2007, we sold a closed SNF in Illinois for approximately \$0.1 million resulting in a loss of \$35 thousand.
- On March 30, 2007, we sold a SNF in Arkansas for approximately \$0.7 million resulting in a loss of \$15 thousand.
- On May 18, 2007, we sold two SNFs in Texas for their net book values, generating cash proceeds of approximately \$1.8 million.

*Held for Sale*

During the three months ended September 30, 2007, a \$1.6 million provision for impairment charge was recorded to reduce the carrying value on one facility to its estimated fair value. At September 30, 2007, we had four facilities classified as held for sale with a net book value of approximately \$3.6 million.

**Liquidity and Capital Resources**

At September 30, 2007, we had total assets of \$1.2 billion, stockholders’ equity of \$583.2 million and debt of \$577.7 million, which represents approximately 49.8% of our total capitalization.

The following table shows the amounts due in connection with the contractual obligations described below as of September 30, 2007.

	<b>Total</b>	<b>Payments due by period</b>			
		<b>Less than 1 year</b>	<b>1-3 years</b>	<b>3-5 years</b>	<b>More than 5 years</b>
Long-term debt (1)	\$ 577,995	\$ 435	\$ 52,960	\$ 600	\$ 524,000
Other long-term liabilities	340	240	100	-	-
<b>Total</b>	<b>\$ 578,335</b>	<b>\$ 675</b>	<b>\$ 53,060</b>	<b>\$ 600</b>	<b>\$ 524,000</b>

- (1) The \$578.0 million includes \$310 million aggregate principal amount of 7% Senior Notes due April 2014, \$175 million aggregate principal amount of 7% Senior Notes due January 2016, \$52.0 million in borrowings under the \$255 million revolving senior secured credit facility that matures in March 2010 and Haven’s \$39 million first mortgage with General Electric Capital Corporation that expires in October 2012.

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***Financing Activities and Borrowing Arrangements***

***Bank Credit Agreements***

At September 30, 2007, we had \$52.0 million outstanding under our \$255 million revolving senior secured credit facility (the "Credit Facility") and \$2.1 million was utilized for the issuance of letters of credit, leaving availability of \$200.9 million. The \$52.0 million of outstanding borrowings had a blended interest rate of 6.40% at September 30, 2007.

Pursuant to Section 2.01 of our Credit Agreement, dated as of March 31, 2006 (the "Credit Agreement"), that governs our Credit Facility, we were permitted under certain circumstances to increase our available borrowing base under the Credit Agreement from \$200 million up to an aggregate of \$300 million. Effective February 22, 2007, we exercised our right to increase the available revolving commitment under Section 2.01 of the Credit Agreement from \$200 million to \$255 million and we consented to add 18 of our properties to the borrowing base assets under the Credit Agreement.

Our long-term borrowings require us to meet certain property level financial covenants and corporate financial covenants, including prescribed leverage, fixed charge coverage, minimum net worth, limitations on additional indebtedness and limitations on dividend payouts. As of September 30, 2007, we were in compliance with all property level and corporate financial covenants.

***7.130 Million Common Stock Offering***

On April 3, 2007, we completed an underwritten public offering of 7,130,000 shares our common stock at \$16.75 per share, less underwriting discounts. The sale included 930,000 shares sold in connection with the exercise of an over-allotment option granted to the underwriters. We received approximately \$112.9 million in net proceeds from the sale of the shares, after deducting underwriting discounts and offering expenses. UBS Investment Bank acted as sole book-running manager for the offering. Banc of America Securities LLC, Deutsche Bank Securities and Stifel Nicolaus acted as co-managers for the offering. The net proceeds were used to repay indebtedness under our Credit Facility.

