

NATIONAL HEALTHCARE CORP  
Form 10-Q  
November 06, 2008

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

**FORM 10 Q**

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

For the quarterly period ended September 30,  
2008

OR

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

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

Commission file number 001 13489

(Exact name of registrant as specified in its  
Charter)

Delaware

52 2057472

(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization Identification No.)

100 Vine Street  
Murfreesboro, TN

37130

(Address of principal executive offices)

(Zip Code)

(615) 890 2020

Registrant=s telephone number, including area  
code

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

Indicate by check mark whether the registrant  
is a large accelerated filer, an accelerated filer, a  
non-accelerated filer or a smaller reporting  
company. (as defined in Rule 12b-2 of the 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 is defined in Rule 12b-2 of  
the Exchange  
Act). Yes  No

12,995,925 shares of common stock of the registrant were outstanding as of October 31, 2008.

**PART I. FINANCIAL INFORMATION**

## Item 1. Financial Statements.

**NATIONAL HEALTHCARE CORPORATION****Interim Condensed Consolidated Statements of Income***(Unaudited)*

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2008	2007	2008	2007
	<i>(in thousands, except share and per share amounts)</i>			
<b>REVENUES:</b>				
Net patient revenues	\$ 146,521	\$ 134,131	\$ 433,649	\$ 401,642
Other revenues	16,750	13,588	50,325	42,527
Net revenues	163,271	147,719	483,974	444,169
<b>COSTS AND EXPENSES:</b>				
Salaries, wages and benefits	88,036	83,540	261,889	244,253
Other operating	44,755	40,992	134,708	123,753
Recovery of notes receivable				(6,195)
Gain on sale of assets		(10,792)		(10,792)
Rent	7,834	10,535	23,628	31,544
Depreciation and amortization	6,218	3,892	18,239	11,476
Interest	274	281	663	851
Total costs and expenses	147,117	128,448	439,127	394,890
Income Before Income Taxes	16,154	19,271	44,847	49,279
Income Tax Provision	(2,381)	(6,145)	(13,416)	(17,221)
Net Income	13,773	13,126	31,431	32,058

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Dividends to Preferred Shareholders		(2,169)		(6,505)	
Net income available to common shareholders	\$	11,604	\$	13,126	\$ 24,926 \$ 32,058
Earnings Per Common Share:					
Basic	\$	.91	\$	1.05	\$ 1.95 \$ 2.56
Diluted	\$	.88	\$	1.01	\$ 1.90 \$ 2.47
Weighted Average Common Shares Outstanding:					
Basic		12,788,968		12,538,340	12,778,786 12,534,269
Diluted		15,678,702		12,981,366	13,099,488 12,989,561

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

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

	Sept. 30	December
	2008	31
		2007
	<i>(unaudited)</i>	
<b>Assets</b>		
Current Assets:		
Cash and cash equivalents	\$ 49,757	\$ 2,379
Restricted cash	86,165	72,238
Marketable securities	68,565	56,322
Restricted marketable securities	1,511	1,348
Investment in enhanced cash fund	12,662	35,492
Accounts receivable, less allowance for doubtful accounts of \$5,997 and \$5,739, respectively	61,996	69,606
Notes receivable	189	189
Inventories	6,538	6,654
Prepaid expenses and other assets	1,791	1,786
Total current assets	289,174	246,014
Property and Equipment:		
Property and equipment, at cost	565,578	519,983
Accumulated depreciation and amortization	(154,652)	(135,696)
Net property and equipment	410,926	384,287
Other Assets:		
Deposits	201	88
Deposits reserved for land acquisition		12,361
Goodwill	3,033	3,033
Notes receivable	20,367	18,392
Notes receivable from National		3,903
Deferred income taxes	18,615	21,303
	9,987	9,027

Investments in limited liability companies and  
other

Total other assets	52,203	68,107
Total assets	\$ 752,303	\$ 698,408

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

*The interim condensed consolidated balance sheet at December 31, 2007 is taken from the audited consolidated financial statements at that date.*

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

	Sept. 30 2008 <i>(unaudited)</i>	December 31 2007
<b>Liabilities and Stockholders Equity</b>		
Current Liabilities:		
Current portion of long-term debt	\$ 2	\$ 7,435
Trade accounts payable	12,158	13,418
Accrued payroll	45,255	46,792
Amounts due to third party payors	13,432	12,339
Accrued risk reserves	96,032	88,382
Deferred income taxes	7,419	3,797
Other current liabilities	15,016	12,110
Dividends payable	5,287	4,506
Accrued interest	514	46
Total current liabilities	195,115	188,825
Long-Term Debt, less Current Portion	10,000	10,000
Revolving credit facility	20,500	
Other Noncurrent Liabilities	19,302	23,790
Deferred Lease Credits	3,938	4,847
Deferred Revenue	15,888	15,238

Commitments,  
Contingencies and  
Guarantees

Stockholders' Equity:

Series A Convertible  
Preferred Stock; \$.01  
par value;

25,000,000 shares  
authorized;

10,841,062 shares

issued and

outstanding; stated  
at liquidation

of \$15.75 per share

170,555

170,555

Common stock, \$.01  
par value; 30,000,000  
shares

authorized;

12,995,825 and

12,757,907 shares,

respectively, issued  
and outstanding

129

127

Capital in excess of  
par value

111,660

103,221

Retained earnings

180,061

164,003

Unrealized gains on  
marketable securities,  
net of taxes

25,155

17,802

Total stockholders  
equity

487,560

455,708

Total liabilities and  
stockholders' equity

\$ 752,303

\$ 698,408

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





## NATIONAL HEALTHCARE CORPORATION

## Interim Condensed Consolidated Statements of Cash Flows

*(Unaudited)*

	Nine Months Ended September 30	
	2008	2007
<b>Cash Flows From Operating Activities:</b>	<i>(in thousands)</i>	
Net income	\$ 31,431	\$ 32,058
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	18,239	11,444
Provision for doubtful accounts receivable	1,616	866
Amortization of intangibles and deferred charges	---	31
Gain on sale of land	---	(10,792)
Amortization of deferred income	(243)	(1,362)
Equity in earnings of unconsolidated investments	(5,415)	(4,331)
Deferred income taxes	(692)	(8,747)
Stock-based compensation	1,822	1,947
Changes in operating assets and liabilities:		
Increase in restricted cash	(13,927)	(4,781)
Accounts (and other) receivables	5,994	(922)
Inventories	116	74
Prepaid expenses and other assets	136	(1,070)
Trade accounts payable	(1,260)	(4,072)
Accrued payroll	(1,537)	7,901
Amounts due to third party payors	1,093	363
Accrued interest	468	(10)
Other current liabilities and accrued risk reserves	10,556	6,065
Entrance fee deposits	(139)	(55)
Other noncurrent liabilities	(2,387)	9,310
Deferred income	1,032	867
Net cash provided by operating activities	46,903	34,784
<b>Cash Flows From Investing Activities:</b>		
Additions to and acquisitions of property and	(34,367)	(11,821)

equipment		
Decrease in deposits reserved for land acquisition	941	
Investments in notes receivable	(2,746)	
Collections of notes receivable	4,674	7,195
Purchase of marketable securities, net	(152)	498
Changes in enhanced cash fund balance	22,830	
Distributions from unconsolidated investments	4,354	2,210
Net cash used in investing activities	(4,466)	(1,918)
<b>Cash Flows From Financing Activities:</b>		
Proceeds from debt	20,500	
Payments on debt	(7,433)	(1,686)
Decrease in minority interests in consolidated subsidiaries	(40)	(6)
Tax benefit from exercise of stock options	1,439	195
Dividends paid to preferred shareholders	(6,168)	
Dividends paid to common shareholders	(8,424)	(7,136)
Issuance of common shares	5,180	499
Increase in deposits	(113)	(63)
Net cash provided by (used in) financing activities	4,941	(8,197)
<b>Net Increase in Cash and Cash Equivalents</b>	<b>47,378</b>	<b>24,669</b>
<b>Cash and Cash Equivalents, Beginning of Period</b>	<b>2,379</b>	<b>50,678</b>
<b>Cash and Cash Equivalents, End of Period</b>	<b>\$ 49,757</b>	<b>\$ 75,347</b>

**NATIONAL HEALTHCARE CORPORATION****Interim Condensed Consolidated Statements of Cash Flows***(continued)*

Nine Months Ended  
September 30  
2008          2007

*(in thousands)***Supplemental Information:**

Effective January 7, 2008, cash proceeds that were being held by a facilitator pending the completion of an IRC §1031 exchange were disbursed to acquire property and equipment

Acquisitions of property and equipment	\$ (11,420)	\$
Deposits reserved for land acquisition	11,420	

Effective July 10, 2007, we sold undeveloped land located in Charleston, South

Carolina. The proceeds were held by a facilitator pending completion of an IRC §1031 exchange

Gain on sale of land	---	10,792
Land	---	1,394
Deposits reserved for land acquisition	---	(12,186)



