

BLUE NILE INC
Form 10-Q
November 12, 2009

Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-Q**

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

For the quarterly period ended October 4, 2009

OR

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

For the transition period from _____ to _____

Commission file number 000-50763

BLUE NILE, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

91-1963165
(I.R.S. Employer Identification No.)

705 Fifth Avenue South, Suite 900, Seattle, Washington
(Address of principal executive offices)

98104
(Zip code)

(206) 336-6700

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

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

Yes No

As of November 1, 2009, the registrant had 14,558,603 shares of common stock outstanding.

Table of Contents

Cautionary Note Regarding Forward-Looking Statements

This quarterly report on Form 10-Q contains forward-looking statements that involve many risks and uncertainties. These statements, which relate to future events and our future performance, are based on current expectations, estimates, forecasts and projections about the industries in which we operate and the beliefs and assumptions of management as of the date of this filing. In some cases, you can identify forward-looking statements by terms such as would, could, may, will, should, expect, intend, plan, anticipate, believe, estimate, predict, continue, the negative of these terms or other variations of such terms. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business and other characterizations of future events or circumstances, are forward-looking statements. These statements are only predictions based upon assumptions made that are believed to be reasonable at the time, and are subject to risk and uncertainties. Therefore, actual events or results may differ materially and adversely from those expressed in any forward-looking statement. In evaluating these statements, you should specifically consider the risks described under the caption Item 1A Risk Factors and elsewhere in this quarterly report on Form 10-Q. These factors, and other factors, may cause our actual results to differ materially from any forward-looking statement. Except as required by law, we undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

**BLUE NILE, INC.
INDEX**

	Page
<u>PART I. FINANCIAL INFORMATION</u>	4
<u>Item 1. Financial Statements</u>	4
<u>Condensed Consolidated Balance Sheets (unaudited)</u>	4
<u>Condensed Consolidated Statements of Operations (unaudited)</u>	5
<u>Condensed Consolidated Statement of Changes in Stockholders' Equity (unaudited)</u>	6
<u>Condensed Consolidated Statements of Cash Flows (unaudited)</u>	7
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	8
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	14
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	19
<u>Item 4. Controls and Procedures</u>	20
<u>PART II. OTHER INFORMATION</u>	21
<u>Item 1. Legal Proceedings</u>	21
<u>Item 1A. Risk Factors</u>	21
<u>Item 6. Exhibits</u>	34
<u>SIGNATURES</u>	35
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	
<u>EX-32.2</u>	

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

BLUE NILE, INC.
Condensed Consolidated Balance Sheets
(unaudited)
(in thousands, except par value)

	October 4, 2009	January 4, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 32,494	\$ 54,451
Short-term investments	15,000	
Trade accounts receivable	1,236	984
Other accounts receivable	142	725
Inventories	17,846	18,834
Deferred income taxes	223	670
Prepays and other current assets	1,078	1,069
Total current assets	68,019	76,733
Property and equipment, net	7,711	7,558
Intangible assets, net	338	271
Deferred income taxes	6,228	5,014
Other assets	144	89
Total assets	\$ 82,440	\$ 89,665
 LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 42,334	\$ 62,291
Accrued liabilities	4,976	6,607
Current portion of long-term financing obligation	43	41
Current portion of deferred rent	205	205
Total current liabilities	47,558	69,144
Long-term financing obligation, less current portion	807	839
Deferred rent, less current portion	226	374
Stockholders' equity:		
Preferred stock, \$0.001 par value; 5,000 shares authorized, none issued and outstanding		
Common stock, \$0.001 par value; 300,000 shares authorized; 19,715 shares and 19,659 shares issued, respectively		
14,549 shares and 14,493 shares outstanding, respectively	20	20
Additional paid-in capital	152,017	144,913
Accumulated other comprehensive income	95	17
Retained earnings	43,558	36,199
Treasury stock, at cost; 5,166 shares outstanding	(161,841)	(161,841)

Edgar Filing: BLUE NILE INC - Form 10-Q

Total stockholders' equity	33,849	19,308
Total liabilities and stockholders' equity	\$ 82,440	\$ 89,665

The accompanying notes are an integral part of these condensed consolidated financial statements

4

Table of Contents

BLUE NILE, INC.
Condensed Consolidated Statements of Operations
(unaudited)
(in thousands, except per share data)

	Quarter ended		Year to date ended	
	October 4, 2009	September 28, 2008	October 4, 2009	September 28, 2008
Net sales	\$ 66,943	\$ 65,376	\$ 199,198	\$ 209,542
Cost of sales	52,146	52,114	156,168	167,233
Gross profit	14,797	13,262	43,030	42,309
Selling, general and administrative expenses	10,936	9,980	31,927	31,636
Operating income	3,861	3,282	11,103	10,673
Other income, net:				
Interest income, net	23	184	101	1,299
Other income, net	77	95	117	471
Total other income, net	100	279	218	1,770
Income before income taxes	3,961	3,561	11,321	12,443
Income tax expense	1,386	1,226	3,962	4,332
Net income	\$ 2,575	\$ 2,335	\$ 7,359	\$ 8,111
Basic net income per share	\$ 0.18	\$ 0.16	\$ 0.51	\$ 0.54
Diluted net income per share	\$ 0.17	\$ 0.15	\$ 0.49	\$ 0.52

The accompanying notes are an integral part of these condensed consolidated financial statements

Table of Contents

BLUE NILE, INC.
Condensed Consolidated Statement of Changes in Stockholders Equity
(unaudited)
(in thousands)

	Common Stock		Additional	Retained	Accumulated	Treasury Stock		Total
	Shares	Amount	Paid-in	Earnings	Other	Shares	Amount	Stockholders
			Capital		Income			Equity
Balance, January 4, 2009	19,659	\$ 20	\$ 144,913	\$ 36,199	\$ 17	(5,166)	\$(161,841)	\$ 19,308
Net income				7,359				7,359
Other comprehensive income:								
Foreign currency translation adjustment					78			78
Total comprehensive income								7,437
Tax benefit from exercise of stock options			214					214
Exercise of common stock options	53		1,195					1,195
Issuance of common stock to directors	3		120					120
Stock-based compensation			5,575					5,575
Balance, October 4, 2009	19,715	\$ 20	\$ 152,017	\$ 43,558	\$ 95	(5,166)	\$(161,841)	\$ 33,849

The accompanying notes are an integral part of these condensed consolidated financial statements

Table of Contents

BLUE NILE, INC.
Condensed Consolidated Statements of Cash Flows
(unaudited)
(in thousands)

	Year to date ended	
	October	September
	4,	28,
	2009	2008
Operating activities:		
Net income	\$ 7,359	\$ 8,111
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,868	1,512
Loss on disposal of property and equipment	62	20
Stock-based compensation	5,615	5,298
Deferred income taxes	(767)	(981)
Tax benefit from exercise of stock options	214	511
Excess tax benefit from exercise of stock options	(47)	(141)
Changes in assets and liabilities:		
Receivables	331	1,195
Inventories	988	2,944
Prepaid federal income taxes		(440)
Prepaid expenses and other assets	(64)	30
Accounts payable	(19,964)	(45,380)
Accrued liabilities	(1,632)	(5,093)
Deferred rent and other	(147)	(78)
Net cash used in operating activities	(6,184)	(32,492)
Investing activities:		
Purchases of property and equipment	(2,063)	(1,553)
Proceeds from the sale of property and equipment		10
Purchase of short-term investments	(15,000)	
Net cash used in investing activities	(17,063)	(1,543)
Financing activities:		
Repurchase of common stock		(65,273)
Proceeds from stock option exercises	1,195	2,984
Excess tax benefit from exercise of stock options	47	141
Principal payments under long-term financing obligation	(30)	(28)
Net cash provided by (used in) financing activities	1,212	(62,176)

Edgar Filing: BLUE NILE INC - Form 10-Q

Effect of exchange rate changes on cash and cash equivalents	78	9
Net decrease in cash and cash equivalents	(21,957)	(96,202)
Cash and cash equivalents, beginning of period	54,451	122,793
Cash and cash equivalents, end of period	\$ 32,494	\$ 26,591

The accompanying notes are an integral part of these condensed consolidated financial statements

7

Table of Contents

Blue Nile, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollar amounts in thousands except for ratios and per share data, unless noted otherwise)

Note 1. Description of Our Business and Summary of Significant Accounting Policies

The Company

Blue Nile, Inc. (the Company) is the leading online retailer of high quality diamonds and fine jewelry in the United States. In addition to sales of diamonds, fine jewelry and watches, the Company provides education, guidance and support to enable customers to more effectively learn about and purchase diamonds as well as classically styled fine jewelry. The Company, a Delaware corporation, based in Seattle, Washington, was formed in March 1999. The Company serves consumers in over 40 countries and territories all over the world and maintains its primary website at www.bluenile.com. The Company also operates the www.bluenile.co.uk and www.bluenile.ca websites.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the Notes to Consolidated Financial Statements contained in the Company's Annual Report on Form 10-K for the year ended January 4, 2009, filed with the Securities and Exchange Commission on March 5, 2009. The same accounting policies are followed for preparing quarterly and annual financial statements. In the opinion of management, all adjustments necessary for the fair presentation of the financial position, results of operations and cash flows for the interim periods have been included and are of a normal, recurring nature.

The financial information as of January 4, 2009 is derived from the Company's audited consolidated financial statements and notes thereto for the fiscal year ended January 4, 2009, included in Item 8 of the Annual Report on Form 10-K for the year ended January 4, 2009.

Due to a number of factors, including the seasonal nature of the retail industry and other factors described in this report, quarterly results are not necessarily indicative of the results for the full fiscal year or any other subsequent interim period.

Principles of Consolidation

The accompanying unaudited condensed consolidated financial statements include the accounts of Blue Nile, Inc. and its wholly-owned subsidiaries, Blue Nile, LLC (LLC), Blue Nile Worldwide, Inc. (Worldwide) and Blue Nile Jewellery, Ltd. (Jewellery). The Company, LLC, and Worldwide are Delaware corporations located in Seattle, Washington. Jewellery is an Irish limited company located in Dublin, Ireland. All intercompany transactions and balances are eliminated in consolidation.

Subsequent Events

The Company evaluated subsequent events for potential recognition or disclosure in the financial statements through November 12, 2009, which is the date these financial statements were issued.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of the more significant estimates include the allowance for sales returns and the estimated fair value of stock options granted. Actual results could differ materially from those estimates.

Foreign Currency

The functional currency of Jewellery is the Euro. The assets and liabilities of Jewellery have been translated to U.S. dollars using the exchange rates effective on the balance sheet dates, while income and expense accounts are

Table of Contents

Blue Nile, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

translated at the average rates in effect during the periods presented. The resulting translation adjustments are recorded in accumulated other comprehensive income (loss).

The Company offers customers the ability to transact in 24 foreign currencies. In addition, some of the Company's entities engage in transactions denominated in currencies other than the entity's functional currency. Gains or losses arising from these transactions are recorded in Other income, net in the consolidated statements of operations.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles which established the Accounting Standards Codification (ASC) as the authoritative source of generally accepted accounting principles (GAAP) in the United States. This guidance also recognized the rules and interpretative releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws as sources of authoritative GAAP for SEC registrants. The ASC was effective for financial statements issued for interim and annual periods ending after September 15, 2009. The adoption of this guidance in the third quarter of 2009 did not have a material impact on the Company's consolidated results of operations or financial condition. The Company included references to the ASC in the notes to the condensed consolidated financial statements.

In September 2006, the FASB issued guidance that was codified in Topic 820, Fair Value Measurements and Disclosure of the ASC which established a common definition for fair value, established a framework for measuring fair value, and expanded disclosure about such fair value measurements. In January 2008, the FASB delayed the effective date of this standard by one year for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The adoption of this standard for these nonfinancial assets and liabilities in the first quarter of 2009 did not have a material impact on the Company's consolidated results of operations or financial condition.

In April 2008, the FASB issued guidance that was codified in Topic 350, Intangibles Goodwill and Other of the ASC which amended the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset. This guidance was effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The adoption of this guidance in the first quarter of 2009 did not have a material impact on the Company's consolidated results of operations or financial condition.