***Dividend Reinvestment and Common Stock Purchase Plan***

We have a Dividend Reinvestment and Common Stock Purchase Plan ("DRIP") that allows for the reinvestment of dividends and the optional purchase of our common stock at a discount to the market. During the third quarter, we suspended the optional purchase portion of the plan, but maintained the dividend reinvestment portion of the plan. On October 16, 2007, we announced that effective November 15, 2007 we would reinstate the optional purchase portion of the plan providing a 1% discount to the market. For the three-month period ended September 30, 2007, a total of 283,328 shares were issued for approximately \$4.4 million in net proceeds. For the nine-month period ended September 30, 2007, a total of 764,853 shares were issued for approximately \$12.2 million in net proceeds.

***Dividends***

In order to qualify as a REIT, we are required to distribute dividends (other than capital gain dividends) to our stockholders in an amount at least equal to (A) the sum of (i) 90% of our "REIT taxable income" (computed without regard to the dividends paid deduction and our net capital gain), and (ii) 90% of the net income (after tax), if any, from foreclosure property, minus (B) the sum of certain items of non-cash income. In addition, if we dispose of any built-in gain asset during a recognition period, we will be required to distribute at least 90% of the built-in gain (after tax), if

any, recognized on the disposition of such asset. Such distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before we timely file our tax return for such year and paid on or before the first regular dividend payment after such declaration. In addition, such distributions are required to be made pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that such class is entitled to such a preference. To the extent that we do not distribute all of our net capital gain or do distribute at least 90%, but less than 100% of our "REIT taxable income," as adjusted, we will be subject to tax thereon at regular ordinary and capital gain corporate tax rates. In addition, our Credit Facility has certain financial covenants that limit the distribution of dividends paid during a fiscal quarter to no more than 95% of our aggregate cumulative FFO as defined in the Credit Agreement, unless a greater distribution is required to maintain REIT status. The Credit Agreement defines FFO as net income (or loss) plus depreciation and amortization and shall be adjusted for charges related to: (i) restructuring our debt; (ii) redemption of preferred stock; (iii) litigation charges up to \$5.0 million; (iv) non-cash charges for accounts and notes receivable up to \$5.0 million; (v) non-cash compensation related expenses; (vi) non-cash impairment charges; and (vii) tax liabilities in an amount not to exceed \$8.0 million.

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***Common Dividends***

On October 16, 2007, the Board of Directors declared a common stock dividend of \$0.28 per share, an increase of \$0.01 per common share compared to the prior quarter. The common dividend will be paid November 15, 2007 to common stockholders of record on October 31, 2007.

On July 17, 2007, the Board of Directors declared a common stock dividend of \$0.27 per share that was paid August 15, 2007 to common stockholders of record on July 31, 2007.

On April 18, 2007, the Board of Directors declared a common stock dividend of \$0.27 per share, an increase of \$0.01 per common share compared to the prior quarter. The common dividend was paid May 15, 2007 to common stockholders of record on April 30, 2007.

On January 16, 2007, the Board of Directors declared a common stock dividend of \$0.26 per share, an increase of \$0.01 per common share compared to the prior quarter. The common dividend was paid February 15, 2007 to common stockholders of record on January 31, 2007.

***Series D Preferred Dividends***

On October 16, 2007, the Board of Directors declared the regular quarterly dividends for the 8.375% Series D Cumulative Redeemable Preferred Stock ("Series D Preferred Stock") to stockholders of record on October 31, 2007. The stockholders of record of the Series D Preferred Stock on October 31, 2007 will be paid dividends in the amount of \$0.52344 per preferred share on November 15, 2007. The liquidation preference for our Series D Preferred Stock is \$25.00 per share. Regular quarterly preferred dividends for the Series D Preferred Stock represent dividends for the period August 1, 2007 through October 31, 2007.

On July 17, 2007, the Board of Directors declared the regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D preferred stock that were paid August 15, 2007 to preferred stockholders of record on July 31, 2007.

On April 18, 2007, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid May 15, 2007 to preferred stockholders of record on April 30, 2007.

On January 16, 2007, the Board of Directors declared regular quarterly dividends of approximately \$0.52344 per preferred share on the Series D Preferred Stock that were paid February 15, 2007 to preferred stockholders of record on January 31, 2007.