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

## NATIONAL HEALTHCARE CORPORATION

## Interim Condensed Consolidated Statements of Stockholders Equity

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

	Preferred Stock		Common Stock		Capital in Excess of Par Value	Retained Earnings	Unrealized Gains (Losses) on Marketable Securities	Total Shareholders Equity	
	Shares	Amount	Shares	Amount					
Balance at December 31, 2006		\$	12,519,671	\$	125	\$ 93,751	\$ 129,681	\$ 25,585	\$ 249,142
Net income						32,058			32,058
Unrealized losses on securities (net of tax benefit of \$1,377)							(2,062)		(2,062)
Total comprehensive income									29,996
Stock-based compensation						1,947			1,947
Tax benefit from exercise of stock options						195			195
Shares sold - stock purchase plans (including 10,000 options exercised)			18,756			499			499
Cumulative impact of a change in						900			900

accounting for income tax uncertainties pursuant to FIN 48														
Dividends declared to common shareholders (\$0.60 per share)						(7,521)		(7,521)						
Balance at September 30, 2007	\$	12,538,427	\$	125	\$	96,392	\$	155,118	\$	23,523	\$	275,158		
Balance at December 31, 2007	10,841,062	\$	170,555	12,757,907	\$	127	\$	103,221	\$	164,003	\$	17,802	\$	455,708
Net income								31,431						31,431
Unrealized gains on securities (net of tax of \$4,901)												7,353		7,353
Total comprehensive income														38,784
Stock-based compensation								1,822						1,822
Tax benefit from exercise of stock options								1,439						1,439
Shares sold options exercised			237,918		2	5,178								5,180
Dividends declared to preferred shareholders (\$0.60 per share)										(6,505)				(6,505)
Dividends declared to common										(8,868)				(8,868)



shareholders  
(\$0.69 per  
share)

Balance at  
September 30,  
2008

10,841,062	\$ 170,555	12,995,825	\$	129	\$ 111,660	\$ 180,061	\$	25,155	\$	487,560
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*The accompanying notes to consolidated financial statements are an integral part of these consolidated statements.*

NATIONAL HEALTHCARE CORPORATION

September 30, 2008

(unaudited)

**Note 1 Consolidated Financial Statements**

The unaudited financial statements to which these notes are attached include, in our opinion, all normal, recurring adjustments which are necessary to fairly present the financial position, results of operations and cash flows of National HealthCare Corporation (ANHC@ or the ACompany@). We assume that users of these interim financial statements have read or have access to the audited December 31, 2007 consolidated financial statements and Management=s Discussion and Analysis of Financial Condition and Results of Operations and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies, may be determined in that context. Accordingly, footnotes and other disclosures which would substantially duplicate the disclosure contained in our most recent annual report to stockholders have been omitted. This interim financial information is not necessarily indicative of the results that may be expected for a full year for a variety of reasons. Our audited December 31, 2007 consolidated financial statements are available at our web site: [www.nhccare.com](http://www.nhccare.com).

**Note 2 Other Revenues**

Other revenues are outlined in the table below. Revenues from insurance services include premiums for workers compensation and professional liability insurance policies that our wholly-owned limited purpose insurance subsidiaries have written for certain long-term health care centers to which we provide management or accounting services. Revenues from management and accounting services include management and accounting fees and revenues from other services provided to managed and other long-term health care centers. Other revenues include non-health care related earnings.

Other revenues include the following:

Three Months Ended	Nine Months Ended
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	September 30		September 30	
	2008	2007	2008	2007
	<i>(in thousands)</i>			
Insurance services	\$ 4,539	\$ 3,900	\$ 12,771	\$ 11,960
Management and accounting service fees	4,354	3,490	13,535	11,876
Guarantee fees				5
Advisory fees from NHR		125		375
Dividends and other realized gains on securities	1,062	983	3,311	2,881
Equity in earnings of unconsolidated investments	1,922	1,734	5,415	4,331
Interest income	1,301	2,022	3,942	7,570
Rental income	3,169	645	10,094	1,939
Other	403	689	1,257	1,590
	\$ 16,750	\$ 13,588	\$ 50,325	\$ 42,527

Interest income decreased in 2008 compared to 2007 due primarily to the expenditure of approximately \$89,600,000 in cash to complete the merger with National Health Realty, Inc. ( NHR ) effective on October 31, 2007. Rental income increased in 2008 compared to 2007 due primarily to the acquisition of (1) the real estate of nine leased properties in Florida in the October 31, 2007 merger with NHR (total revenue of \$5,654,000 through September 30, 2008) and (2) the fixtures and real estate of a leased 544 bed long term care center and associated 66 unit assisted living facility in Chattanooga, Tennessee in a November 1, 2007 purchase and subsequent lease to a third party operator (\$1,800,000 through September 30, 2008).

Certain of our affiliates manage five long-term care centers owned by National Health Corporation ( National ). During the nine months ended September 30, 2008 and 2007, National paid and we recognized no management fees or interest on management fees.

NATIONAL HEALTHCARE CORPORATION

September 30, 2008

(unaudited)

The unpaid fees from the five centers owned by National, because the amount collectable could not be reasonably determined when the management services were provided, and because we cannot estimate the timing or amount of expected future collections, will be recognized as revenues only when fixed or determinable and collectibility of these fees can be reasonably assured. Under the terms of our management agreement with National, the payment of these fees to us may be subordinated to other expenditures of the five long-term care centers. We continue to manage these centers so that we may be able to collect our fees in the future and because the incremental savings from discontinuing services to a center may be small compared to the potential benefit. We may receive payment for the unrecognized management fees in whole or in part in the future only if cash flows from the operating and investing activities of the five centers are sufficient to pay the fees. There can be no assurance that such future improved cash flows will occur.

Certain of our affiliates manage 18 long-term care centers that were previously owned by National Health Investors, Inc. ( NHI ). During the nine months ended September 30, 2008 and 2007, we recognized \$2,219,000 and \$2,158,000, respectively, of management fees and interest from these 18 long-term care centers.

Of the total 18 centers managed, the management fee revenues from eight centers were currently paid and recognized on the accrual method in 2008 and 2007. The fees from the remaining ten centers, because of insufficient historical collections and the lack of expected future collections, are recognized only when realized. Under the terms of the management agreements, the payment of these fees to us may be subordinated to other expenditures of each of the long-term care providers. Our affiliates continue to manage these centers so that we may be able to collect our fees in the future and because the incremental savings from discontinuing services to a center may be small compared to the potential benefit. We may receive payment for the unrecognized management fees in whole or in part in the future only if cash flows from operating and investing activities of the centers are sufficient to pay the fees. There can be no assurance that such future improved cash flows will occur.

**Note 3 Accounting for Uncertainty in Income Taxes**

We believe that our liabilities reflect the anticipated outcome of known uncertain tax positions in conformity with Financial Accounting Standards Board ( FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ). Our liabilities for unrecognized tax benefits are presented in the

consolidated balance sheet within Other Noncurrent Liabilities.

NHC continually evaluates for uncertain tax positions. Uncertain tax positions may arise where tax laws may allow for alternative interpretations or where the timing of recognition of income is subject to judgment. We believe we have made adequate provision for unrecognized tax benefits related to uncertain tax positions. However, because of uncertainty of interpretation by various tax authorities and the possibility that there are issues that have not been recognized by management, we cannot guarantee we have accurately estimated our tax liabilities.

On January 1, 2007, we adopted the recognition and disclosure provisions of FIN 48. Under FIN 48, tax positions are evaluated for recognition using a more likely than not threshold, and those tax positions requiring recognition are measured at the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.

Prior to January 1, 2007, we maintained a liability for the estimated amount of contingent liabilities for income tax matters in accordance with Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (SFAS 5).

NATIONAL HEALTHCARE CORPORATION

September 30, 2008

(unaudited)

In accordance with the adoption of FIN 48, the Company has established a liability for unrecognized tax benefits, which are differences between a tax position taken or expected to be taken in a tax return and the benefit recognized and measured pursuant to this Interpretation. Generally a liability is created for an unrecognized tax benefit because it represents a company's potential future obligation to a taxing authority for a tax position that was not recognized per above.

As a result of adopting FIN 48, we reported a \$900,000 increase to our January 1, 2007, balance of retained earnings and a decrease in our accruals for uncertain tax positions and related interest and penalties of a corresponding amount. On January 1, 2007, we had \$21,051,000 of unrecognized tax benefits, composed of \$11,409,000 of deferred tax assets, \$ 0 of deferred tax liabilities, \$4,117,000 of permanent differences, and \$5,525,000 of accrued interest and penalties payable.

During the nine months ended September 30, 2008, we have recognized a \$6,288,000 decrease in unrecognized tax benefits (including \$2,101,000 of temporary differences and \$2,050,000 of related interest and penalties), due to the effect of statute of limitations lapse. The favorable impact on our tax provision was \$4,187,000 composed of \$2,137,000 tax and \$934,000 interest and penalties on permanent differences, and \$1,116,000 interest and penalties on temporary differences.