In May 2009, the FASB issued guidance that was codified in Topic 855, Subsequent Events of the ASC which established principles and disclosure requirements for subsequent events, which are defined as events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This guidance was effective for financial statements issued for interim and annual periods ending after June 15, 2009. The adoption of this guidance in the second quarter of 2009 did not have a material impact on the Company's consolidated results of operations or financial condition.

In August 2009, the FASB issued Accounting Standards Update No. 2009-05 (ASU 2009-05), an update to Topic 820, Fair Value Measurements and Disclosures. This update provides amendments to reduce potential ambiguity in financial reporting when measuring the fair value of liabilities. Among other provisions, this update provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the following valuation techniques: (1) a valuation technique that uses the quoted market price of an identical liability or similar liabilities when traded as assets; or (2) another valuation technique that is consistent with the principles of Topic 820. ASU 2009-05 will become effective in the first reporting period after issuance, which for the Company is the fourth quarter of 2009. The Company does not expect ASU 2009-05 to have a material impact on its consolidated results of operations or financial condition.

Table of Contents**Blue Nile, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****Note 2. Stock-based Compensation**

The Company accounts for stock-based compensation arrangements in accordance with the provisions of ASC Topic 718, Stock Compensation. Stock options are granted at prices equal to the fair market value of the Company's common stock on the date of grant. Stock options granted generally provide for 25% vesting on the first anniversary of the date of grant, with the remainder vesting monthly in equal amounts over the following three years, and expire 10 years from the date of grant. As of October 4, 2009, the Company had four equity plans. Additional information regarding these plans is disclosed in the Company's Annual Report on Form 10-K for the year ended January 4, 2009.

In the first quarter of 2009, the Company granted restricted stock units (RSUs) to executives under the 2004 Equity Incentive Plan. The RSUs have a grant date fair value of approximately \$260,000 and vest 50% on the first anniversary from the date of grant and the remainder on the second anniversary. Each RSU is converted to one share of common stock when it vests. No RSUs were granted in the second or third quarter of 2009.

Stock-based compensation is reduced for estimated forfeitures, and compensation expense is recognized on a straight-line basis over the requisite service period for each stock option and restricted stock unit grant.

The fair value of each stock option on the date of grant is estimated using the Black-Scholes-Merton option valuation model.

The following weighted-average assumptions were used for the valuation of options granted during the periods presented:

	Quarter ended		Year to date ended	
	October 4,	September	October 4,	September
	2009	28,	2009	28,
		2008		2008
Expected term	4 years	4 years	4 years	4 years
Expected volatility	57.5%	48.9%	55.1%	47.8%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	1.77%	2.79%	1.37%	2.54%
Estimated fair value per option granted	\$23.48	\$ 16.85	\$11.17	\$ 17.55

The assumptions used to calculate the fair value of options granted are evaluated and revised, if necessary, to reflect market conditions and the Company's experience.

The fair value of each restricted stock unit is based on the fair market value of the Company's common stock on the date of grant.

Table of Contents**Blue Nile, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

A summary of stock option activity for the year to date ended October 4, 2009 is as follows:

	Options (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Balance, January 4, 2009	2,290	\$ 34.38		
Granted	557	25.55		
Exercised	(53)	22.59		
Cancelled	(34)	52.02		
Balance, October 4, 2009	2,760	\$ 32.60	6.73	\$ 79,741
Vested and expected to vest at October 4, 2009	2,623	\$ 32.45	6.62	\$ 76,202
Exercisable, October 4, 2009	1,700	\$ 29.90	5.58	\$ 53,251

A summary of restricted stock unit activity for the year to date ended October 4, 2009 is as follows:

	RSUs (in thousands)	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Balance, January 4, 2009		\$		
Granted	12	21.22		
Vested				
Cancelled				
Balance, October 4, 2009	12	\$ 21.22	0.89	\$ 732

The aggregate intrinsic value in the tables above is before applicable income taxes and represents the amount recipients would have received if all options had been exercised or restricted stock units had been converted on the last business day of the period indicated, based on the Company's closing stock price.

The total intrinsic value of options exercised during the year to date ended October 4, 2009 was \$1.4 million. During the year to date ended October 4, 2009, the total fair value of options vested was \$6.0 million. As of October 4, 2009, the Company had total unrecognized compensation costs related to unvested stock options and restricted stock units of

\$13.2 million. The Company expects to recognize this cost over a weighted average period of 2.8 years for its options and 1.4 years for its restricted stock units.

Table of Contents**Blue Nile, Inc.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****Note 3. Short-term Investments**

In August 2009, the Company purchased an investment in the form of a time deposit with a financial institution. The \$15.0 million investment matures in January 2010 and is classified within short-term investments. At October 4, 2009 the carrying value of the short-term investment approximates market value.

Note 4. Inventories

Inventories are stated at cost and consist of the following:

	October 4, 2009	January 4, 2009		
Loose diamonds	\$ 697	\$ 695		
Fine jewelry, watches and other	17,149	18,139		
			(33)	0
Accrued expenses and other liabilities	(248)	0		
Tenant reserves, escrows, deposits and prepaid rents	(57)	0		
Gains on purchase of minority interests in majority-owned LLCs	(316)	0		
Cash Paid for purchase of minority interests in majority-owned LLCs	\$ 170	\$ 0		

See accompanying notes to these condensed consolidated financial statements.

Table of Contents

UNIVERSAL HEALTH REALTY INCOME TRUST

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2014

(unaudited)

(1) General

This Quarterly Report on Form 10-Q is for the Quarterly Period ended June 30, 2014. In this Quarterly Report, we, us, our and the Trust refer to Universal Health Realty Income Trust.

You should carefully review all of the information contained in this Quarterly Report, and should particularly consider any risk factors that we set forth in this Quarterly Report and in other reports or documents that we file from time to time with the Securities and Exchange Commission (the SEC). In this Quarterly Report, we state our beliefs of future events and of our future financial performance. In some cases, you can identify those so-called forward-looking statements by words such as may, will, should, could, would, predicts, potential, continue, expects, intends, plans, believes, estimates, appears, projects and similar expressions, as well as statements in future tense. You should be aware that those statements are only our predictions. Actual events or results may differ materially. In evaluating those statements, you should specifically consider various factors, including the risks outlined herein and in our Annual Report on Form 10-K for the year ended December 31, 2013 in *Item 1A Risk Factors* and in *Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations - Forward Looking Statements*. Those factors may cause our actual results to differ materially from any of our forward-looking statements.

In certain of our markets, the general real estate market has been unfavorably impacted by increased competition/capacity and decreases in occupancy and rental rates which may adversely impact our operating results and the underlying value of our properties. In addition, although credit markets conditions and the instability in certain banking and financial institutions over the past several years has not had a material impact on us, there can be no assurance that unfavorable changes in credit market conditions, should they occur, will not materially increase our cost of borrowings and/or have a material adverse impact on our ability to finance our future growth through borrowed funds.

In this Quarterly Report on Form 10-Q, the term revenues does not include the revenues of the unconsolidated limited liability companies (LLCs) in which we have various non-controlling equity interests ranging from 33% to 95%. We currently account for our share of the income/loss from these investments by the equity method (see Note 5). As of June 30, 2014, we had investments in eleven jointly-owned LLCs, all of which are accounted for by the equity method as of June 30, 2014. Palmdale Medical Properties was consolidated in our financial statements through June 30, 2013 as a result of a master lease arrangement with a wholly-owned subsidiary of UHS. As previously disclosed, the master lease expired effective as of July 1, 2013 and, as of that date, we began accounting for Palmdale Medical Properties under the equity method through December 31, 2013. Effective January 1, 2014, we purchased the third-party minority ownership interests in Palmdale Medical Properties and Sparks Medical Properties in which we formerly held non-controlling majority ownership interests. As a result of our purchase of the minority ownership interests, we now hold 100% of the ownership interests in these LLCs which own MOBs and we began accounting for them on a consolidated basis effective January 1, 2014. Each of the property's assets and liabilities are recorded at their fair values. (See Note 4 to the consolidated financial statements for additional disclosure).

Edgar Filing: BLUE NILE INC - Form 10-Q

The financial statements included herein have been prepared by us, without audit, pursuant to the rules and regulations of the SEC and reflect all normal and recurring adjustments which, in our opinion, are necessary to fairly present results for the interim periods. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although we believe that the accompanying disclosures are adequate to make the information presented not misleading. It is suggested that these financial statements be read in conjunction with the financial statements, the notes thereto and accounting policies included in our Annual Report on Form 10-K for the year ended December 31, 2013.

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

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

The combined revenues generated from the leases on the UHS hospital facilities comprised approximately 30% of our consolidated revenues for each of the three months ended June 30, 2014 and 2013, and approximately 29% and 30% of our consolidated revenues for the six months ended June 30, 2014 and 2013, respectively. Including 100% of the revenues generated at the unconsolidated LLCs in which we have various non-controlling equity interests ranging from 33% to 95%, the leases on the UHS hospital facilities accounted for approximately 22% of the combined consolidated and unconsolidated revenue for each of the three and six-month periods ended June 30, 2014 and 2013.

In addition, twelve MOBs, that are either wholly or jointly-owned, include or will include tenants which are subsidiaries of UHS.

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

Management cannot predict whether the leases with subsidiaries of UHS, which have renewal options at existing lease rates or fair market value lease rates (as indicated below), will be renewed at the end of their lease term. As indicated below, The Bridgeway s (Bridgeway) lease term is scheduled to expire in December, 2014 and we can provide no assurance that this lease will be renewed at the fair market value lease rate. Our revenues, net cash provided by operating activities and funds from operations include approximately \$1.1 million annually earned in connection with Bridgeway s lease. If UHS exercises its right to purchase the Bridgeway facility, or any of its other hospital facilities, at the end of the current lease terms at the appraised fair market value, we would consider, among other things, redeploying the sale proceeds generated from the divestiture to acquire other real estate property. If we are unable to redeploy the proceeds generated from the divestiture, or if we were unable to generate the same rate of return on the redeployed proceeds, our revenues, cash provided by operating activities and funds from operations could be unfavorably impacted. In the event that The Bridgeway s lease, or the lease on any other hospital leased to a subsidiary of UHS, is not renewed, and UHS does not exercise its right to purchase the facility for the appraised fair market value at the end of the lease term, we will be required to find other operators for the property and/or enter into leases on terms potentially less favorable to us than the current lease.

The table below details the existing lease terms and renewal options for each of the UHS hospital facilities:

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

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

As discussed above, Palmdale Medical Plaza, which is located in Palmdale, California, on the campus of a UHS hospital, had a master lease commitment by a wholly-owned subsidiary of UHS which expired effective as of July 1, 2013. This MOB, tenants of which include subsidiaries of UHS, was completed and opened during the third quarter of 2008 at which time the master lease commenced. The LLC that owns this MOB was deemed to be a variable interest entity during the term of the master lease and was therefore consolidated in our financial statements through June 30, 2013 since we were the primary beneficiary through that date. Effective July 1, 2013, this LLC was no longer be deemed a variable interest entity and is accounted for in our financial statements on an unconsolidated basis pursuant to the equity method from July 1, 2013 through December 31, 2013.

Table of Contents

Effective January 1, 2014, we purchased the third-party minority ownership interests in two LLCs (Palmdale Medical Properties and Sparks Medical Properties) in which we formerly held non-controlling majority ownership interest. As a result of our purchase of the minority ownership interests, we now hold 100% of the ownership interests in these LLCs (which own MOBs) and began accounting for them on a consolidated basis.

We have funded \$2.3 million in equity as of June 30, 2014, and are committed to fund an additional \$2.1 million, in exchange for a 95% non-controlling equity interest in an LLC (Texoma Medical Properties) that developed, constructed, owns and operates the Texoma Medical Plaza located in Denison, Texas, which was completed and opened during the first quarter of 2010. This MOB is located on the campus of a UHS acute care hospital which is owned and operated by Texoma Medical Center (Texoma Hospital), a wholly-owned subsidiary of UHS. This MOB has tenants that include subsidiaries of UHS. This LLC has a third-party term loan of \$12.4 million, which is non-recourse to us, outstanding as of June 30, 2014. As this LLC is not considered to be a variable interest entity and does not meet the other criteria requiring consolidation of an investment, it is accounted for pursuant to the equity method.