***Liquidity***

We believe our liquidity and various sources of available capital, including cash from operations, our existing availability under our Credit Facility and expected proceeds from mortgage payoffs are more than adequate to finance operations, meet recurring debt service requirements and fund future investments through the next twelve months.

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We regularly review our liquidity needs, the adequacy of cash flow from operations, and other expected liquidity sources to meet these needs. We believe our principal short-term liquidity needs are to fund:

- normal recurring expenses;
- debt service payments;
- preferred stock dividends;
- common stock dividends; and
- growth through acquisitions of additional properties.

The primary source of liquidity is our cash flows from operations. Operating cash flows have historically been determined by: (i) the number of facilities we lease or have mortgages on; (ii) rental and mortgage rates; (iii) our debt service obligations; and (iv) general and administrative expenses. The timing, source and amount of cash flows provided by financing activities and used in investing activities are sensitive to the capital markets environment, especially to changes in interest rates. Changes in the capital markets environment may impact the availability of cost-effective capital and affect our plans for acquisition and disposition activity.

Cash and cash equivalents totaled \$0.6 million as of September 30, 2007, a decrease of \$0.1 million as compared to the balance at December 31, 2006. The following is a discussion of changes in cash and cash equivalents due to operating, investing and financing activities, which are presented in our Consolidated Statements of Cash Flows.

Operating Activities – Net cash flow from operating activities generated \$67.0 million for the nine months ended September 30, 2007, as compared to \$46.8 million for the same period in 2006, an increase of \$20.2 million.

Investing Activities– Net cash flow from investing activities was an outflow of \$32.6 million for the nine months ended September 30, 2007, as compared to an outflow of \$166.8 million for the same period in 2006. The decrease in cash outflow from investing activities of \$134.1 million relates primarily to the timing of acquisitions in 2006 compared to 2007. For the nine months ended September 30, 2006, we acquired real estate, primarily 30 SNFs and one independent living center from Litchfield for \$179.6 million. For the nine months ended September 30, 2007, we purchased (5) SNFs from Litchfield for \$39.5 million. In 2006, we sold shares of Sun’s common stock for approximately \$7.6 million.

Financing Activities– Net cash flow from financing activities was an outflow of \$34.0 million for the nine months ended September 30, 2007 as compared to an inflow of \$116.0 million for the same period in 2006. The \$150.0 million change in financing cash flow was a result of a net payment of \$98.4 million on our Credit Facility and other borrowings during the nine months of 2007 compared to a net proceed of \$138.1 million for the same period in 2006, an increase in dividend payment of \$10.3 million as compared to the same period in 2006, and the reduction in dividend reinvestment proceeds of \$16.9 million compared to the same period in 2006; offset by proceeds of \$112.9 million from a common stock offering in the second quarter of 2007.

## **Item 3 – Quantitative and Qualitative Disclosures about Market Risk**

We are exposed to various market risks, including the potential loss arising from adverse changes in interest rates. We do not enter into derivatives or other financial instruments for trading or speculative purposes, but we seek to mitigate the effects of fluctuations in interest rates by matching the term of new investments with new long-term fixed rate borrowing to the extent possible.



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There were no material changes in our market risk during the three months ended September 30, 2007. For additional information, refer to Item 7A as presented in our annual report on Form 10-K for the year ended December 31, 2006.

**Item 4 – Controls and Procedures**

Disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) are controls and other procedures that are designed to provide reasonable assurance that the information that we are required to disclose in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

In connection with the preparation of this Form 10-Q, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2007. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at a reasonable assurance level as of September 30, 2007.

*Material Weakness Previously Reported*

As noted under Item 9A in Management’s Report on Internal Control over Financial Reporting in our Form 10-K for the year ended December 31, 2006, management determined that a material weakness in our internal control over financial reporting existed as of December 31, 2006. Management determined that as of December 31, 2006, we lacked sufficient internal control processes, procedures and personnel resources necessary to address accounting for certain complex and/or non-routine transactions. This material weakness resulted in errors in accounting for financial instruments, income taxes and straight-line rental revenue in our financial statements for the three years ended December 31, 2005 and in our interim financial statements for the quarterly periods ended March 31, 2006 and June 30, 2006 that were not prevented or detected on a timely basis.