At September 30, 2008, we had \$19,302,000 of unrecognized tax benefits, composed of \$11,526,000 of deferred tax assets, \$-0- of deferred tax liabilities, \$3,664,000 of permanent differences, and \$4,112,000 of accrued interest and penalties. Unrecognized tax benefits of \$4,797,000 (including \$1,133,000 of accrued interest and penalties) at September 30, 2008, attributable to permanent differences, would favorably impact our effective tax rate if recognized. We do not expect to recognize significant increases or decreases in unrecognized tax benefits within twelve months of September 30, 2008, except for the effect of decreases related to statute of limitations lapse estimated at \$1,448,000, composed of temporary differences of \$-0-, permanent tax differences of \$975,000 and interest and penalties of \$473,000.

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

The Company is no longer subject to U.S. federal and state examinations by tax authorities for years before 2005. Currently, there are no U.S. federal or state returns under examination.

**Note 4 Earnings per Share**

Basic earnings per share is based on the weighted average number of common shares outstanding during the period.

Diluted earnings per share assumes the exercise of options using the treasury stock method and the conversion of the Series A Convertible Preferred Stock using the if converted method, to the extent dilutive.

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

## NATIONAL HEALTHCARE CORPORATION

September 30, 2008

(unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2008	2007	2008	2007
<b>Basic:</b>				
Weighted average common shares outstanding	12,788,968	12,538,340	12,778,786	12,534,269
Net income	\$ 13,773,000	\$ 13,126,000	\$ 31,431,000	\$ 32,058,000
Dividends to preferred stockholders	(2,169,000)		(6,505,000)	
Net income available to common stockholders	11,604,000	13,126,000	24,926,000	32,058,000
Earnings per common share, basic	\$ .91	\$ 1.05	\$ 1.95	\$ 2.56
<b>Diluted:</b>				
Weighted average common shares outstanding	12,788,968	12,538,340	12,778,786	12,534,269
Dilutive effect of stock options	265,763	443,026	320,702	455,292
Convertible preferred stock	2,623,971			
Assumed average common shares outstanding	15,678,702	12,981,366	13,099,488	12,989,561
Net income available to common shareholders	\$ 11,604,000	\$ 13,126,000	\$ 24,926,000	\$ 32,058,000
Add dilutive preferred stock dividends for effect of assumed conversion of preferred stock	2,169,000			
Net income for diluted net income per common share	\$ 13,773,000	\$ 13,126,000	\$ 24,926,000	\$ 32,058,000
Earnings per common share, diluted	\$ .88	\$ 1.01	\$ 1.90	\$ 2.47

In the above table, 238,590 shares of stock options have been excluded in the three and nine month periods and 2,623,971 of preferred stock potential common shares issuable upon the conversion of the preferred stock have been excluded in the nine month period, due to their anti-dilutive impact.



**Note 5 Investment in Enhanced Cash Fund**

At September 30, 2008, we reported in current assets in our Consolidated Balance Sheets an investment of \$12,662,000 in the Columbia Strategic Cash Portfolio Fund (the Fund). The Fund invests in obligations denominated in U.S. dollars consisting of asset backed securities, corporate bonds and notes, certificates of deposit, short-term corporate debt obligations, commercial paper, extendible commercial notes, and municipal bonds.

We received notice on December 6, 2007 at a time when our carrying value in the Fund was \$39,500,000, that the Fund cash redemptions were suspended and that the Fund would begin an orderly liquidation and dissolution of its assets for distribution to the Fund holders, including to NHC. Activity in the Fund may be summarized as follows:

	Three Months Ended September 30		Nine Months Ended September 30	
	2008	2007	2008	2007
	<i>(in thousands)</i>			
Fund balance, beginning of period	\$ 18,234	\$	\$ 35,492	\$
Realized losses	(202)		(363)	
Reduction to adjust the Fund balance to its net asset value, and charged to earnings	(12)		(272)	
Cash distributed to NHC	(5,358)		(22,195)	
Fund balance, end of period	\$ 12,662	\$	\$ 12,662	\$

NATIONAL HEALTHCARE CORPORATION

September 30, 2008

(unaudited)

Not included in the periods shown above, in December 2007, we reported realized losses of \$42,000, reductions to adjust the Fund to its net asset value of \$453,000 and cash distributed from the fund to NHC of \$3,513,000.

The Fund's valuation fluctuates based on changes in the market values of the securities held by the Fund. In addition to the transaction gains or losses reported by the Fund to us, since December, 2007 we have adjusted our carrying value to the Fund's net asset value, which adjustments have required us to charge earnings and reduce our carrying value in the Fund. Because the Fund is invested in financial instruments with exposure to the current turmoil in the credit markets in the United States and because the Fund currently intends to liquidate the investments in the fund within the next twelve months, we consider the write-down amount to be an other-than-temporary impairment. It is difficult to predict the timing or magnitude of these other-than-temporary impairments and additional impairments may occur. Under such circumstances, our earnings will be negatively affected.

The Fund assets are valued each business day by a third party accounting agent. A third party pricing service, or services, delivers the nightly security valuations based on widely available market data and sources to the accounting agents.

As to balance sheet classification, prior to December 6, 2007, we classified the investment as a cash equivalent in the Consolidated Balance Sheets because the funds were immediately available for distribution. Since the suspension by the Fund manager of Fund redemptions, we no longer consider the investment in the Fund to be a cash equivalent and classify it instead as Investments in Enhanced Cash Fund. We have classified the Fund as a current asset because we believe that the Fund will be substantially liquidated during the next twelve months.

**Note 6 - Purchases of Property**

On August 1, 2008, we purchased a 132-bed skilled nursing and rehabilitation facility and a 60-bed assisted living facility for approximately \$13,250,000 located in Charleston, South Carolina.

On January 2, 2008 we purchased a 109-bed skilled nursing and rehabilitation facility from the St. Mary's Health System for \$6,347,000 in cash. Holston Health and Rehabilitation Center is located in Knoxville, Tennessee.

In January, 2008, we purchased for \$5,073,000 in cash two tracts of land located in the state of South Carolina and one tract of land located in Tennessee. The tracts were undeveloped and are held for future development.

## NATIONAL HEALTHCARE CORPORATION

September 30, 2008

(unaudited)

**Note 7 - Long-Term Debt and Commitments***Long-Term Debt*

Long-term debt consists of the following:

	Weighted Average Interest Rate	Maturities	Long-Term Debt	
			9/30/08	12/31/07
<i>(dollars in thousands)</i>				
Term loan, interest payable monthly	Repaid	–	\$ –	\$ 7,050
Senior notes, secured, principal and interest payable quarterly	Repaid	–	–	382
Notes and other obligations, principal and interest payable periodically	Variable, 12%	2008	2	3
Unsecured term note payable to National, interest payable quarterly, principal payable at maturity	Variable, 4.2%	2018	10,000 10,002	10,000 17,435
Less current portion			(2)	(7,435)
			\$ 10,000	\$ 10,000

**Note 8 - \$75,000,000 Revolving Credit Facility**

Effective October 28, 2008, we extended the maturity of our Credit Agreement (the "Credit Agreement") with Bank of America, N.A., as lender (the "Lender"). The Credit Agreement provides for a \$75,000,000 revolving credit facility (the "Credit Facility"), of which up to \$5,000,000 may be utilized for letters of credit.

Borrowings bear interest at either (i) the Eurodollar rate plus 0.375% or (ii) the prime rate. Letter of credit fees are equal to 0.25% times the maximum amount available to be drawn under outstanding letters of credit. Prior to the extension, borrowings bore interest at the Eurodollar rate plus 0.25% (2.7% at September 30, 2008).

Beginning October 28, 2008, commitment fees are payable on the daily unused portion of the Credit Facility at a rate of five (5) basis points per annum for each day when utilization is less than \$37,500,000 and two (2) basis points per annum when utilization is equal to or more than \$37,500,000.

The Credit Facility matures on October 27, 2009. Between 90 and 120 days prior to the maturity date, NHC may request the extension of the maturity date. If the Lender elects to consent to such extension, subject to certain conditions, the maturity date will be extended to the date which is 364 days after the then maturity date.

NHC is permitted to prepay the loans outstanding under the Credit Facility at any time, without penalty.

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

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

The Credit Facility is available for general corporate purposes, including working capital and acquisitions. Borrowings under the Credit Facility at September 30, 2008 before renewal were \$20,500,000 which were used primarily to repay our term loan (\$7,050,000) and to finance the acquisition of a 132-bed nursing and rehabilitation facility and a 60-bed assisted living facility (\$13,250,000). This amount has been classified as a non current liability in the accompanying September 30, 2008 consolidated balance sheet based on the maturity date of the Credit Facility, as amended.