Advisory Agreement: UHS of Delaware, Inc. (the Advisor), a wholly-owned subsidiary of UHS, serves as Advisor to us under an Advisory Agreement (the Advisory Agreement) dated December 24, 1986. Pursuant to the Advisory Agreement, the Advisor is obligated to present an investment program to us, to use its best efforts to obtain investments suitable for such program (although it is not obligated to present any particular investment opportunity to us), to provide administrative services to us and to conduct our day-to-day affairs. All transactions between us and UHS must be approved by the Trustees who are unaffiliated with UHS (the Independent Trustees). In performing its services under the Advisory Agreement, the Advisor may utilize independent professional services, including accounting, legal, tax and other services, for which the Advisor is reimbursed directly by us. The Advisory Agreement may be terminated for any reason upon sixty days written notice by us or the Advisor. The Advisory Agreement expires on December 31 of each year; however, it is renewable by us, subject to a determination by the Independent Trustees, that the Advisor's performance has been satisfactory. In December of 2013, based upon a review of our advisory fee and other general and administrative expenses, as compared to an industry peer group, the Advisory agreement was renewed for 2014 pursuant to the same terms as the Advisory Agreement in place during 2013.

The Advisory Agreement provides that the Advisor is entitled to receive an annual advisory fee equal to 0.70% of our average invested real estate assets, as derived from our condensed consolidated balance sheet. The average real estate assets for advisory fee calculation purposes exclude certain items from our condensed consolidated balance sheet such as, among other things, accumulated depreciation, cash and cash equivalents, base and bonus rent receivables, deferred charges and other assets. The advisory fee is payable quarterly, subject to adjustment at year-end based upon our audited financial statements. In addition, the Advisor is entitled to an annual incentive fee equal to 20% of the amount by which cash available for distribution to shareholders for each year, as defined in the Advisory Agreement, exceeds 15% of our equity as shown on our condensed consolidated balance sheet, determined in accordance with generally accepted accounting principles without reduction for return of capital dividends. The Advisory Agreement defines cash available for distribution to shareholders as net cash flow from operations less deductions for, among other things, amounts required to discharge our debt and liabilities and reserves for replacement and capital improvements to our properties and investments. No incentive fees were paid during the first six months of 2014 or 2013 since the incentive fee requirements were not achieved. Advisory fees incurred and paid (or payable) to UHS amounted to \$620,000 and \$585,000 for the three months ended June 30, 2014 and 2013, respectively, and were based upon average invested real estate assets of \$354 million and \$334 million for the three-month periods ended June 30, 2014 and 2013, respectively. Advisory fees incurred and paid (or payable) to UHS amounted to \$1.23 million and \$1.16 million for the six months ended June 30, 2014 and 2013, respectively, and were based upon average invested real estate assets of \$351 million and \$330 million for the six-month periods ended June 30, 2014 and 2013, respectively.

Edgar Filing: BLUE NILE INC - Form 10-Q

Officers and Employees: Our officers are all employees of a wholly-owned subsidiary of UHS and although as of June 30, 2014 we had no salaried employees, our officers do typically receive annual stock-based compensation awards in the form of restricted stock. In special circumstances, if warranted and deemed appropriate by the Compensation Committee of the Board of Trustees, our officers may also receive one-time special compensation awards in the form of restricted stock and/or cash bonuses.

Share Ownership: As of June 30, 2014 and December 31, 2013, UHS owned 6.1% of our outstanding shares of beneficial interest.

SEC reporting requirements of UHS: UHS is subject to the reporting requirements of the SEC and is required to file annual reports containing audited financial information and quarterly reports containing unaudited financial information. Since the leases on the hospital facilities leased to wholly-owned subsidiaries of UHS comprised 30% of our consolidated revenues during each of the three month periods ended June 30, 2014 and 2013, and comprised approximately 29% and 30% of our consolidated revenues during the six months ended June 30, 2014 and 2013, respectively, and since a subsidiary of UHS is our Advisor, you are encouraged to obtain the publicly available filings for Universal Health Services, Inc. from the SEC's website at www.sec.gov. These filings are the sole responsibility of UHS and are not incorporated by reference herein.

Table of Contents

(3) Dividends and Equity Issuance Program

We declared and paid dividends of \$8.1 million, or \$.63 per share, during the second quarter of 2014 and \$7.9 million, or \$.625 per share, during the second quarter of 2013. We declared and paid dividends of \$16.2 million, or \$1.255 per share, during the six-month period ended June 30, 2014 and \$15.8 million, or \$1.245 per share, during the six-month period ended June 30, 2013.

During the fourth quarter of 2013, we entered into an ATM Equity Offering Sales Agreement (Sales Agreement) with Merrill Lynch, Pierce, Fenner and Smith Incorporated (Merrill Lynch), under which we may offer and sell our common shares of beneficial interest, up to an aggregate sales price of \$50 million. The common shares will be offered pursuant to the Registration Statement filed with the Securities and Exchange Commission, which became effective in November, 2012, under which we can offer up to \$50 million of our securities pursuant to supplemental prospectuses which we may file from time to time.

Pursuant to this ATM program, during the first six months of 2014, we issued 57,410 shares at an average price of \$42.67 per share (all issued during the first quarter of 2014). Including the shares issued at the end of the fourth quarter of 2013, which settled during the first quarter of 2014, the ATM program generated approximately \$2.9 million of net cash proceeds, (net of approximately \$182,000, consisting of compensation of approximately \$76,000 to Merrill Lynch, as well as approximately \$106,000 of other various fees and expenses) during the first six months of 2014. Approximately \$592,000 of net cash proceeds (net of approximately \$15,000 of compensation to Merrill Lynch) related to the shares issued late in the fourth quarter of 2013 were received by us during the first quarter of 2014.

Since inception of this program, we have issued 212,123 shares at an average price of \$41.97 per share, which generated approximately \$8.4 million of cash proceeds or receivables (net of approximately \$537,000, consisting of compensation of approximately \$222,000 to Merrill Lynch, as well as approximately \$315,000 of other various fees and expenses).

(4) Acquisitions, Dispositions and New Construction

Six Months Ended June 30, 2014:

Acquisition:

We paid an aggregate of \$7.2 million to purchase the following in January, 2014 in a single transaction:

The Children s Clinic at Springdale a 9,800 square foot, single-tenant medical office building located in Springdale, Arkansas, and;

The Northwest Medical Center at Sugar Creek a 16,700 square foot, multi-tenant medical office building located in Bentonville, Arkansas.

The aggregate purchase price for these MOBs was allocated to the assets and liabilities acquired consisting of tangible property and identified intangible assets, based on their respective fair values at acquisition as detailed in the table below. Substantially all of the intangible assets include the value of the in-place leases at the MOBs at the time of acquisition which will be amortized over the average remaining lease term of approximately 9.7 years at the time of acquisition.

Land	\$ 1,710
Buildings and improvements	4,440
Intangible assets	1,050
Deposit paid in 2013	(150)
Net cash paid	\$ 7,050

The acquisition was preliminarily valued utilizing the income capitalization approach. The calculated fair value, utilizing the income capitalization approach, is based upon the basis of capitalization of the net estimated earnings expectancy of the property, assuming continued use similar to the existing use of the acquired property. The property's continued cash flow analysis were also utilized in estimating the fair value of the property, whereby cash flows from the various tenants are calculated based upon lease commencement and termination dates.

Additionally, effective January 1, 2014, we paid an aggregate of \$170,000 to purchase the 5% minority ownership interests held by third-party members in two LLCs in which we previously held noncontrolling, 95% majority ownership interests (Palmdale Medical Properties and Sparks Medical Properties). As a result of these minority ownership purchases, we now own 100% of each of these LLCs. Pursuant to current accounting standards, during the first quarter of 2014, we were required to record each property's assets and liabilities at their fair values which resulted in the recording of a \$316,000 non-cash gain, which is included in our Condensed Consolidated Statement of Income for the six months ended June 30, 2014, representing the difference between the fair values and the equity method carrying value of each investment. The calculated fair value, utilizing the income capitalization approach, is based upon the basis of capitalization of the net estimated earnings expectancy of the property, assuming continued use similar to the existing use of the acquired property. The property's continued cash flow analysis were also utilized in estimating the fair value of the property, whereby cash flows from the various tenants are calculated based upon lease commencement and termination dates.

Table of Contents

We began accounting for each property on a consolidated basis effective January 1, 2014. The aggregate fair values of these MOBs was allocated to net tangible property (\$19.5 million), identified intangible assets (\$2.8 million), and long term debt (\$10.7 million). Substantially all of the intangible assets include the value of the in-place leases at these

MOBs at the time of acquisition which will be amortized over the combined average remaining lease term of approximately 5.3 years at the time of acquisition. Other than the increased depreciation and amortization expense resulting from the amortization of the intangible assets recorded in connection with these transactions, there was no material impact on our net income as a result of the consolidation of these LLCs.

Additionally, effective August 1, 2014, we agreed to purchase the minority ownership interests held by third-party members in six LLCs, as listed below, in which we previously held noncontrolling majority ownership interests. As a result of these minority ownership purchases, we will own 100% of each of these LLCs and will begin accounting for each on a consolidated basis effective August 1, 2014. The aggregate purchase price in connection with the purchase of these minority ownership interests is approximately \$6.8 million, a portion of which is in the form of a note payable to the previous third-party member. Each of the property's assets and liabilities will be recorded at their estimated fair values during the third quarter of 2014. We expect to record a related aggregate gain during the third quarter of 2014.

Other than the increased depreciation and amortization expense resulting from the fair value recognition recorded in connection with these transactions, we do not anticipate a material impact on our net income or funds from operations as a result of the purchase of these minority ownership interests or related consolidation of these LLCs.

The following table represents the six LLCs in which we agreed to purchase the minority ownership interests and will begin to be accounted for on a consolidated basis effective August 1, 2014:

Name of LLC/LP	Ownership prior to minority interest purchase	Property Owned by LLC
DVMC Properties	90%	Desert Valley Medical Center
Santa Fe Scottsdale	90%	Santa Fe Professional Plaza
PCH Medical Properties	85%	Rosenberg Children's Medical Plaza
Sierra Medical Properties	95%	Sierra San Antonio Medical Plaza
PCH Southern Properties	95%	Phoenix Children's East Valley Care Center
3811 Bell Medical Properties	95%	3811 E. Bell Medical Building Medical Plaza

Divestitures:

There were no divestitures during the first six months of 2014.

Six Months Ended June 30, 2013:*Acquisition:*

On June 6, 2013, we purchased the 5004 Poole Road medical office building (MOB), located in Denison, Texas, on the campus of Texoma Medical Center, a wholly-owned subsidiary of UHS. This single-tenant MOB, which was

purchased for approximately \$625,000, consists of approximately 4,400 rentable square feet and is located adjacent to our Texoma Medical Plaza MOB.

New Construction:

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

Divestitures:

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

(5) Summarized Financial Information of Equity Affiliates

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

Table of Contents

property; (ii) annual budget approval, and; (iii) financing commitments. These investments, which represent 33% to 95% non-controlling ownership interests, are recorded initially at our cost and subsequently adjusted for our net equity in the net income, cash contributions to, and distributions from, the investments. Pursuant to certain agreements, allocations of sales proceeds and profits and losses of some of the LLC investments may be allocated disproportionately as compared to ownership interests after specified preferred return rate thresholds have been satisfied.