*Remediation of Previously Reported Material Weakness in Internal Control*

Our remediation plan, as described in our Form 10-K for the year ended December 31, 2006 included: developing formal processes, review procedures and documentation standards for the accounting and monitoring of non-routine and complex transactions; expanding the personnel in our accounting department with the appropriate technical skills; providing additional training for our accounting personnel; reviewing prior acquisition and investment agreements and documentation to confirm assets are appropriately recorded; and implementing procedures to have agreements and documentation reviewed by our tax counsel and financial advisors.

While the planned remediation steps were designed and in place by the end of the six months ended June 30, 2007, management continued to evaluate the operating effectiveness of our disclosure controls and procedures through the end of the nine months ended September 30, 2007, when it was concluded that our internal control over financial reporting was sufficiently mature to support an assessment that the controls were effective. We implemented a review process for significant complex and/or non-routine accounting transactions. We enhanced the formal communication processes between senior management and financial management with regard to significant transactions and our business environment. Additionally, in March 2007, we added a Chief Accounting Officer, Michael Ritz, who has over 14 years of experience in general accounting and financial reporting. Mr. Ritz’s prior experience includes over five years of service in executive-level accounting positions with two different publicly-traded corporations. We provided additional training for our accounting personnel. We, along with our advisors, reviewed prior acquisition and investment agreements and documentation and confirmed assets were appropriately recorded. Finally, we implemented additional procedures for the review of agreements and documentation by our tax counsel and financial

advisors.

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Management believes we have taken the steps necessary to remediate the material weakness discussed above and our internal control over financial reporting is effective at the reasonable assurance level as of September 30, 2007. This conclusion has not been audited by our independent registered public accounting firm at this time, primarily because accounting firms generally only report on internal control over financial reporting as of the end of a fiscal year. The report of our independent registered public accounting to be included in our Form 10-K for the year ended December 31, 2007 will address our internal control over financial reporting as of December 31, 2007. Because of the possibility of changed circumstances between now and year-end, and because the testing of our internal control over financial reporting is not yet completed, we cannot assure you that management and our independent registered public accounting firm will not identify material weaknesses in our internal control over financial reporting and conclude that our disclosure controls and procedures were not effective at a reasonable assurance level and that we did not maintain effective internal control over financial reporting as of year-end.

*Changes in Internal Controls*

Other than noted above in this Item 4, there were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the period covered by this report identified in connection with the evaluation of our disclosure controls and procedures described above that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II – OTHER INFORMATION**

**Item 1 – Legal Proceedings**

See Note 8 – Litigation to the Consolidated Financial Statements in PART I, Item 1 hereto, which is hereby incorporated by reference in response to this item.

**Item 1A- Risk Factors**

We filed our Annual Report on Form 10-K for the year ended December 31, 2006 with the Securities and Exchange Commission on February 23, 2007, which sets forth our risk factors in Item 1A therein. We have not experienced any material changes from the risk factors previously described therein.

**Item 6 – Exhibits**

Exhibit No.	Description
31.1	Rule 13a-14(a)/15d-14(a) Certification of the Chief Executive Officer.
31.2	Rule 13a-14(a)/15d-14(a) Certification of the Chief Financial Officer.
32.1	Section 1350 Certification of the Chief Executive Officer.
32.2	Section 1350 Certification of the Chief Financial Officer.

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**SIGNATURES**

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

OMEGA HEALTHCARE INVESTORS, INC.  
Registrant

Date: November 5, 2007 By: /S/ C. TAYLOR PICKETT  
C. Taylor Pickett  
Chief Executive Officer

Date: November 5, 2007 By: /S/ ROBERT O.  
STEPHENSON  
Robert O. Stephenson  
Chief Financial Officer