**Note 8 Stock Option Plans**

Our shareholders approved the 2005 Stock Option, Employee Stock Purchase, Physician Stock Purchase and Stock Appreciation Rights Plan (the APlan@) which provides for the grant of stock options to key employees, directors and non employee consultants. Under the Plan, the Compensation Committee of the Board of Directors (Athe Committee@) has the authority to select the participants to be granted options; to designate whether the option granted is an incentive stock option (AISO@), a non qualified option, or a stock appreciation right; to establish the number of shares of common stock that may be issued upon exercise of the option; to establish the vesting provision for any award; and to establish the term any award may be outstanding. The exercise price of any ISO=s granted will not be less than 100% of the fair market value of the shares of common stock on the date granted and the term of an ISO may not be any more than ten years. The exercise price of any non qualified options granted will not be less than 100% of the fair market value of the shares of common stock on the date granted unless so determined by the Committee.

Under the Plan, options issued to non employee directors are granted automatically on the date of our annual shareholder meeting, vest immediately upon grant and have a maximum five year term. Options issued to employees in 2000 vested over a six year period and had a maximum six year term. Options issued to employees in 2004 vest over a five year period and have a maximum five year term. Options issued to employees in 2007 vest over a 2.1 year

period and have a maximum 2.1 year term.

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), AShare Based Payment@ (SFAS 123(R)@), using the modified prospective application transition method. Under this method, compensation cost is recognized, beginning January 1, 2006, based on the requirements of SFAS 123(R) for all share based payments granted after the effective date, and based on Statement of Financial Accounting Standards No. 123, AAccounting for Stock Based Compensation (SFAS 123@), for all awards granted to employees prior to January 1, 2006 that remain unvested on the effective date. Prior to January 1, 2006, we applied Accounting Principles Board Opinion No. 25, AAccounting for Stock Issued to Employees@ (APB 25@) and related interpretations in accounting for our employee stock benefit plans. Accordingly, no compensation cost was recognized for stock options granted under the plans because the exercise prices for options granted were equal to the quoted market prices on the option grant dates and all option grants were to employees or directors. Results for prior periods have not been restated.

The fair value of each option award is estimated on the grant date, using the Black Scholes option valuation model with the weighted average assumptions indicated in the following table. Generally, awards are subject to cliff vesting.

Each grant is valued as a single award with an expected term based upon expected participants and termination behavior. Compensation cost is recognized over the requisite service period in a manner consistent with the option vesting provisions. The straight line attribution method requires that compensation expense is recognized at least equal to the portion of the grant date fair value that is vested at that date. The expected volatility is derived using weekly historical data for periods immediately preceding the date of grant. The risk free interest rate is the approximate yield on the United States Treasury Strips having a life equal to the expected option life on the date of grant. The expected life is an estimate of the number of years an option will be held before it is exercised. The following table summarizes the assumptions used to value the options granted in the periods shown.

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	Nine Months Ended	
	September 30	
	2008	2007
Risk-free interest rate	2.60%	4.64%
Expected volatility	25.5%	27.9%
Expected life, in years	2.0 years	2.1 years
Expected dividend yield	2.36%	1.92%
Expected forfeiture rate	0.00%	0.00%

The following table summarizes option activity:

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value
Options outstanding at December 31, 2005	1,431,000	\$ 21.72	—
Options granted	122,394	42.33	—
Options exercised	(239,174)	24.33	—
Shares cancelled	(22,901)	38.13	—
Options forfeited	(2,140)	37.00	—
Options outstanding at December 31, 2006	1,289,179	23.13	—
Options granted	161,748	53.67	—
Options exercised	(229,480)	24.95	—
Options cancelled	(53,000)	20.90	—
Options forfeited	(1,797)	55.45	—
Options outstanding at December 31, 2007	1,166,650	27.06	—
Options granted	112,586	51.39	—
Options exercised	(237,818)	21.76	—



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Options forfeited	(1,996)		50.94	–
Options outstanding at September 30, 2008	1,039,422	\$	29.36	\$ 17,857,000
Options exercisable at September 30, 2008	369,000	\$	43.58	\$ 1,646,000

Options Outstanding Sept. 30, 2008	Exercise Prices	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life in Years
650,832	\$20.90 to \$27.01	\$21.28	0.5
388,590	\$32.01 to \$55.00	\$46.90	2.7
1,039,422			

At September 30, 2008, 369,000 options outstanding are exercisable. Exercise prices on the options range from \$20.90 to \$55.00. The weighted average remaining contractual life of options outstanding at September 30, 2008 is 1.3 years. The weighted average fair value of options granted during the nine months ended September 30, 2008 and 2007 were \$7.36 (\$829,000) and \$9.47 (\$1,532,000) per share, respectively. The total intrinsic value of shares exercised during the nine months ended September 30, 2008 and 2007 was \$6,249,000 and \$341,000, respectively.

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Additionally, the Plan allows employees to purchase our shares of stock through payroll deductions. Employees may terminate participation at any time.

Our policy is to issue new shares to satisfy share option exercises. In addition to the stock options issued and outstanding under the Plan, we have reserved an additional 875,787 shares of common stock for issuance under these plans.

NHC recognized \$1,822,000 and \$1,947,000 of share-based compensation expense for the nine month periods ended September 30, 2008 and 2007, respectively. SFAS 123(R) requires that the benefits of tax deductions in excess of amounts recognized as compensation cost be reported as a financing cash flow, rather than an operating cash flow, as required under prior accounting guidance. Tax deductions in excess of amounts recognized as compensation costs totaled \$3,597,000 and \$488,000 for the nine months ended September 30, 2008 and 2007, respectively. No share based compensation cost was capitalized during the current periods. The total compensation cost related to non-vested awards not yet recognized at September 30, 2008 is \$675,000 and the weighted average period over which it is to be recognized is 1.3 years.

## **Note 9 Guarantees and Contingencies**

### *Accrued Risk Reserves*

We are self insured for risks related to health insurance and have wholly-owned limited purpose insurance companies that insure risks related to workers' compensation and general and professional liability insurance claims both for our owned or leased entities and certain of the entities to which we provide management or accounting services. The liability we have recognized for reported claims and estimates for incurred but unreported claims totals \$96,032,000

and \$88,382,000 at September 30, 2008 and December 31, 2007, respectively. This liability is classified as a current liability based on the uncertainty regarding the timing of potential payments. The liability is included in accrued risk reserves in the consolidated balance sheets and is subject to adjustment for actual claims incurred. It is possible that these claims plus unasserted claims could exceed our insurance coverages and our reserves, which would have a material adverse effect on our financial position, results of operations and cash flows.

As a result of the terms of our insurance policies and our use of wholly-owned limited purpose insurance companies, we have retained significant insurance risk with respect to workers' compensation and general and professional liability. We use independent actuaries to estimate our exposures for claims obligations (for both asserted and unasserted claims) related to deductibles and exposures in excess of coverage limits, and we maintain reserves for these obligations. Such estimates are based on many variables including historical and statistical information and other factors. It is possible that claims against us could exceed our coverage limits and our reserves, which would have a material adverse effect on our financial position, results of operations and cash flows.

#### *Workers' Compensation*

For workers' compensation, we utilize a wholly-owned Tennessee domiciled property/casualty insurance company to write coverage for NHC affiliates and for third-party customers. Policies are written for a duration of twelve months and cover only risks related to workers' compensation losses. All customers are companies which operate in the long-term care industry. Business is written on a direct basis. Direct business coverage is written for statutory limits and the insurance company's losses in excess of \$1,000,000 per claim up to \$10,000,000 are covered by reinsurance.

For these workers' compensation insurance operations, the premium revenues reflected in the consolidated financial statements within *Other Revenues* for 2008 and 2007, respectively, are \$4,992,000 and \$5,462,000. Associated losses and expenses are reflected in the consolidated financial statements as *Other operating costs and expenses*.

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*General and Professional Liability Lawsuits and Insurance*

Across the nation, the entire long term care industry has experienced significant amounts of personal injury/wrongful death claims and awards based on alleged negligence by nursing facilities and their employees in providing care to residents. As of September 30, 2008, we and/or our managed centers are currently defendants in 67 such claims covering the years 1999 through September 30, 2008. Eleven of the 67 suits are in Florida, where we have not operated or managed long-term care providers since September 30, 2000. Of the 11 Florida suits, four suits relate to events before and seven suits relate to events after our cessation of business in Florida. These latter seven suits assert allegations of continued exposure even after we ceased operations.

When bids were solicited for third party professional liability insurance coverage for 2002, only two companies would quote coverage. Both quotations were so onerous and expensive that we elected to pay the premiums into a wholly-owned licensed captive insurance company, incorporated in the Cayman Islands, for the purpose of managing the Company's losses related to these risks. Thus, for years 2002-2008, insurance coverage for incidents occurring at all providers owned or leased, and most providers managed by us, is provided through this wholly-owned insurance company. Policies are written for a duration of twelve months.

Our coverages for all years include both primary policies and excess policies. Commencing with 2002, deductibles were eliminated with first dollar coverage being provided through the wholly-owned insurance company. The excess coverage is provided by a third party insurer for 2002.