At June 30, 2014, we have non-controlling equity investments or commitments in eleven jointly-owned LLCs which own MOBs. As of June 30, 2014, we accounted for these LLCs on an unconsolidated basis pursuant to the equity method since they are not variable interest entities. The majority of these LLCs are joint-ventures between us and a non-related party that manages and holds minority ownership interests in the entities. Each LLC is generally self-sustained from a cash flow perspective and generates sufficient cash flow to meet its operating cash flow requirements and service the third-party debt (if applicable) that is non-recourse to us. Although there is typically no ongoing financial support required from us to these entities since they are cash-flow sufficient, we may, from time to time, provide funding for certain purposes such as, but not limited to, significant capital expenditures, leasehold improvements and debt financing. Although we are not obligated to do so, if approved by us at our sole discretion, additional cash fundings are typically advanced as equity or member loans.

Effective January 1, 2014, we purchased the 5% minority ownership interests held by third-party members in two LLCs in which we previously held noncontrolling majority ownership interests (Palmdale Medical Properties and Sparks Medical Properties). As a result of these minority ownership purchases, we now own 100% of each of these LLCs and account for them on a consolidated basis. Prior to January 1, 2014, these LLCs were accounted for on an unconsolidated basis pursuant to the equity method. Previously, Palmdale Medical Properties (Palmdale) was included in our financial statements on a consolidated basis through June 30, 2013 as a result of a master lease arrangement with a wholly-owned subsidiary of UHS, which expired on July 1, 2013.

At June 30, 2014, the LLCs in which we hold various non-controlling ownership interests are not variable interest entities and therefore are not subject to consolidation. As a result of master lease arrangements between UHS and various LLCs in which we hold majority non-controlling ownership interests, we have consolidated or deconsolidated these LLCs as required in accordance with the FASB's standards and guidance.

Effective August 1, 2014, we agreed to purchase the minority ownership interests held by third-party members in six LLCs, as mentioned above, in which we previously held noncontrolling majority ownership interests. The aggregate purchase price in connection with the purchase of these minority ownership interests is approximately \$6.8 million, a portion of which is in the form of a note payable to the previous third-party member. Please see *Note (4) Acquisitions, Dispositions and New Construction* for additional information.

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

The following property table represents the eleven LLCs in which we own a noncontrolling interest and were accounted for under the equity method as of June 30, 2014:

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

(a.) Tenants of this medical office building include subsidiaries of UHS.

Table of Contents

- (b.) We have funded \$5.2 million in equity as of June 30, 2014 and are committed to invest an additional \$1.2 million. This LLC has a third-party term loan of \$23.7 million, which is non-recourse to us, outstanding as of June 30, 2014.
- (c.) We have funded \$2.3 million in equity as of June 30, 2014, and are committed to fund an additional \$2.1 million. This building, which is on the campus of a UHS hospital and has tenants that include subsidiaries of UHS. This LLC has a third-party term loan of \$12.4 million, which is non-recourse to us, outstanding as of June 30, 2014.
- (d.) During the third quarter of 2012, this limited partnership entered into an agreement to develop, construct, own and operate the Forney Medical Plaza II, which opened on April 1, 2013. We have committed to invest up to \$2.5 million in equity and debt financing, of which \$1.2 million has been funded as of June 30, 2014. This LLC has a third-party construction loan of \$5.6 million, which is non-recourse to us, outstanding as of June 30, 2014.
- (e.) Effective August 1, 2014, we agreed to purchase the third-party minority ownership interest (ranging from 5% to 15%) in this LLC. As a result of our purchase of the minority ownership interest, as of August 1, 2014, we hold 100% of the ownership interest in the LLC and will be accounting for it on a consolidated basis effective August 1, 2014.

Below are the condensed combined statements of income (unaudited) for the LLCs accounted for under the equity method at June 30, 2014 and 2013.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013 (b.)	2014	2013 (b.)
	(amounts in thousands)			
Revenues	\$ 5,014	\$ 5,206	\$ 9,923	\$ 10,246
Operating expenses	2,164	2,398	4,135	4,400
Depreciation and amortization	879	1,069	1,775	2,093
Interest, net	1,361	1,635	2,679	2,889
Net income	\$ 610	\$ 104	\$ 1,334	\$ 864
Our share of net income (a.)	\$ 679	\$ 461	\$ 1,272	\$ 1,030

- (a.) Our share of net income includes interest income earned by us on various advances made to LLCs of approximately \$360,000 and \$620,000 for the three months ended June 30, 2014 and 2013, respectively, and \$712,000 and \$877,000 for the six months ended June 30, 2014 and 2013, respectively.
- (b.) As mentioned above, we began to account for Sparks Medical Properties on a consolidated basis as of January 1, 2014. Prior to January 1, 2014, the financial results of this entity were accounted for under the equity method on an unconsolidated basis. These amounts include the financial results for Sparks Medical Properties for the three and six months ended June 30, 2013. As also mentioned above, we began to account for Palmdale Medical Properties on a consolidated basis as of January 1, 2014. Prior thereto, as a result of a master lease commitment with a wholly-owned subsidiary of UHS which expired effective as of July 1, 2013, Palmdale Medical Properties was accounted for on a consolidated basis during the three and six-month periods ended June 30, 2013 and are therefore not reflected in the table above.

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

	June 30, 2014	December 31, 2013(a.)
	(amounts in thousands)	
Net property, including CIP	\$ 96,338	\$ 119,547
Other assets	8,630	9,479
Total assets	\$ 104,968	\$ 129,026
Liabilities	\$ 4,328	\$ 5,336
Mortgage notes payable, non-recourse to us	68,538	80,112
Advances payable to us	15,504	22,911
Equity	16,598	20,667
Total liabilities and equity	\$ 104,968	\$ 129,026
Our share of equity and advances to LLCs	\$ 27,952	\$ 39,201

Table of Contents

(a.) As mentioned above, we began to account for Palmdale Medical Properties and Sparks Medical Properties on a consolidated basis effective January 1, 2014. The amounts reflected for December 31, 2013, include the balance sheet amounts for each of these entities since they were accounted for on an unconsolidated basis pursuant to the equity method as of December 31, 2013.

As of June 30, 2014, aggregate principal amounts due on mortgage notes payable by unconsolidated LLCs, which are accounted for under the equity method and are non-recourse to us, are as follows (amounts in thousands):

2014	\$ 13,085
2015	35,353
2016	443
2017	11,689
2018	7,968
Total	\$ 68,538

Name of LLC	Mortgage/ Construction Loan Balance		Maturity Date
	(a.)		
Grayson Properties (b.)	\$	12,381	2014
Brunswick Associates		7,863	2015
Arlington Medical Properties		23,674	2015
DVMC Properties		3,916	2015
FTX MOB Phase II (c.)		5,596	2017
PCH Southern Properties		6,551	2017
PCH Medical Properties		8,557	2018
	\$	68,538	

- (a.) All mortgage loans, other than construction loans, require monthly principal payments through maturity and include a balloon principal payment upon maturity.
- (b.) We believe the terms of this loan are within current market underwriting criteria. At this time, we expect to refinance this loan during 2014 (this loan was extended through October 1, 2014) for a three to ten year term at the then current market interest rate. In the unexpected event that we are unable to refinance this loan on reasonable terms, we will explore other financing alternatives, including, among other things, potentially increasing our equity investment in the property utilizing funds borrowed under our revolving credit facility.
- (c.) Construction loan.

Pursuant to the operating agreements of the LLCs, the third-party member and the Trust, at any time, have the right to make an offer (Offering Member) to the other member(s) (Non-Offering Member) in which it either agrees to: (i) sell

the entire ownership interest of the Offering Member to the Non-Offering Member (Offer to Sell) at a price as determined by the Offering Member (Transfer Price), or; (ii) purchase the entire ownership interest of the Non-Offering Member (Offer to Purchase) at the equivalent proportionate Transfer Price. The Non-Offering Member has 60 days to either: (i) purchase the entire ownership interest of the Offering Member at the Transfer Price, or; (ii) sell its entire ownership interest to the Offering Member at the equivalent proportionate Transfer Price. The closing of the transfer must occur within 60 days of the acceptance by the Non-Offering Member.

The LLCs in which we have invested maintain property insurance on all properties. Although we believe that generally our properties are adequately insured, two of the LLCs (one in which we own a non-controlling equity interest), own properties in California that are located in earthquake zones. These properties are not covered by earthquake insurance since earthquake insurance is no longer available at rates which are economical in relation to the risks covered.

(6) Recent Accounting Pronouncements

In April 2014, the Financial Accounting Standards Board updated the accounting guidance related to the definition of a discontinued operation and the related disclosures. The updated accounting guidance defines a discontinued operation as a disposal of a component or a group of components that is to be disposed of or is classified as held for sale and represents a strategic shift that has or will have a major effect on an entity's operations and financial results. The updated guidance is applicable to us effective January 1, 2015 with early adoption permitted. We do not expect the adoption of this update to have a material impact on our condensed consolidated financial statements.

Table of Contents**(7) Debt and Financial Instruments***Debt:*

In July, 2011, we entered into a \$150 million revolving credit agreement (Credit Agreement) which is scheduled to expire on July 24, 2015. The Credit Agreement includes a \$50 million sub limit for letters of credit and a \$20 million sub limit for swingline/short-term loans. The Credit Agreement also provides an option to increase the total facility borrowing capacity by an additional \$50 million, subject to lender agreement. Borrowings made pursuant to the Credit Agreement will bear interest, at our option, at one, two, three, or six month LIBOR plus an applicable margin ranging from 1.75% to 2.50% or at the Base Rate plus an applicable margin ranging from 0.75% to 1.50%. The Credit Agreement defines Base Rate as the greatest of: (a) the administrative agent's prime rate; (b) the federal funds effective rate plus 0.50%, and; (c) one month LIBOR plus 1%. A fee of 0.30% to 0.50% will be charged on the unused portion of the commitment. The margins over LIBOR, Base Rate and the commitment fee are based upon our ratio of debt to total capital. At June 30, 2014, the applicable margin over the LIBOR rate was 2.00%, the margin over the Base Rate was 1.00%, and the commitment fee was 0.35%.

At June 30, 2014, we had \$102.4 million of outstanding borrowings and \$8.1 million of letters of credit outstanding against our revolving credit agreement. We had \$39.6 million of available borrowing capacity, net of the outstanding borrowings and letters of credit outstanding as of June 30, 2014. There are no compensating balance requirements.

On July 1, 2014, we borrowed an additional \$9.1 million under our revolving credit agreement, which was utilized to repay the outstanding mortgage balance on the Summerlin Hospital Medical Office Building I. The mortgage loan on this property matured on July 1, 2014.

Covenants relating to the Agreement require the maintenance of a minimum tangible net worth and specified financial ratios, limit our ability to incur additional debt, limit the aggregate amount of mortgage receivables and limit our ability to increase dividends in excess of 95% of cash available for distribution, unless additional distributions are required to comply with the applicable section of the Internal Revenue Code of 1986 and related regulations governing real estate investment trusts. We are in compliance with all of the covenants at June 30, 2014. We also believe that we would remain in compliance if the full amount of our commitment was borrowed.

The following table includes a summary of the required compliance ratios, giving effect to the covenants contained in the Credit Agreement (dollar amounts in thousands):

	Covenant	June 30, 2014
Tangible net worth	\$ 125,000	\$ 137,374
Debt to total capital	< 55%	39.1%
Debt service coverage ratio	> 3.00x	17.5x
Debt to cash flow ratio	< 3.50x	2.36x

We have fourteen mortgages, all of which are non-recourse to us, included on our condensed consolidated balance sheet as of June 30, 2014, with a combined outstanding balance of \$114.6 million (excluding net debt premium of \$604,000). The following table summarizes our outstanding mortgages, excluding net debt premium, at June 30, 2014 (amounts in thousands):

Facility Name	Outstanding Balance (in thousands)(a)	Interest Rate	Maturity Date
Summerlin Hospital Medical Office Building I fixed rate mortgage loan (b.)	\$ 9,081	6.55%	2014
Spring Valley Medical Office Building fixed rate mortgage loan	5,023	5.50%	2015
Palmdale Medical Plaza fixed rate mortgage loan	6,084	3.69%	2015
Summerlin Hospital Medical Office Building III floating rate mortgage loan	11,187	3.40%	2016
Peace Health fixed rate mortgage loan	21,465	5.64%	2017
Auburn Medical II floating rate mortgage loan	7,295	2.90%	2017
Medical Center of Western Connecticut fixed rate mortgage loan	4,842	6.00%	2017
Summerlin Hospital Medical Office Building II fixed rate mortgage loan	11,877	5.50%	2017

Table of Contents

Facility Name	Outstanding Balance (in thousands)(a)	Interest Rate	Maturity Date
Centennial Hills Medical Office Building floating rate mortgage loan	10,791	3.40%	2018
Sparks Medical Building/Vista Medical Terrace floating rate mortgage loan	4,541	3.40%	2018
Vibra Hospital-Corpus Christi fixed rate mortgage loan	2,943	6.50%	2019
700 Shadow Lane and Goldring MOB's fixed rate mortgage loan	6,684	4.54%	2022
BRB Medical Office Building fixed rate mortgage loan	6,757	4.27%	2022
Tuscan Professional Building fixed rate mortgage loan	6,065	5.56%	2025
Total	\$ 114,635		

(a) Amortized principal payments are made on a monthly basis.

(b) This loan was repaid in full on July 1, 2014, utilizing funds borrowed under our revolving credit facility.

The mortgages are secured by the real property of the buildings as well as property leases and rents. The mortgages have a combined fair value of approximately \$116.2 million as of June 30, 2014. Changes in market rates on our fixed rate debt impacts the fair value of debt, but it has no impact on interest incurred or cash flow.

Financial Instruments:

During the third quarter of 2013, we entered into an interest rate cap on a total notional amount of \$10 million whereby we paid a premium of \$136,000. During the first quarter of 2014, we entered into two additional interest rate cap agreements on a total notional amount of \$20 million whereby we paid premiums of \$134,500. In exchange for the premium payments, the counterparties agreed to pay us the difference between 1.50% and one-month LIBOR if one-month LIBOR rises above 1.50% during the term of the cap. The caps expire on January 13, 2017.

(8) Segment Reporting

Our primary business is investing in and leasing healthcare and human service facilities through direct ownership or through joint ventures, which aggregate into a single reportable segment. We actively manage our portfolio of healthcare and human service facilities and may from time to time make decisions to sell lower performing properties not meeting our long-term investment objectives. The proceeds of sales are typically reinvested in new developments or acquisitions, which we believe will meet our planned rate of return. It is our intent that all healthcare and human service facilities will be owned or developed for investment purposes. Our revenue and net income are generated from the operation of our investment portfolio.

Our portfolio is located throughout the United States, however, we do not distinguish or group our operations on a geographical basis for purposes of allocating resources or measuring performance. We review operating and financial data for each property on an individual basis; therefore, we define an operating segment as our individual properties.

Individual properties have been aggregated into one reportable segment based upon their similarities with regard to both the nature and economics of the facilities, tenants and operational processes, as well as long-term average financial performance.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
Overview

We are a real estate investment trust (REIT) that commenced operations in 1986. We invest in healthcare and human service related facilities including acute care hospitals, behavioral healthcare facilities, rehabilitation hospitals, sub-acute facilities, surgery centers, childcare centers and medical office buildings (MOBs). As of June 30, 2014, we have fifty-eight real estate investments or commitments located in sixteen states consisting of:

seven hospital facilities consisting of three acute care, one behavioral healthcare, one rehabilitation and two sub-acute;

forty-seven medical office buildings, including eleven owned by unconsolidated limited liability companies (LLCs), and;

four pre-school and childcare centers.

Forward Looking Statements and Certain Risk Factors

This report contains forward-looking statements that reflect our current estimates, expectations and projections about our future results, performance, prospects and opportunities. Forward-looking statements include, among other things, the information concerning our possible future results of operations, business and growth strategies, financing plans, expectations that regulatory

Table of Contents

developments or other matters will not have a material adverse effect on our business or financial condition, our competitive position and the effects of competition, the projected growth of the industry in which we operate, and the benefits and synergies to be obtained from our completed and any future acquisitions, and statements of our goals and objectives, and other similar expressions concerning matters that are not historical facts. Words such as may, will, should, could, would, predicts, potential, continue, expects, anticipates, future, intends, plans, appears, projects and similar expressions, as well as statements in future tense, identify forward-looking statements.

Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by which, such performance or results will be achieved. Forward-looking information is based on information available at the time and/or our good faith belief with respect to future events, and is subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in the statements. Such factors include, among other things, the following:

a substantial portion of our revenues are dependent upon one operator, Universal Health Services, Inc. (UHS);

a number of legislative initiatives have recently been passed into law that may result in major changes in the health care delivery system on a national or state level to the operators of our facilities, including UHS. No assurances can be given that the implementation of these new laws will not have a material adverse effect on the business, financial condition or results of operations of our operators;

a subsidiary of UHS is our Advisor and our officers are all employees of a wholly-owned subsidiary of UHS, which may create the potential for conflicts of interest;

lost revenues from purchase option exercises and lease expirations and renewals, loan repayments and other restructuring;

The Bridgeway s (Bridgeway) lease term is scheduled to expire in December, 2014 and we can provide no assurance that this lease will be renewed at the fair market value lease rate. See Relationship with UHS and Related Party Transactions in Note 2 to the condensed consolidated financial statements for additional information;

the availability and terms of capital to fund the growth of our business;

the outcome of known and unknown litigation, government investigations, and liabilities and other claims asserted against us or the operators of our facilities;

failure of the operators of our hospital facilities to comply with governmental regulations related to the Medicare and Medicaid licensing and certification requirements could have a material adverse impact on our

future revenues and the underlying value of the property;

the potential unfavorable impact on our business of deterioration in national, regional and local economic and business conditions, including a worsening of unfavorable credit and/or capital market conditions, which may adversely affect, on acceptable terms, our access to sources of capital which may be required to fund the future growth of our business and refinance existing debt with near term maturities;

further deterioration in general economic conditions which could result in increases in the number of people unemployed and/or insured and likely increase the number of individuals without health insurance; as a result, the operators of our facilities may experience decreases in patient volumes which could result in decreased occupancy rates at our medical office buildings;

a worsening of the economic and employment conditions in the United States could materially affect the business of our operators, including UHS, which may unfavorably impact our future bonus rentals (on the UHS hospital facilities) and may potentially have a negative impact on the future lease renewal terms and the underlying value of the hospital properties;

real estate market factors, including without limitation, the supply and demand of office space and market rental rates, changes in interest rates as well as an increase in the development of medical office condominiums in certain markets;

government regulations, including changes in the reimbursement levels under the Medicare and Medicaid program resulting from, among other things, the various health care reform initiatives being implemented;

the issues facing the health care industry that affect the operators of our facilities, including UHS, such as: changes in, or the ability to comply with, existing laws and government regulations; unfavorable changes in the levels and terms of reimbursement by third party payors or government programs, including Medicare (including, but not limited to, the potential unfavorable impact of future reductions to Medicare reimbursements resulting from the Budget Control Act of 2011, as discussed below) and Medicaid (most states have reported significant budget deficits that have, in the past, resulted in the reduction of Medicaid funding to the operators of our facilities, including UHS); demographic changes; the ability to enter into managed care provider agreements on acceptable terms; an increase in uninsured and self-pay patients which unfavorably impacts the collectability of patient accounts; decreasing in-patient admission trends; technological and pharmaceutical improvements that may increase the cost of providing, or reduce the demand for, health care, and; the ability to attract and retain qualified medical personnel, including physicians;

Table of Contents

in August, 2011, the Budget Control Act of 2011 (the 2011 Act) was enacted into law. The 2011 Act imposed annual spending limits for most federal agencies and programs aimed at reducing budget deficits by \$917 billion between 2012 and 2021, according to a report released by the Congressional Budget Office. The 2011 Act provides for new spending on program integrity initiatives intended to reduce fraud and abuse under the Medicare program. Among its other provisions, the law established a bipartisan Congressional committee, known as the Joint Select Committee on Deficit Reduction (the Joint Committee), which was tasked with making recommendations aimed at reducing future federal budget deficits by an additional \$1.5 trillion over 10 years. The Joint Committee was unable to reach an agreement by the November 23, 2011 deadline and, as a result, across-the-board cuts to discretionary, national defense and Medicare spending were implemented on March 1, 2013 resulting in Medicare payment reductions of up to 2% per fiscal year with a uniform percentage reduction across all Medicare programs. We cannot predict whether Congress will restructure the implemented Medicare payment reductions or what federal other deficit reduction initiatives may be proposed by Congress. We also cannot predict the effect this enactment will have on operators (including UHS), and, thus, our business;

in March, 2010, the Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act were enacted into law and created significant changes to health insurance coverage for U.S. citizens as well as material revisions to the federal Medicare and state Medicaid programs. The two combined primary goals of these acts are to provide for increased access to coverage for healthcare and to reduce healthcare-related expenses. Medicare, Medicaid and other health care industry changes are scheduled to be implemented at various times during this decade. We cannot predict the effect, if any, these enactments will have on operators (including UHS) and, thus, our business;

two LLCs that own properties in California, (one in which we have a non-controlling equity interest), could not obtain earthquake insurance at rates which are economically beneficial in relation to the risks covered;

competition for our operators from other REITs;

the operators of our facilities face competition from other health care providers, including physician owned facilities and other competing facilities, including certain facilities operated by UHS but the real property of which is not owned by us. Such competition is experienced in markets including, but not limited to, McAllen, Texas, the site of our McAllen Medical Center, a 430-bed acute care hospital, and Riverside County, California, the site of our Southwest Healthcare System-Inland Valley Campus, a 132-bed acute care hospital;

changes in, or inadvertent violations of, tax laws and regulations and other factors than can affect REITs and our status as a REIT;

should we be unable to comply with the strict income distribution requirements applicable to REITs, utilizing only cash generated by operating activities, we would be required to generate cash from other sources which could adversely affect our financial condition;

our majority ownership interests in various LLCs in which we hold non-controlling equity interests. In addition, pursuant to the operating agreements of most of the LLCs, the third-party member and the Trust, at any time, have the right to make an offer (Offering Member) to the other member(s) (Non-Offering Member) in which it either agrees to: (i) sell the entire ownership interest of the Offering Member to the Non-Offering Member (Offer to Sell) at a price as determined by the Offering Member (Transfer Price), or; (ii) purchase the entire ownership interest of the Non-Offering Member (Offer to Purchase) at the equivalent proportionate Transfer Price. The Non-Offering Member has 60 days to either: (i) purchase the entire ownership interest of the Offering Member at the Transfer Price, or; (ii) sell its entire ownership interest to the Offering Member at the equivalent proportionate Transfer Price. The closing of the transfer must occur within 60 days of the acceptance by the Non-Offering Member;

fluctuations in the value of our common stock, and;

other factors referenced herein or in our other filings with the Securities and Exchange Commission.

Given these uncertainties, risks and assumptions, you are cautioned not to place undue reliance on such forward-looking statements. Our actual results and financial condition, including the operating results of our lessees and the facilities leased to subsidiaries of UHS, could differ materially from those expressed in, or implied by, the forward-looking statements.

Forward-looking statements speak only as of the date the statements are made. We assume no obligation to publicly update any forward-looking statements to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information, except as may be required by law. All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by this cautionary statement.

Table of Contents

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the amounts reported in our condensed consolidated financial statements and accompanying notes. We consider our critical accounting policies to be those that require us to make significant judgments and estimates when we prepare our financial statements, including the following:

Revenue Recognition: Our revenues consist primarily of rentals received from tenants, which are comprised of minimum rent (base rentals), bonus rentals and reimbursements from tenants for their pro-rata share of expenses such as common area maintenance costs, real estate taxes and utilities.