For the period 2003-2008, both primary and excess professional liability insurance coverage is provided through our wholly-owned liability insurance company. Primary coverage is in the amount of \$1 million per incident, \$3 million per location subject to an annual primary aggregate limit. That limit is \$16 million for 2008. Excess coverage under a \$7.5 million annual excess aggregate policy is applicable to years 2003-2007. The 2008 year is subject to annual excess aggregate policies in the total amount of \$29 million.

For these professional liability insurance operations, the premium revenues reflected in the financials within Other revenues for the quarters ended September 30, 2008 and 2007, respectively, are \$3,013,000 and \$2,600,000.

Associated losses and expenses including those for self-insurance are included in the consolidated financial statements as Other operating costs and expenses .

*Debt Guarantees*

In addition to our primary debt obligations, which are included in our consolidated financial statements, we have guaranteed certain of the debt obligations of National and the ESOP. This guarantee, which is not included as debt obligations in our consolidated financial statements, totals \$1,030,000 at September 30, 2008.

The \$1,030,000 of guarantees of debt of National and the ESOP relates to senior secured notes held by financial institutions. The total outstanding balance of National and the ESOP's obligations under these senior secured notes is \$1,030,000. None of this obligation has been included in our debt obligations because we are not a direct obligor on this indebtedness. The \$1,030,000, which is not included in our debt obligations because we are not a direct obligor, is due from NHI to National and the ESOP.

The \$1,030,000 guarantee described above has cross-default provisions with other debt of National and the ESOP. We currently believe that National and the ESOP are in compliance with the terms of their debt agreements.

As of September 30, 2008, our maximum potential loss related to debt guarantees and financial guarantees is \$1,030,000.

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**Note 10 - Fair Value Measurements**

As described in Note 11, we adopted the provisions of SFAS No. 157, Fair Value Measurements ( SFAS 157 ) as of January 1, 2008 for financial assets and financial liabilities. SFAS 157 is a technical standard which defines fair value, establishes a consistent framework for measuring fair value, and expands disclosures for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. SFAS 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. Valuation techniques are the market, cost or income approach.

As a basis for considering such assumptions, SFAS 157 establishes a three-tier fair value hierarchy which prioritizes the inputs used in measuring fair value as follows: Level 1 quoted prices for identical assets or liabilities in active markets, Level 2 quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active and model-based valuations in which significant inputs are corroborated by observable market data and Level 3 valuation techniques in which significant inputs are unobservable.

Financial assets and financial liabilities measured at fair value on a recurring basis during the period are as follows (in thousands):

	Fair Value At	Quoted Prices in Active Markets	Other Observable Inputs	Valuation Technique
	Sept. 30, 2008	For Identical Assets (Level 1)	(Level 2)	
Marketable securities	\$ 68,565	\$ 68,565	\$	Market
Restricted marketable securities	1,511	1,511		Market

Investment in en-hanced cash fund	12,662	12,662 Market
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## Note 11 New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements . This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. The new FASB rule does not supersede all applications of fair value in other pronouncements, but creates a fair value hierarchy and prioritizes the inputs to valuation techniques for use in most pronouncements. It requires companies to assess the significance of an input to the fair value measurement in its entirety. Statement 157 also requires companies to disclose information to enable users of financial statements to assess the inputs used to develop the fair value measurements. SFAS 157 is effective for fiscal periods beginning after November 15, 2007 and interim periods within those fiscal years, with the following exception. FASB Staff Position (FSP) FAS 157-2, Effective Date of FASB Statement No. 157, defers the effective date to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The implementation of FAS 157, for financial assets and financial liabilities, did not have a material impact on the Company's consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115 . This Statement amends FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities , with respect to accounting for a transfer to the trading category for all entities with available-for-sale and trading securities electing the fair value option. This statement allows companies to elect fair value accounting for many financial instruments and other items that currently are not required to be accounted as such, allows different applications for electing the option for a single item or groups of items, and requires

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disclosures to facilitate comparisons of similar assets and liabilities that are accounted for differently in relation to the fair value option. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The implementation of FAS 159 did not have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* which replaces SFAS No. 141, *Business Combinations*. This Statement establishes principles and requirements for how the acquirer (i) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (ii) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (iii) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company will adopt this standard at the beginning of the Company's fiscal year ending December 31, 2009 for all prospective business acquisitions. The Company has not determined the effect that the adoption of SFAS 141(R) will have on its consolidated financial statements, but the impact will be limited to any future acquisitions beginning in fiscal year 2009.

In December 2007, the FASB issued SFAS No. 160 *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51*. This Statement requires all entities to report noncontrolling interests in subsidiaries as equity in the consolidated financial statements. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company will adopt this Statement effective January 1, 2009. The Company has not determined the effect that the adoption of SFAS No. 160 will have on its consolidated results of operations or financial position.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ( SFAS No. 162 ). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP in the United States ( the GAAP hierarchy ). The current GAAP hierarchy is set forth in the AICPA Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles* ( SAS No. 69 ). The FASB believes the GAAP hierarchy should be directed to entities because it is the entity (not its auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB and has issued SFAS No. 162 to achieve that result. SFAS No. 162 is effective 60 days following the SEC's approval of the Public Accounting



Oversight Board amendments to SAS No. 69. We do not expect the adoption of SFAS No. 162 to have an impact on our consolidated financial position, results of operations, or cash flows.

**Note 12 Subsequent Events**

Subsequent to September 30, 2008, the credit and liquidity crisis in the United States and throughout the global financial system triggered significant events and substantial volatility in world financial markets and the banking system that have had a significant negative impact on foreign and domestic financial markets. As a result, our investment portfolio has incurred a significant decline in fair value since September 30, 2008. However, because the values of our individual investments have and will fluctuate in response to changing market conditions, the amount of losses that will be recognized in subsequent periods, if any, cannot be determined.

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**Item 2.**

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

Overview

National HealthCare Corporation (ANHC@ or the ACompany@) is a leading provider of long term health care services. We operate or manage, through certain affiliates, 76 long term health care centers with 9,772 beds in 10 states and provide other services in two additional states. These operations are provided by separately funded and maintained subsidiaries. We provide long term health care services to patients in a variety of settings including long term nursing centers, managed care specialty units, sub acute care units, Alzheimer's care units, hospice programs, homecare programs, assisted living centers and independent living centers. In addition, we provide management and accounting services to owners of long term health care centers.

Summary of Goals and Areas of Focus

*Earnings* To monitor our earnings, we have developed budgets and management reports to monitor labor, census, and the composition of revenues. Inflationary increases in our costs may cause net earnings from patient services to decline.

*Development and Growth* - During the first quarter of 2007, we placed in service 60 bed additions to existing long term care facilities located in Garden City and Columbia, South Carolina. In July, 2008 we opened a 60 bed addition to an existing facility located in North Augusta, South Carolina. We broke ground in September, 2008 for construction of a new 120 bed health care center in Bluffton, South Carolina (expected cost \$21,657,000), and we expect to break ground in the winter of 2008 on a new assisted living facility in Mauldin, South Carolina (expected cost of \$8,000,000).

In January, 2008, we purchased a 109-bed skilled nursing rehabilitation facility from the St. Mary's Health System for \$6,437,000 in cash. Holston Health and Rehabilitation Center is located in Knoxville, Tennessee.

Also in January 2008, we purchased for \$5,073,000 in cash, two tracts of land located in the state of South Carolina and one tract of land located in the state of Tennessee. The tracts are undeveloped and are held for future development.

Effective February 1, 2008, we were selected by the McKendree Village, Inc. to manage under a five-year contract McKendree Village, a continuing care retirement community located on 42 acres in the Nashville, Tennessee suburb of Hermitage. McKendree Village offers nursing care in the 300-bed McKendree Health Center, assisted living services in the 85-unit McKendree Manor, and independent senior care living in a 234-unit residential tower and in 30 individually designed cottages.

In August 2008, we purchased for \$13,250,000 in cash, a 132-bed skilled nursing and rehabilitation facility and a 60-bed assisted living facility located in Charleston, South Carolina.

In 2008, we are continuing to develop an active hospice program in South Carolina independently of our partnership with Caris Healthcare and are also exploring opportunities to expand our home health care services. Also during 2008, we will apply for Certificates of Need for additional beds in our markets and also evaluate the feasibility of expansion into new markets by building private pay health care centers or by the purchase of existing health care centers.

*Accrued Risk Reserves* Our accrued professional liability reserves, workers= compensation reserves and health insurance reserves totaled \$96,032,000 at September 30, 2008 and are a primary area of management focus. We have set aside restricted cash to fund substantially all of our professional liability and workers= compensation reserves.

As to exposure for professional liability claims, we have developed for our centers performance certification criteria to measure and bring focus to the patient care issues most likely to produce professional liability exposure, including in house acquired pressure ulcers, significant weight loss and numbers of falls. These programs for certification,



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which we regularly modify and improve, have produced measurable improvements in reducing these incidents. Our experience is that achieving goals in these patient care areas improves both patient and employee satisfaction. Furthermore, we are continuing efforts to identify and restructure the ownership or management of our higher risk operations and locations to eliminate NHC liability exposure.