The minimum rent for all hospital facilities is fixed over the initial term or renewal term of the respective leases. Rental income recorded by our consolidated and unconsolidated medical office buildings (MOBs) relating to leases in excess of one year in length is recognized using the straight-line method under which contractual rents are recognized evenly over the lease term regardless of when payments are due. The amount of rental revenue resulting from straight-line rent adjustments is dependent on many factors including the nature and amount of any rental concessions granted to new tenants, scheduled rent increases under existing leases, as well as the acquisitions and sales of properties that have existing in-place leases with terms in excess of one year. As a result, the straight-line adjustments to rental revenue may vary from period-to-period. Bonus rents are recognized when earned based upon increases in each facility's net revenue in excess of stipulated amounts. Bonus rentals are determined and paid each quarter based upon a computation that compares the respective facility's current quarter's net revenue to the corresponding quarter in the base year. Tenant reimbursements for operating expenses are accrued as revenue in the same period the related expenses are incurred.

Real Estate Investments: On the date of acquisition, the purchase price of a property is allocated to the property's land, buildings and intangible assets based upon our estimates of their fair values. Depreciation is computed using the straight-line method over the useful lives of the buildings and capital improvements. The value of intangible assets is amortized over the remaining lease term.

Asset Impairment: Real estate investments and related intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the property might not be recoverable. A property to be held and used is considered impaired only if management's estimate of the aggregate future cash flows, less estimated capital expenditures, to be generated by the property, undiscounted and without interest charges, are less than the carrying value of the property. This estimate takes into consideration factors such as expected future operating income, trends and prospects, as well as the effects of demand, competition, local market conditions and other factors.

The determination of undiscounted cash flows requires significant estimates by management, including the expected course of action at the balance sheet date that would lead to such cash flows. Subsequent changes in estimated undiscounted cash flows arising from changes in anticipated action to be taken with respect to the property could impact the determination of whether an impairment exists and whether the effects could materially impact our net income. To the extent estimated undiscounted cash flows are less than the carrying value of the property, the loss will be measured as the excess of the carrying amount of the property over the fair value of the property.

Assessment of the recoverability by us of certain lease related costs must be made when we have reason to believe that a tenant might not be able to perform under the terms of the lease as originally expected. This requires us to make estimates as to the recoverability of such costs. If we determine that the intangible assets are not recoverable from

future cash flows, the excess of carrying value of the intangible asset over its estimated fair value is charged to income.

An other than temporary impairment of an investment/advance in an LLC is recognized when the carrying value of the investment is not considered recoverable based on evaluation of the severity and duration of the decline in value, including projected declines in cash flow. To the extent impairment has occurred, the excess carrying value of the asset over its estimated fair value is charged to income.

Investments in Limited Liability Companies (LLCs): Our condensed consolidated financial statements include the consolidated accounts of our controlled investments and those investments that meet the criteria of a variable interest entity where we are the primary beneficiary. In accordance with the FASB's standards and guidance relating to accounting for investments and real estate ventures, we account for our unconsolidated investments in LLCs which we do not control using the equity method of accounting. The third-party members in these investments have equal voting rights with regards to issues such as, but not limited to: (i) divestiture of property; (ii) annual budget approval, and; (iii) financing commitments. These investments, which represent 33% to 95% non-controlling ownership interests, are recorded initially at our cost and subsequently adjusted for our net equity in the net income, cash contributions to, and distributions from, the investments. Pursuant to certain agreements, allocations of sales proceeds and profits and losses of some of the LLC investments may be allocated disproportionately as compared to ownership interests after specified preferred return rate thresholds have been satisfied.

Table of Contents

At June 30, 2014, we have non-controlling equity investments or commitments in eleven jointly-owned LLCs which own MOBs. As of June 30, 2014, we accounted for these LLCs on an unconsolidated basis pursuant to the equity method since they are not variable interest entities. Palmdale Medical Properties was consolidated in our financial statements through June 30, 2013. As previously disclosed, the master lease with a wholly-owned subsidiary of UHS related to Palmdale Medical Properties expired effective as of July 1, 2013 and, as of that date, we began accounting for Palmdale Medical Properties under the equity method. Although the expiration of the master lease will have an unfavorable impact on our net income and funds from operations, we do not believe the impact will be material to our financial condition or liquidity.

Effective January 1, 2014, we purchased the third-party minority ownership interests in Palmdale Medical Properties and Sparks Medical Properties, in each of which we formerly held non-controlling majority ownership interest. As a result of our purchase of the minority ownership interests, we now hold 100% of the ownership interests in these LLCs which own MOBs and we began accounting for them on a consolidated basis effective January 1, 2014. Each of the property's assets and liabilities were recorded at their fair values.

The majority of these LLCs are joint-ventures between us and a non-related party that manages and holds minority ownership interests in the entities. Each LLC is generally self-sustained from a cash flow perspective and generates sufficient cash flow to meet its operating cash flow requirements and service the third-party debt (if applicable) that is non-recourse to us. Although there is typically no ongoing financial support required from us to these entities since they are cash-flow sufficient, we may, from time to time, provide funding for certain purposes such as, but not limited to, significant capital expenditures, leasehold improvements and debt financing. Although we are not obligated to do so, if approved by us at our sole discretion, additional cash fundings are typically advanced as equity or member loans.

Effective August 1, 2014, we agreed to pay approximately \$6.8 million, a portion of which is in the form of a note payable to the previous third-party member, to purchase the minority ownership interests held by third-party members in six LLCs (DVMC Properties, Santa Fe Scottsdale, PHC Medical Properties, PCH Southern Properties, Sierra Medical Properties and 3811 Bell Medical Properties), in which we previously held noncontrolling majority ownership interests. As a result of these minority ownership purchases, we will own 100% of each of these LLCs and will begin accounting for each on a consolidated basis effective August 1, 2014.

Federal Income Taxes: No provision has been made for federal income tax purposes since we qualify as a REIT under Sections 856 to 860 of the Internal Revenue Code of 1986, and intend to continue to remain so qualified. As such, we are exempt from federal income taxes and we are required to distribute at least 90% of our real estate investment taxable income to our shareholders.

We are subject to a federal excise tax computed on a calendar year basis. The excise tax equals 4% of the amount by which 85% of our ordinary income plus 95% of any capital gain income for the calendar year exceeds cash distributions during the calendar year, as defined. No provision for excise tax has been reflected in the financial statements as no tax is expected to be due.

Earnings and profits, which determine the taxability of dividends to shareholders, will differ from net income reported for financial reporting purposes due to the differences for federal tax purposes in the cost basis of assets and in the estimated useful lives used to compute depreciation and the recording of provision for investment losses.

Relationship with Universal Health Services, Inc. (UHS) and Related Party Transactions - UHS is our principal tenant and through UHS of Delaware, Inc., a wholly owned subsidiary of UHS, serves as our advisor (the Advisor) under an Advisory Agreement dated December 24, 1986 between the Advisor and us (the Advisory Agreement). Our

officers are all employees of UHS (through UHS of Delaware, Inc.) and although as of June 30, 2014 we had no salaried employees, our officers do receive stock-based compensation from time-to-time.

Pursuant to the Advisory Agreement, the Advisor is obligated to present an investment program to us, to use its best efforts to obtain investments suitable for such program (although it is not obligated to present any particular investment opportunity to us), to provide administrative services to us and to conduct our day-to-day affairs. All transactions between us and UHS must be approved by the Trustees who are unaffiliated with UHS (the Independent Trustees). In performing its services under the Advisory Agreement, the Advisor may utilize independent professional services, including accounting, legal, tax and other services, for which the Advisor is reimbursed directly by us. The Advisory Agreement may be terminated for any reason upon sixty days written notice by us or the Advisor. The Advisory Agreement expires on December 31 of each year; however, it is renewable by us, subject to a determination by the Independent Trustees that the Advisor's performance has been satisfactory. The Advisor is entitled to certain advisory fees for its services. In December of 2013, based upon a review of our advisory fee and other general and administrative expenses, as compared to an industry peer group, the Advisory Agreement was renewed for 2014. See Relationship with UHS and Related Party Transactions in Note 2 to the condensed consolidated financial statements for additional information on the Advisory Agreement and related fees.

The combined revenues generated from the leases on the UHS hospital facilities comprised approximately 30% of our consolidated revenues for each of the three month periods ended June 30, 2014 and 2013, and approximately 29% and 30% of our consolidated revenues for the six months ended June 30, 2014 and 2013, respectively. Including 100% of the revenues generated at the unconsolidated LLCs in which we have various non-controlling equity interests ranging from 33% to 95%, the leases on the UHS

Table of Contents

hospital facilities accounted for approximately 22% of the combined consolidated and unconsolidated revenue for each of the three and six-month periods ended June 30, 2014 and 2013. In addition, twelve MOBs, that are either wholly or jointly-owned, include or will include tenants which are subsidiaries of UHS. The leases to the hospital facilities of UHS are guaranteed by UHS and cross-defaulted with one another.

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

Management cannot predict whether the leases with subsidiaries of UHS, which have renewal options at existing lease rates or fair market value lease rates, will be renewed at the end of their lease term. The Bridgeway's (Bridgeway) lease term is scheduled to expire in December, 2014 and we can provide no assurance that it will be renewed at the fair market value lease rate. Our revenues, net cash provided by operating activities and funds from operations include approximately \$1.1 million annually earned in connection with Bridgeway's lease. If UHS exercises its right to purchase the Bridgeway facility, or any of its other hospital facilities, at the end of the current lease terms at the appraised fair market value, we would consider, among other things, redeploying the sale proceeds generated from the divestiture to acquire other real estate property. If we are unable to redeploy the proceeds generated from the divestiture, or if we were unable to generate the same rate of return on the redeployed proceeds, our revenues, cash provided by operating activities and funds from operations could be unfavorably impacted. In the event that The Bridgeway's lease, or the lease on any other hospital leased to a subsidiary of UHS, is not renewed, and UHS does not exercise its right to purchase the facility for the appraised fair market value at the end of the lease term, we will be required to find other operators for the property and/or enter into leases on terms potentially less favorable to us than the current lease.

For additional disclosure related to our relationship with UHS, please refer to Note 2 to the condensed consolidated financial statements, Relationship with Universal Health Services, Inc. (UHS) and Related Party Transactions.

Results of Operations

Effective January 1, 2014, we purchased the 5% minority ownership interests held by third-party members in Palmdale Medical Properties and Sparks Medical Properties, two LLCs in which we previously held noncontrolling majority ownership interests. As a result of these minority ownership purchases, we now own 100% of each of these LLCs and our Condensed Consolidated Statement of Income for the three and six months ended June 30, 2014 includes the revenues and expenses associated with each of these properties. Prior to January 1, 2014, these LLCs were accounted for on an unconsolidated basis pursuant to the equity method. Previously, Palmdale Medical Properties was included in our financial statements on a consolidated basis through June 30, 2013, as a result of a master lease arrangement with a wholly-owned subsidiary of UHS, which expired effective on July 1, 2013. Therefore, our Condensed Consolidated Statement of Income for the three and six months ended June 30, 2013, also included the revenues and expenses associated with Palmdale Medical Properties.

The tables below reflect the As Adjusted Statements of Income for the three and six months ended June 30, 2013, reflecting the revenue and expense impact of the consolidation of the Sparks Medical Properties as if it had been consolidated effective January 1, 2013, since our Condensed Consolidated Statement of Income for the three and six month periods of 2014 includes the revenue and expenses associated with Sparks Medical Properties. As mentioned above, Palmdale Medical Properties was included in our financial statements on a consolidated basis through June 30, 2013, therefore, there is no As Adjusted presentation for Palmdale Medical Properties for the three and six months ended June 30, 2013. There was no material impact to our net income as a result of the consolidation of these LLCs.