Application of Critical Accounting Policies

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

Our critical accounting policies that are both important to the portrayal of our financial condition and results and require our most difficult, subjective or complex judgments are as follows:

*Revenue Recognition Third Party Payors* Approximately 60% (2007), 63% (2006), and 63% (2005) of our net revenues are derived from Medicare, Medicaid, and other government programs. Amounts earned under these programs are subject to review by the Medicare and Medicaid intermediaries. In our opinion, adequate provision has been made for any adjustments that may result from these reviews. Any differences between our estimates of settlements and final determinations are reflected in operations in the year finalized. At September 30, 2008, we have made provisions of approximately \$13,432,000 for other various Medicare and Medicaid issues for current and prior year cost reports. Consistent with our revenue recognition policies, we will record revenues associated with the various issues when the approvals, including the final cost report audits, are assured. Revenues for such cost report adjustments in the three and nine months ended September 30, 2008 and 2007 were not significant.

*Revenue Recognition Private Pay* For private pay patients in skilled nursing or assisted living facilities, we bill room and board in advance for the current month with payment being due upon receipt of the statement in the month the services are performed. Charges for ancillary, pharmacy, therapy and other services to private patients are billed in the month following the performance of services. All billings are recognized as revenue when the services are performed.

*Valuations and Impairments to our Investment in Enhanced Cash Fund* At September 30, 2008, we reported an aggregate investment of \$12,662,000 in the Columbia Strategic Cash Portfolio Fund (the Fund ) which invests principally in high quality corporate debt, mortgage-backed securities and asset-backed securities. During December, 2007 the Fund's manager notified us that due to turmoil in credit markets in the United States (1) Fund cash redemptions to investors were suspended, (2) the Fund's valuation will be based on the market value of the underlying securities instead of amortized cost, (3) interest would continue to accrue and be paid and (4) the Fund would begin an orderly liquidation and dissolution of its assets for distribution to the Fund holders that is expected to be completed in early 2009. As the Fund is liquidated, we expect to receive our pro rata share of the Fund in cash distributions.

The Fund's valuation fluctuates based on changes in the market values of the securities held by the Fund. In addition to any transaction gains or losses reported by the Fund to us, since December 7, 2007 we have adjusted our carrying value to the Fund's net asset value, which adjustments have required us to charge earnings and reduce our carrying value in the Fund by a total of \$724,000, of which amount \$453,000 was expensed in the fourth quarter of 2007, \$259,000 in the first quarter of 2008, \$0.00 in the second quarter of 2008, and \$12,000 in the third quarter of 2008.

We will continue to evaluate our investment in the Fund for other-than-temporary impairments. It is possible that future events could require us to make significant adjustments or revisions to our estimates of the Fund value.

As to valuation methods, all Fund assets are valued each business day by a third party accounting agent under the oversight of a valuation committee within Columbia Management. Historically, in over 95% of the cases, a third party

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pricing service, or services, delivers the nightly security valuations based on widely available market data and sources to the accounting agent for the Fund.

For securities where prices from third party valuation services are not available (in less than 5% of the cases) , the Columbia Management valuation committee meets and determines a value for the security based on an evaluation of available data, portfolio manager input, trading desk input as well as any other appropriate factors. The portfolio manager of the Fund may present facts to the valuation committee but does not have a vote in this process.

The valuation committee comprises investment professionals, fixed income and equity traders, risk management professionals and accountants and is advised at each meeting by legal, compliance and internal audit professionals. Valuations used for each individual security within the Fund are reviewed every night by Columbia Management fixed income traders prior to the calculation of the Fund's NAV for that day. If the fixed income traders determine that adjustments are required, they must be verified by an independent third party or approved by the valuation committee.

The Fund does not provide detailed information on prices on individual securities except annually at December 31.

*Accrued Risk Reserves* We are principally self insured for risks related to employee health insurance, workers= compensation and professional and general liability claims. Our accrued risk reserves primarily represent the accrual for self insured risks associated with employee health insurance, workers= compensation and professional and general liability claims. The accrued risk reserves include a liability for reported claims and estimates for incurred but unreported claims. Our policy with respect to a significant portion of our workers= compensation and professional and general liability claims is to use an actuary to support the estimates recorded for incurred but unreported claims. Our health insurance reserve is based on our known claims incurred and an estimate of incurred but unreported claims determined by our analysis of historical claims paid. We reassess our accrued risk reserves on a quarterly basis.

Professional liability remains an area of particular concern to us. The entire long term care industry has seen personal injury/wrongful death claims based on alleged negligence by nursing homes and their employees in providing care to residents. As of September 30, 2008, we and/or our managed centers are defendants in 67 such claims inclusive of years 1999 through 2008. It remains possible that these pending matters plus potential unasserted claims could exceed

our reserves, which would have a material adverse effect on our financial position, results of operations and cash flows. It is also possible that future events could cause us to make significant adjustments or revisions to these reserve estimates and cause our reported net income to vary significantly from period to period.

We maintain insurance coverage for incidents occurring in all provider locations owned, leased or managed by us. The coverages include both primary policies and umbrella policies.

For 2002, we maintain primary coverage through our own insurance company with excess coverage provided by a third party insurance company. For 2003-2008, we maintain both primary and excess coverage through our own insurance subsidiary. In all years, settlements, if any, in excess of available insurance policy limits and our own reserves would be expensed by us.

*Revenue Recognition Subordination of Fees and Uncertain Collections* We provide management services to certain long-term care facilities and to others we provide accounting and financial services. We generally charge 6% of net revenues for our management services and a predetermined fixed rate per bed for the accounting and financial services. Our policy is to recognize revenues associated with both management services and accounting and financial services on an accrual basis as the services are provided. However, under the terms of our management contracts, payments for our management services are subject to subordination to other expenditures of the long-term care center being managed. Furthermore, there are certain of the third parties with whom we have contracted to provide services and which we have determined, based on insufficient historical collections and the lack of expected future collections, that collection is not reasonably assured and our policy is to recognize income only in the period in which the amounts are realized. We recognize the expenses related to the provision of those services in the period in which they are incurred. We may receive



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payment for the unpaid and unrecognized management fees in whole or in part in the future only if cash flows from the operating and investing activities of the centers are sufficient to pay the fees. There can be no assurance that such future cash flows will occur. The realization of such previously unrecognized revenue could cause our reported net income to vary significantly from period to period.

We agree to subordinate our fees to the other expenses of a managed center because we believe we know how to improve the quality of patient services and finances of a long term care center and because subordinating our fees demonstrates to the owner and employees of the managed center how confident we are of the impact we can have in making the center operations successful. We may continue to provide services to certain managed centers despite not being fully paid currently so that we may be able to collect unpaid fees in the future from improved operating results and because the incremental savings from discontinuing services to a center may be small compared to the potential benefit. Also, we may benefit from providing other ancillary services to the managed center. We may receive payment for the unrecognized management fees in whole or in part in the future only if cash flows from the operating and investment activities of the centers are sufficient to pay the fees. There can be no assurance that such future cash flows will occur.

Certain of our accounts receivable from private paying patients and certain of our notes receivable are subject to credit losses. We have attempted to reserve for expected accounts receivable credit losses based on our past experience with similar accounts receivable and believe our reserves to be adequate.

We continually monitor and evaluate the carrying amount of our notes receivable in accordance with Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan An Amendment of FASB Statements No. 5 and 15. It is possible, however, that the accuracy of our estimation process could be materially impacted as the composition of the receivables changes over time. We continually review and refine our estimation process to make it as reactive to these changes as possible. However, we cannot guarantee that we will be able to accurately estimate credit losses on these balances. It is possible that future events could cause us to make significant adjustments or revisions to these estimates and cause our reported net income to vary significantly from period to period.

*Potential Recognition of Deferred Income* - During 1988, we sold the assets of eight long-term health care centers to National Health Corporation (ANational@), our administrative general partner at the time of the sale. The resulting

profit of \$15,745,000 was deferred. \$10,000,000 of the deferred gain and related deferred income taxes of \$4,000,000 was recognized as income in December, 2007 with the collection of the \$10,000,000 note from National. \$3,745,000 of the deferred gain has been amortized into income on a straight-line basis over the 20-year management contract period. Additional deferred income of \$2,000,000 will be reported when the Company no longer has an obligation to advance the \$2,000,000 working capital loan which obligation was extended until January 20, 2018 with the extension of the management agreement with National to that date.

*Guarantees* We guarantee certain debt of National and the ESOP (\$1,030,000). It is possible that future events could cause us to make significant adjustments to our estimates and liability under this guarantee and cause our reported net income to vary from period to period.

*Uncertain Tax Positions* NHC continually evaluates for uncertain tax positions. These uncertain positions may arise where tax laws may allow for alternative interpretations or where the timing of recognition of income is subject to judgment. We believe we have adequate provisions for our uncertain tax positions including related penalties and interest. However, because of uncertainty of interpretation by various tax authorities and the possibility that there are issues that have not been recognized by management, we cannot guarantee we have accurately estimated our tax liabilities.