Table of Contents**Three Months Ended June 30, 2014 as compared to Three Months Ended June 30, 2013:**

	As reported in Condensed Consolidated Statements of Income for the Three Months Ended June 30, 2014	As reported in Condensed Consolidated Statements of Income for the Three Months Ended June 30, 2013	Three months ended June 30, 2013 Statements of Income for Sparks Medical Properties	As Adjusted Three Months Ended June 30, 2013	As Adjusted Variance
Revenues	\$ 14,317	\$ 13,502	\$ 289	\$ 13,791	\$ 526
Expenses:					
Depreciation and amortization	4,782	4,722	83	4,805	23
Advisory fees to UHS	620	585	0	585	(35)
Other operating expenses	4,134	3,744	201	3,945	(189)
Transaction costs	41	49	0	49	8
	9,577	9,100	284	9,384	(193)
Income before equity in income of unconsolidated LLCs and interest expense	4,740	4,402	5	4,407	333
Equity in income of unconsolidated LLCs	679	461	48	509	170
Interest expense, net	(2,011)	(1,922)	(53)	(1,975)	(36)
Net income	\$ 3,408	\$ 2,941	\$ 0	\$ 2,941	\$ 467

Six Months Ended June 30, 2014 as compared to Six Months Ended June 30, 2013:

	As reported in Condensed Consolidated Statements of Income for the Six Months Ended June 30, 2014	As reported in Condensed Consolidated Statements of Income for the Six Months Ended June 30, 2013	Six months ended June 30, 2013 Statements of Income for Sparks Medical Properties	As Adjusted Six Months Ended June 30, 2013	As Adjusted Variance
Revenues	\$ 28,605	\$ 27,387	\$ 576	\$ 27,963	\$ 642
Expenses:					
Depreciation and amortization	9,608	9,536	166	9,702	94

Edgar Filing: BLUE NILE INC - Form 10-Q

Advisory fees to UHS	1,230	1,156	0	1,156	(74)
Other operating expenses	8,067	7,409	367	7,776	(291)
Transaction costs	103	131	0	131	28
	19,008	18,232	533	18,765	(243)
Income before equity in income of unconsolidated LLCs, interest expense and gains	9,597	9,155	43	9,198	399
Equity in income of unconsolidated LLCs	1,272	1,030	82	1,112	160
Gains on fair value recognition resulting from purchase of minority interests in majority-owned LLCs	316	0	0	0	316
Interest expense, net	(4,003)	(3,817)	(125)	(3,942)	(61)
Net income	\$ 7,182	\$ 6,368	\$ 0	\$ 6,368	\$ 814

Table of Contents

For the three months ended June 30, 2014, net income was \$3.4 million as compared to \$2.9 million during the comparable prior year quarter. For the six-month period ended June 30, 2014, net income was \$7.2 million as compared to \$6.4 million during the comparable six-month period of the prior year.

The \$467,000 increase in net income during the second quarter of 2014, as compared to the comparable prior year quarter, was attributable to:

an increase of \$181,000 in bonus rental earned on the hospital facilities leased to wholly-owned subsidiaries of Universal Health Services, Inc. (UHS), and;

other combined net increases of \$286,000.

The increase in net income of \$814,000 during the first six months of 2014, as compared to the first six months of 2012, was primarily attributable to:

an increase of \$316,000 resulting from the aggregate gain recorded on the fair value recognition in connection with the purchase of minority interests in majority-owned LLCs, as discussed above;

an increase of \$233,000 in bonus rental earned on the hospital facilities leased to wholly-owned subsidiaries of UHS, and;

other combined net increases of \$265,000.

Total revenues increased by \$526,000 (As Adjusted) during the three months ended June 30, 2014 as compared to the comparable period of 2013, and \$642,000 (As Adjusted) during the six months ended June 30, 2014, as compared to the comparable period of 2013. The increases in revenues during the second quarter and the first six months of 2014, as compared to the comparable periods of 2013, was primarily due to: (i) the revenues generated at MOBs acquired during the third quarter of 2013 and the first quarter of 2014; (ii) an increase in bonus rental revenue, as mentioned above, and; (iii) other combined net changes at existing properties.

Included in our other operating expenses are expenses related to the consolidated medical office buildings, which totaled \$3.7 million and \$3.6 million (As Adjusted) for the three-month periods ended June 30, 2014 and 2013, respectively, and \$7.3 million and \$7.0 million (As Adjusted) for the six-month periods ended June 30, 2014 and 2013, respectively. A large portion of the expenses associated with our consolidated medical office buildings is passed on directly to the tenants either directly as tenant reimbursements of common area maintenance expenses or included in base rental amounts. Tenant reimbursements for operating expenses are accrued as revenue in the same period the related expenses are incurred and are included as tenant reimbursement revenue in our condensed consolidated statements of income.

Funds from operations (FFO) is a widely recognized measure of performance for Real Estate Investment Trusts (REITs). We believe that FFO and FFO per diluted share, and adjusted funds from operations (AFFO) and AFFO per diluted share, which are non-GAAP financial measures (GAAP is Generally Accepted Accounting Principles in the United States of America), are helpful to our investors as measures of our operating performance. We compute FFO,

as reflected below, in accordance with standards established by the National Association of Real Estate Investment Trusts (NAREIT), which may not be comparable to FFO reported by other REITs that do not compute FFO in accordance with the NAREIT definition, or that interpret the NAREIT definition differently than we interpret the definition. AFFO was also computed for the three and six-month periods ended June 30, 2014 and 2013, as reflected below, since we believe it is helpful to our investors since it adjusts for the effect of the transaction costs related to acquisitions. FFO/AFFO do not represent cash generated from operating activities in accordance with GAAP and should not be considered to be an alternative to net income determined in accordance with GAAP. In addition, FFO/AFFO should not be used as: (i) an indication of our financial performance determined in accordance with GAAP; (ii) an alternative to cash flow from operating activities determined in accordance with GAAP; (iii) a measure of our liquidity, or; (iv) an indicator of funds available for our cash needs, including our ability to make cash distributions to shareholders.

Table of Contents

Below is a reconciliation of our reported net income to FFO and AFFO for the three and six-month periods ended June 30, 2014 and 2013 (in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Net income	\$ 3,408	\$ 2,941	\$ 7,182	\$ 6,368
Depreciation and amortization expense on consolidated investments	4,703	4,660	9,455	9,417
Depreciation and amortization expense on unconsolidated affiliates	709	789	1,382	1,542
Gains on fair value recognition resulting from the purchase of minority interests in majority-owned LLCs	0	0	(316)	0
Funds From Operations	\$ 8,820	\$ 8,390	\$ 17,703	\$ 17,327
Transaction costs	41	49	103	131
Adjusted Funds From Operations	\$ 8,861	\$ 8,439	\$ 17,806	\$ 17,458

Our FFO and AFFO increased by \$430,000 and \$422,000, respectively, during the three-month period ended June 30, 2014, as compared to the comparable quarter of 2013. Our FFO and AFFO increased by \$376,000 and \$348,000 during the six-month period ended June 30, 2014, as compared to the comparable period of 2014. The increases during both periods is primarily attributable to the increases in net income, as discussed above, offset by a net decreases in the depreciation and amortization expense incurred at our properties (on a consolidated and unconsolidated basis) during the three and six-month periods ended June 30, 2014.

Liquidity and Capital Resources**Net cash provided by operating activities**

Net cash provided by operating activities was \$15.3 million and \$15.7 million during the six-month periods ended June 30, 2014 and 2013, respectively. The \$358,000 net decrease was attributable to:

a favorable change of \$609,000 due to an increase in net income plus/minus the adjustments to reconcile net income to net cash provided by operating activities (depreciation and amortization, amortization on debt net premium, restricted/stock-based compensation and gains on purchase of minority interests in majority-owned LLCs), as discussed above in Results of Operations;

a favorable change of \$240,000 due to an increase in prepaid rents;

an unfavorable change of \$1.2 million in accrued expenses and other liabilities resulting primarily from the timing of accrued expenses and other liabilities disbursements, and;

other combined net unfavorable changes of \$46,000.

Net cash used in investing activities

Net cash used in investing activities was \$8.9 million during the six months ended June 30, 2014 as compared to \$6.6 million during the six months ended June 30, 2013.

During the six-month period ended June 30, 2014, we funded: (i) \$887,000 in equity investments in various unconsolidated LLCs; (ii) \$1.5 million in capital additions to real estate investments primarily for tenant improvements at various MOBs; (iii) \$7.1 million to acquire the real estate assets of two medical office buildings, as discussed above, and; (iv) \$170,000 to acquire the minority interests in two majority-owned LLCs, as discussed above. In addition, during the six-month period ended June 30, 2014, we received \$741,000 of cash distributions in excess of income from our unconsolidated LLCs.

During the six-month period ended June 30, 2013, we funded: (i) \$1.8 million in equity investments in various unconsolidated LLCs; (ii) \$4.1 million in advances in the form of member loans to unconsolidated LLCs; (iii) \$1.4 million in capital additions, and; (iv) \$625,000 to acquire the real estate assets of the 5004 Poole Road medical office building. In addition, during the six-month period ended June 30, 2013, we received: (i) \$1.3 million of cash distributions in excess of income from our unconsolidated LLCs, and; (ii) \$67,000 in repayments of advances previously made to unconsolidated LLCs.

Table of Contents

Net cash used in financing activities

Net cash used in financing activities was \$6.1 million during the six months ended June 30, 2014, as compared to \$9.0 million during the six months ended June 30, 2013.

During the six-month period ended June 30, 2014, we: (i) received \$8.7 million of additional net borrowings on our revolving line of credit, and; (ii) generated \$3.0 million of net cash from the issuance of shares of beneficial interest, (as discussed below). Additionally, during the six months ended June 30, 2014, we paid: (i) \$1.6 million on mortgage and other notes payable that are non-recourse to us, and; (ii) \$16.2 million of dividends.

During the six-month period ended June 30, 2013, we: (i) received \$8.6 million of additional net borrowings on our revolving line of credit; (ii) received \$11.2 million of proceeds related to a new mortgage note payable (refinance) that is non-recourse to us, and; (iii) generated \$128,000 of net cash from the issuance of shares of beneficial interest. Additionally, during the six months ended June 30, 2013, we paid: (i) \$13.0 million on mortgage and other notes payable that are non-recourse to us (including the pay-off of a mortgage note payable that was refinanced during the first quarter of 2013, resulting in \$11.2 million of proceeds to us); (ii) \$95,000 of financing costs on mortgage and other notes payable, and; (iii) \$15.8 million of dividends.

During the fourth quarter of 2013, we commenced an at-the-market (ATM) equity issuance program, pursuant to the terms of which we may sell, from time-to-time, common shares of our beneficial interest up to an aggregate sales price of \$50 million to or through Merrill Lynch, Pierce, Fenner and Smith, Incorporated (Merrill Lynch), as sales agent and/or principal. Pursuant to this ATM program, during the first six months of 2014, we issued 57,410 shares at an average price of \$42.67 per share (all issued during the first quarter of 2014). Including the shares issued at the end of the fourth quarter of 2013, which settled during the first quarter of 2014, the ATM program generated approximately \$2.9 million of net cash proceeds, (net of approximately \$182,000, consisting of compensation of approximately \$76,000 to Merrill Lynch, as well as approximately \$106,000 of other various fees and expenses) during the first six months of 2014. Approximately \$592,000 of net cash proceeds (net of approximately \$15,000 of compensation to Merrill Lynch) related to the shares issued late in the fourth quarter of 2013 were received by us during the first quarter of 2014. Since inception of this program, we have issued 212,123 shares at an average price of \$41.97 per share, which generated approximately \$8.4 million of cash proceeds or receivables (net of approximately \$537,000, consisting of compensation of approximately \$222,000 to Merrill Lynch, as well as approximately \$315,000 of other various fees and expenses).

Additional cash flow and dividends paid information for the six-month periods ended June 30, 2014 and 2013:

As indicated on our condensed consolidated statement of cash flows, we generated net cash provided by operating activities of \$15.3 million and \$15.7 million during the six-month periods ended June 30, 2014 and 2013, respectively.

As also indicated on our statement of cash flows, noncash expenses such as depreciation and amortization expense, restricted/stock-based compensation expense as well as the gains recorded during the first six months of 2014, are the primary differences between our net income and net cash provided by operating activities during each period. In addition, as reflected in the cash flows from investing activities section, we received \$741,000 and \$1.3 million during the six months ended June 30, 2014 and 2013, respectively, of cash distributions in excess of income from various unconsolidated LLCs which represents our share of the net cash flow distributions from these entities. These cash distributions in excess of income represent operating cash flows net of capital expenditures and debt repayments made by the LLCs.