The above listing is not intended to be a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles, with no need for management=s judgment in their application. There are also areas in which management=s judgment in selecting any available alternative would not produce a materially different result. See our audited consolidated financial statements and notes thereto which contain accounting policies and other disclosures required by generally accepted accounting principles.

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Government Program Financial Changes

Cost containment will continue to be a priority for Federal and State governments for health care services, including the types of services we provide. Government reimbursement programs such as Medicare and Medicaid prescribe, by law, the billing methods and amounts that health care providers may charge and be reimbursed to care for patients covered by these programs. Congress has passed a number of laws that have effected major changes in the Medicare and Medicaid programs. The Balanced Budget Act of 1997, or the Budget Act, sought to achieve a balanced federal budget by, among other things, reducing federal spending on Medicare and Medicaid to various providers. In February 2006, Congress enacted the Deficit Reduction Act, or DRA, which reduced net Medicare and Medicaid spending, and in December 2006, Congress passed the Tax Relief and Health Care Act of 2006, which also affects payments under the Medicare and Medicaid programs. In the Tax Relief and Health Care Act of 2006, Congress reduced the limit on Medicaid provider taxes for the period January 1, 2008 through September 30, 2011 from the 6 percent set by CMS regulations to a 5.5 percent limit set by statute.

*Medicare*

Effective October 1, 2007, our PPS rates were increased by 5.5% due to inflation update (3.3%) and Care Based Statistical Area (CBSA) designations. We estimate that the positive revenue effect of the Centers for Medicare and Medicaid Services (CMS) final rule was \$3,946,766 for the first nine months of 2008. The inflation update (or market basket increase) was 3.1% in 2006 and 3.3% in 2007.

For the first nine months of 2008 our average Medicare per diem increased by 3.80% over the same period of 2007.

No assurances can be given as to whether Congress will increase or decrease reimbursement in the future, the timing of any action or the form of relief, if any, that may be enacted.

*Medicaid*

Tennessee annual Medicaid rate increases were implemented effective July 1, 2008. The increase in revenue was approximately \$513,000 per quarter.

Missouri Medicaid funded a global rate increase for all providers of \$3.00 per day effective for February 1, 2007 through June 30, 2007. Effective July 1, 2007, an additional \$6.00 per day increase was funded. The combined effect of the eleven months in rate increases was approximately \$1,275,000 in 2007. The first nine months of 2008 effect was approximately \$1,528,000.

South Carolina Medicaid annual per diem rate increases that were implemented on October 1, 2007 have resulted in additional revenues of approximately \$251,000 per quarter.

For the first nine months of 2008 our average Medicaid per diem increased by 3.60% over the same period in 2007.

We face challenges with respect to states' Medicaid payments, because many currently do not cover the total costs incurred in providing care to those patients. States will continue to control Medicaid expenditures but also look for adequate funding sources, including provider assessments. The DRA includes several provisions designed to reduce Medicaid spending. These provisions include, among others, provisions strengthening the Medicaid asset transfer restrictions for persons seeking to qualify for Medicaid long-term care coverage, which could, due to the timing of the penalty period, increase facilities' exposure to uncompensated care. Other provisions could increase state funding for home and community-based services, potentially having an impact on funding for nursing facilities. There is no assurance that the funding for our services will increase or decrease in the future.

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Results of Operations

*Three Months Ended September 30, 2008 Compared to Three Months Ended September 30, 2007.*

Results for the three month period ended September 30, 2008 include a 10.5% increase in net revenues and a 107.1% increase in net income compared to the same period in 2007 after removing the after tax effect of a gain on sale of assets (\$6,475,000) occurring in the 2007 period.

Net patient revenues increased \$12,390,000 or 9.2% compared to the same period last year. Medicare, Medicaid and private pay per diem rates increased 4.1%, 2.85% and 5.84%, respectively, compared to the quarter a year ago. Additionally, the January 2, 2008 acquisition of a 109-bed skilled nursing and rehabilitation facility located in Knoxville, Tennessee, the acquisition of a 132-bed skilled nursing and rehabilitation facility and a 60-bed assisted living facility located in Charleston, South Carolina, effective August 1, 2008, and the completion of a 60-bed addition to an existing facility located in North Augusta, South Carolina, effective July 1, 2008 added approximately \$4,351,000 in net patient revenues.

The total census at owned and leased centers for the quarter averaged 92.4% compared to an average of 93.1% for the same quarter a year ago.

Other revenues increased \$3,162,000 or 23.3% in the three month 2008 period to \$16,750,000 from \$13,588,000 in the 2007 three month period. Increases in other revenues include increased collections of management and accounting services fees (\$864,000), increased dividends and other realized gains on securities due both to higher dividend rates and greater numbers of securities owned (\$79,000), greater earnings from our equity in unconsolidated investments (primarily from Caris HealthCare L.P., \$188,000), and increased rental income (\$2,524,000). The increased rental income is due primarily to (1) rental revenues from nine Florida facilities acquired on October 31, 2007 in the merger with NHR (\$1,850,000) and (2) rental revenues from the real estate of a 544 bed long term care center and 66 unit assisted living center located in Chattanooga, Tennessee acquired on November 1, 2007 (\$600,000).

Increases in other revenues in the 2008 period over the 2007 period were offset in part due to decreases in interest revenue (\$721,000) and in advisory fees (\$125,000). Interest revenue decreased in 2008 compared to 2007 due primarily to decreased investments caused by the expenditure by NHC of approximately \$89,600,000 in cash to complete the merger with NHR effective on October 31, 2007. Further, interest income decreased in 2008 compared to 2007 due to the collection of notes receivable of \$13,571,000 occurring in the second, (\$6,195,000) and fourth (\$7,376,000) quarters of 2007. The advisory fee income from NHR was terminated with completion of the NHR merger with NHC on October 31, 2007.

Total costs and expenses for the 2008 third quarter compared to the 2007 third quarter increased \$18,669,000 or 14.5% to \$147,117,000 from \$128,448,000. Salaries, wages and benefits, the largest operating costs of this service company, increased \$4,496,000 or 5.4% to \$88,036,000 from \$83,540,000. Other operating expenses increased \$3,763,000 or 9.2% to \$44,755,000 for the 2008 period compared to \$40,992,000 in the 2007 period. Rent expense decreased \$2,701,000 to \$7,834,000 compared to \$10,535,000 in the 2007 period. Depreciation and amortization increased \$2,326,000 or 59.8% to \$6,218,000 from \$3,892,000. Interest costs decreased \$7,000 to \$274,000. Costs and expenses for the 2007 third quarter include a \$10,792,000 gain from the sale of land located in South Carolina.

Increases in salaries, wages and benefits are due to increased staffing due to the acquisition of two long-term skilled health care facilities (241 long-term beds), a 60-bed assisted living facility and due to completion of construction of a 60-bed addition to an existing facility (\$2,374,000), increased costs for therapist services (\$728,000) and inflationary wage increases. Increases in other operating costs are due to costs associated with the acquisition of two long-term skilled health care facilities (241 long-term beds), a 60-bed assisted living facility and due to completion of construction of a 60-bed addition to an existing facility (\$1,723,000) and inflationary increases offset in part due to decreases in workers compensation (\$820,000).

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Rent expense in the third quarter of 2008 declined by approximately \$2,701,000 compared to the same quarter last year because NHC is no longer paying rent to NHR after the October 31, 2007 merger between the two companies.

This decline in rent expense is offset in part due to increased percentage rent to NHI (\$101,000). Percentage rent to NHI is equal to 4% of the increase in facility revenues over the 2007 base year revenues.

Depreciation expense increased primarily due to the acquisition of certain depreciable assets during the last year. The merger with NHR completed on October 31, 2007 added depreciable real property of \$247,649,000 and the net increase in depreciation in the quarter ended September 30, 2008 was \$2,326,000.

The income tax provision for the three months ended September 30, 2008 is \$2,381,000 (an effective income tax rate of 14.7%). The income tax provision and effective tax rate for 2008 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of \$4,187,000 (including \$2,050,000 of interest and penalties) under FIN 48, or 25.9% of income before taxes. The income tax provision for the three months ended September 30, 2007 was \$6,145,000 (an effective tax rate of 31.9%). The income tax provision and effective tax rate for 2007 were favorably impacted by statute of limitation expirations of \$1,504,000 (including \$499,000 of interest and penalties) under FIN 48, or 7.8% of income before taxes.

*Nine Months Ended September 30, 2008 Compared to Nine Months Ended September 30, 2007.*

Results for the nine month period ended September 30, 2008 include a 9.0% increase in net revenues and a 43.7% increase in net income compared to the same period in 2007 after removing both recovery and tax effect of the recovery of the note receivable and gain on sale of land occurring in the 2007 period.