We generated \$16.0 million and \$16.9 million of net cash during the six months ended June 30, 2014 and 2013, respectively, related to the operating activities of our properties recorded on a consolidated and an unconsolidated

basis. We paid dividends of \$16.2 million and \$15.8 million during the six months ended June 30, 2014 and 2013, respectively. During the first six months of 2014, the \$16.0 million of net cash generated related to the operating activities of our properties was approximately \$200,000 less than the \$16.2 million of dividends paid during the period. During the first six months of 2013, the \$16.9 million of net cash generated related to operating activities of our properties was approximately \$1.1 million more than the \$15.8 million of dividends paid during the period.

As indicated in the cash flows from investing activities and cash flows from financing activities sections of the statements of cash flows, there were various other sources and uses of cash during the six months ended June 30, 2014 and 2013. Therefore, the funding source for our dividend payments is not wholly dependent on the operating cash flow generated by our properties in any given period. Rather, our dividends, as well as our capital reinvestments into our existing properties, acquisitions of real property and other investments are funded based upon the aggregate net cash inflows or outflows from all sources and uses of cash from the properties we own either in whole or through LLCs, as outlined above.

Table of Contents

In determining and monitoring our dividend level on a quarterly basis, our management and Board of Trustees consider many factors in determining the amount of dividends to be paid each period. These considerations primarily include: (i) the minimum required amount of dividends to be paid in order to maintain our REIT status; (ii) the current and projected operating results of our properties, including those owned in LLCs, and; (iii) our future capital commitments and debt repayments, including those of our LLCs. Based upon the information discussed above, as well as consideration of projections and forecasts of our future operating cash flows, management and the Board of Trustees have determined that our operating cash flows have been sufficient to fund our dividend payments. Future dividend levels will be determined based upon the factors outlined above with consideration given to our projected future results of operations.

Included in the various sources of cash were: (i) funds generated from the repayments of advances made from us to LLCs (\$67,000 for the six months ended June 30, 2013); (ii) net borrowings on our revolving credit agreement (\$8.7 million and \$8.6 million for the six months ended June 30, 2014 and 2013, respectively); (iii) proceeds from mortgage notes payable (\$11.2 million for the six months ended June 30, 2013), and; (iv) net cash generated in connection with the issuance of shares of beneficial interest (\$3.0 million and \$128,000 for the six months ended June 30, 2014 and 2013, respectively).

In addition to the dividends paid, the following were also included in the various uses of cash: (i) investments in LLCs (\$887,000 and \$1.8 million for the six months ended June 30, 2014 and 2013, respectively); (ii) advances made to LLCs (\$4.1 million for the six months ended June 30, 2013); (iii) net real estate additions (\$1.5 million and \$1.4 million for the six months ended June 30, 2014 and 2013, respectively); (iv) repayments of mortgage and other notes payable (\$1.6 million and \$13.0 million for the six months ended June 30, 2014 and 2013, respectively); (v) financing cost paid on mortgage and other notes payable (\$95,000 for the six months ended June 30, 2013); (vi) acquisition of minority interests in majority-owned LLCs (\$170,000 for the six months ended June 30, 2014), and; (vii) acquisitions of medical office buildings (\$7.1 million and \$625,000 for the six months ended June 30, 2014 and 2013, respectively).

We expect to finance all capital expenditures and acquisitions and pay dividends utilizing internally generated and additional funds. Additional funds may be obtained through: (i) borrowings under our existing \$150 million revolving credit facility agreement (which has \$39.6 million of available borrowing capacity, net of outstanding borrowings and letters of credit, as of June 30, 2014); (ii) the issuance of equity pursuant to an at-the-market equity issuance program; (iii) borrowings under or refinancing of existing third-party debt pursuant to mortgage and construction loan agreements entered into by our LLCs, and/or; (iv) the issuance of other long-term debt.

We believe that our operating cash flows, cash and cash equivalents, available borrowing capacity under our revolving credit facility and access to the capital markets provide us with sufficient capital resources to fund our operating, investing and financing requirements for the next twelve months, including providing sufficient capital to allow us to make distributions necessary to enable us to continue to qualify as a REIT under Sections 856 to 860 of the Internal Revenue Code of 1986. In the event we need to access the capital markets or other sources of financing, there can be no assurance that we will be able to obtain financing on acceptable terms or within an acceptable time. Our inability to obtain financing on terms acceptable to us could have a material unfavorable impact on our results of operations, financial condition and liquidity.

Credit facilities and mortgage debt

In July, 2011, we entered into a \$150 million revolving credit agreement (Credit Agreement) which is scheduled to expire on July 24, 2015. The Credit Agreement includes a \$50 million sub limit for letters of credit and a \$20 million sub limit for swingline/short-term loans. The Credit Agreement also provides an option to increase the total facility

borrowing capacity by an additional \$50 million, subject to lender agreement. Borrowings made pursuant to the Credit Agreement will bear interest, at our option, at one, two, three, or six month LIBOR plus an applicable margin ranging from 1.75% to 2.50% or at the Base Rate plus an applicable margin ranging from 0.75% to 1.50%. The Credit Agreement defines Base Rate as the greatest of: (a) the administrative agent's prime rate; (b) the federal funds effective rate plus 0.50%, and; (c) one month LIBOR plus 1%. A fee of 0.30% to 0.50% will be charged on the unused portion of the commitment. The margins over LIBOR, Base Rate and the commitment fee are based upon our ratio of debt to total capital. At June 30, 2014, the applicable margin over the LIBOR rate was 2.00%, the margin over the Base Rate was 1.00%, and the commitment fee was 0.35%.

At June 30, 2014, we had \$102.4 million of outstanding borrowings and \$8.1 million of letters of credit outstanding against our revolving credit agreement. We had \$39.6 million of available borrowing capacity, net of the outstanding borrowings and letters of credit outstanding as of June 30, 2014. There are no compensating balance requirements.

On July 1, 2014, we borrowed an additional \$9.1 million under our revolving credit agreement, which was utilized to repay the outstanding mortgage balance on the Summerlin Hospital Medical Office Building I. The mortgage loan on this property matured on July 1, 2014.

Table of Contents

Covenants relating to the Agreement require the maintenance of a minimum tangible net worth and specified financial ratios, limit our ability to incur additional debt, limit the aggregate amount of mortgage receivables and limit our ability to increase dividends in excess of 95% of cash available for distribution, unless additional distributions are required to comply with the applicable section of the Internal Revenue Code of 1986 and related regulations governing real estate investment trusts. We are in compliance with all of the covenants at June 30, 2014. We also believe that we would remain in compliance if the full amount of our commitment was borrowed.

The following table includes a summary of the required compliance ratios, giving effect to the covenants contained in the Credit Agreement (dollar amounts in thousands):

	Covenant	June 30, 2014
Tangible net worth	\$ 125,000	\$ 137,374
Debt to total capital	< 55%	39.1%
Debt service coverage ratio	> 3.00x	17.5x
Debt to cash flow ratio	< 3.50x	2.36x

We have fourteen mortgages, all of which are non-recourse to us, included on our condensed consolidated balance sheet as of June 30, 2014, with a combined outstanding balance of \$114.6 million (excluding net debt premium, of \$604,000 at June 30, 2014). The following table summarizes our outstanding mortgages, excluding net debt premium, at June 30, 2014 (amounts in thousands):

Facility Name	Outstanding Balance (in thousands)(a)	Interest Rate	Maturity Date
Summerlin Hospital Medical Office Building I fixed rate mortgage loan (b.)	9,081	6.55%	2014
Spring Valley Medical Office Building fixed rate mortgage loan	5,023	5.50%	2015
Palmdale Medical Plaza fixed rate mortgage loan	6,084	3.69%	2015
Summerlin Hospital Medical Office Building III floating rate mortgage loan	11,187	3.40%	2016
Peace Health fixed rate mortgage loan	21,465	5.64%	2017
Auburn Medical II floating rate mortgage loan	7,295	2.90%	2017
Medical Center of Western Connecticut fixed rate mortgage loan	4,842	6.00%	2017
Summerlin Hospital Medical Office Building II fixed rate mortgage loan	11,877	5.50%	2017
Centennial Hills Medical Office Building floating rate mortgage loan	10,791	3.40%	2018
Sparks Medical Building/Vista Medical Terrace floating rate mortgage loan	4,541	3.40%	2018
Vibra Hospital-Corpus Christi fixed rate mortgage loan	2,943	6.50%	2019

Edgar Filing: BLUE NILE INC - Form 10-Q

700 Shadow Lane and Goldring MOBs fixed rate mortgage loan	6,684	4.54%	2022
BRB Medical Office Building fixed rate mortgage loan	6,757	4.27%	2022
Tuscan Professional Building fixed rate mortgage loan	6,065	5.56%	2025
Total	\$ 114,635		

(a.) Amortized principal payments are made on a monthly basis.

(b.) This loan was fully repaid on July 1, 2014, utilizing funds borrowed under our revolving credit facility.

During the third quarter of 2013, we entered into an interest rate cap on a total notional amount of \$10 million whereby we paid a premium of \$136,000. During the first quarter of 2014, we entered into two additional interest rate cap agreements on a total notional amount of \$20 million whereby we paid premiums of \$134,500. In exchange for the premium payments, the counterparties agreed to pay us the difference between 1.50% and one-month LIBOR if one-month LIBOR rises above 1.50% during the term of the cap. The caps expire on January 13, 2017.

Table of Contents

Off Balance Sheet Arrangements

As of June 30, 2014, we are party to certain off balance sheet arrangements consisting of standby letters of credit and equity and debt financing commitments. Our outstanding letters of credit at June 30, 2014 totaled \$8.1 million consisting of: (i) \$2.1 million related to Centennial Hills Medical Properties; (ii) \$1.7 million related to Grayson Properties; (iii) \$1.3 million related to Palmdale Medical Properties; (iv) \$1.3 million related to Banbury Medical Properties; (v) \$1.2 million related to FTX MOB Phase II, LP; and; (vi) \$478,000 related to Arlington Medical Properties.

Acquisition and Divestiture Activity

Please see Note 4 to the condensed consolidated financial statements for completed transactions.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Reference is made to Item 7A in our Annual Report on Form 10-K for the year ended December 31, 2013 which included two additional interest rate cap agreements entered into during the first quarter of 2014. Otherwise, there have been no material changes in the quantitative and qualitative disclosures during the first six months of 2014.

Item 4. Controls and Procedures

As of June 30, 2014, under the supervision and with the participation of our management, including the Trust's Chief Executive Officer (CEO) and Chief Financial Officer (CFO), we performed an evaluation of the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended (the 1934 Act).

Based on this evaluation, the CEO and CFO have concluded that our disclosure controls and procedures are effective to ensure that material information is recorded, processed, summarized and reported by management on a timely basis in order to comply with our disclosure obligations under the 1934 Act and the SEC rules thereunder.

There have been no changes in our internal control over financial reporting or in other factors during the second quarter of 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

UNIVERSAL HEALTH REALTY INCOME TRUST

Item 1A. Risk Factors

Our Annual Report on Form 10-K for the year ended December 31, 2013 includes a listing of risk factors to be considered by investors in our securities. There have been no material changes in our risk factors from those set forth in our Annual Report on Form 10-K for the year ended December 31, 2013.

Item 6. Exhibits

(a.) Exhibits:

- 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15(d)-14(a) under the Securities Exchange Act of 1934, as amended.
- 31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15(d)-14(a) under the Securities Exchange Act of 1934, as amended.
- 32.1 Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

Table of Contents

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.

Date: August 8, 2014

UNIVERSAL HEALTH REALTY INCOME TRUST

(Registrant)

/s/ Alan B. Miller
Alan B. Miller,
Chairman of the Board,

President and Chief Executive Officer

(Principal Executive Officer)

/s/ Charles F. Boyle
Charles F. Boyle, Vice President and Chief Financial
Officer

(Principal Financial Officer)

Table of Contents**EXHIBIT INDEX****Exhibit**

No.	Description
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a)/15(d)-14(a) under the Securities Exchange Act of 1934, as amended.
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15(d)-14(a) under the Securities Exchange Act of 1934, as amended.
32.1	Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document