Net patient revenues increased \$32,007,000 or 8.0% compared to the same period last year. Medicare, Medicaid and private pay per diem rates increased 3.8%, 3.6% and 6.1%, respectively, compared to the nine month period last year. Additionally, the January 2, 2008 acquisition of a 109-bed skilled nursing and rehabilitation facility located in Knoxville, Tennessee, the acquisition of a 132-bed skilled nursing and rehabilitation facility and a 60-bed assisted living facility located in Charleston, South Carolina effective August 1, 2008 and due to completion of construction of a 60-bed addition to an existing facility added approximately \$7,857,000 in net patient revenues.

The total census at owned and leased centers for the nine months averaged 92.7% compared to an average of 92.75% for the same nine months a year ago.

Other revenues increased \$7,798,000 or 18.3% in the nine month 2008 period to \$50,325,000 from \$42,527,000 in the 2007 nine month period. Increases in other revenues include increased premiums from insurance services (\$811,000), increased collections of management and accounting services fees (\$1,659,000) increased dividends and other realized gains on securities due both to higher dividend rates and greater numbers of securities owned (\$430,000), greater earnings from our equity in unconsolidated investments (primarily from Caris HealthCare L.P., \$1,084,000), and increased rental income (\$8,155,000). The increased rental income is due primarily to (1) rental revenues from nine Florida facilities received on October 31, 2007 in the merger with NHR (\$5,654,000) and (2) rental revenues from the real estate of a 544 bed long term care center and 66 unit assisted living center located in Chattanooga, Tennessee acquired on November 1, 2007 (\$1,800,000).

Increases in other revenues in the 2008 period over the 2007 period were offset in part due to decreases in interest revenue (\$3,628,000) and in advisory fees (\$375,000). Interest revenue decreased in 2008 compared to 2007 due primarily to decreased investments caused by the expenditure by NHC of approximately \$89,600,000 in cash to complete the merger with NHR effective on October 31, 2007. Further, interest income decreased in 2008 compared to 2007 due to the collection of notes receivable of \$13,571,000 occurring in the second, (\$6,195,000) and fourth (\$7,376,000) quarters of 2007. The advisory fee income from NHR was terminated with completion of the NHR merger with NHC on October 31, 2007.



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Total costs and expenses for the 2008 nine months compared to the 2007 nine months increased \$44,237,000 or 11.2% to \$439,127,000 from \$394,890,000. Salaries, wages and benefits, the largest operating costs of this service company, increased \$17,636,000 or 7.2% to \$261,889,000 from \$244,253,000. Other operating expenses increased \$10,955,000 or 8.9% to \$134,708,000 for the 2008 period compared to \$123,753,000 in the 2007 period. Rent expense decreased \$7,916,000 to \$23,628,000 compared to \$31,544,000 in the 2007 period. Depreciation and amortization increased \$6,763,000 or 58.9% to \$18,239,000 from \$11,476,000. Interest costs decreased \$188,000 to \$663,000.

Costs and expenses for the 2007 nine months included a \$6,195,000 recovery of a note receivable which had previously been written off and \$10,792,000 gain on the sale of land.

Increases in salaries, wages and benefits are due to increased staffing due to the acquisition of two long-term health care facilities (241 long-term beds) and a 60-bed assisted living facility and due to the completion of construction of a 60-bed addition to an existing facility (\$4,177,000), increased costs for therapist services (\$3,091,000), increases in the provision for workers compensation and health insurance claims accrued (\$1,239,000) and inflationary wage increases. Increases in other operating costs are due to costs associated with the acquisition of two long-term health care facilities (241 long-term beds) and a 60-bed assisted living facility and due to the completion of construction of a 60-bed addition to an existing facility (\$3,689,000) and inflationary increases offset in part due to decreases in workers compensation (\$1,781,000).

Rent expense in the 2008 period declined by approximately \$7,916,000 compared to the same period last year because NHC is no longer paying rent to NHR after the October 31, 2007 merger between the two companies. This decline in rent expense is offset in part due to increased percentage rent to NHI (\$429,000). Percentage rent to NHI is equal to 4% of the increase in facility revenues over the 2007 base year revenues.

Depreciation expense increased primarily due to the acquisition of depreciable assets in the last year. The merger with NHR completed on October 31, 2007 added depreciable real property of \$247,649,000 and the net increase in depreciation in the nine months ended September 30, 2008 was \$6,763,000.

The income tax provision for the nine months ended September 30, 2008 is \$13,416,000 (an effective tax rate of 29.9%). The income tax provision and effective tax rate for 2008 were favorably impacted by statute of limitation expirations of \$4,187,000 (including \$2,050,000 of interest and penalties) under FIN 48, or 9.3% of income before taxes. The income tax provision for the nine months ended September 30, 2007 was \$17,221,000 (an effective tax rate of 34.9%). The income tax provision and effective tax rate for 2007 were favorably impacted by statute of limitation expirations of \$1,504,000 (including \$499,000 of interest and penalties) under FIN 48, or 3.1% of income before taxes.

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

*Sources and Uses of Funds* - Our primary sources of cash include revenues from the healthcare and senior living facilities we operate, insurance services, management services and accounting services. Our primary uses of cash include salaries, wages and other operating costs of our home office and the facilities we operate, the cost of additions to and acquisitions of real property, rent expenses, debt service payments (including principal and interest) and dividend distributions. These sources and uses of cash are reflected in our Consolidated Statements of Cash Flows and are discussed in further detail below. The following is a summary of our sources and uses of cash flows (dollars in thousands):

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	Three Months Ended		Three Month Change		Nine Months Ended		Nine Month Change	
	September 30				September 30			
	2008	2007	\$	%	2008	2007	\$	%
Cash and Cash equivalents at beginning of period	\$ 29,791	\$ 67,702	\$ (37,911)	(56.0)	\$ 2,379	\$ 50,678	\$ (48,299)	(95.3)
Cash provided from (used) in operating activities	18,876	13,270	5,606	42.2	46,903	34,784	12,199	34.8
Cash provided from (used) in investing activities	(12,434)	(2,402)	(10,032)	(417.6)	(4,466)	(1,918)	(2,548)	(132.8)
Cash provided from (used) in financing activities	13,524	(3,223)	16,747	519.6	4,941	(8,197)	13,138	160.3
Cash and cash equivalents at end of period	\$ 49,757	\$ 75,347	\$ (25,590)	(34.0)	\$ 49,757	\$ 75,347	\$ (25,590)	(34.0)

*Operating Activities* - Net cash provided by operating activities for the nine months ended September 30, 2008, was \$46,903,000 as compared to \$34,784,000 provided in the same period last year. Cash provided by operating activities for the current period benefited from increases in various accrued current liabilities including accrued risk reserves and decreases in deferred income, and accounts receivable. The increases were offset by increases in the equity in earnings of unconsolidated investments and decreases in accrued payroll. Increases in restricted cash totaled \$13,927,000 compared to a \$4,781,000 increase in the prior period. The decrease in accounts receivable is due to collections and timing differences.

The increase in restricted cash in the current period is due primarily to the increase in cash reserved for our accrued risk reserves, including professional liability claims and workers compensation insurance claims, due to cash paid out for those claims.

The increase in other current liabilities and accrued risks reserves accounted for \$10,556,000 in 2008 and \$6,065,000 in 2007 of the cash provided by operating activities. If the risks materialize as expected, which may not be finally known for several years, they will require the use of our restricted cash.

*Investing Activities* - Cash used in investing activities totaled \$4,466,000 for the nine months ended September 30, 2008, as compared to \$1,918,000 used in investing activities for the nine months ended September 30, 2007. Cash used for property and equipment additions was \$34,367,000 for the nine months ended September 30, 2008 and \$11,821,000 in the comparable period in 2007. Investments in notes receivable totaled \$2,746,000 in 2008 compared to \$0 in 2007. Cash provided by net collections of notes receivable was \$4,674,000 in 2008 compared to \$7,195,000 in 2007. Collections of our investment in the enhanced cash fund balance totaled \$22,830,000 in the first nine months of 2008 compared to \$-0- in 2007.

Costs included in property and equipment additions include \$3,648,000 for a 60-bed addition to an existing facility located in North Augusta, South Carolina and \$13,250,000 for the acquisition of a 132-bed long-term health care facility and a 60-bed assisted living facility located in Charleston, South Carolina. The majority of the investments in notes receivable was a working capital loan to a leased facility.

Net cash provided by financing activities totaled \$4,941,000 in the nine months ended September 30, 2008 compared to \$8,197,000 net cash used for the same period in 2007. Cash used for payments of debt totaled \$7,433,000 and dividend payments to common and preferred shareholders totaled \$14,592,000. In the prior year, cash used for payments of debt totaled \$1,686,000, dividend payments to common shareholders totaled \$7,136,000. Tax benefits from exercise of stock options provided cash of \$1,439,000 in 2008 and \$195,000 in 2007. In the current period, \$20,500,000 cash was provided by borrowing against our revolving credit facility compared to -0- borrowings in the same period in 2007.



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At September 30, 2008, our ratio of long term debt to total capitalization (total debt plus deferred income plus shareholders equity) is 1.9%.

Table of Contractual Cash Obligations

Our contractual cash obligations for periods subsequent to September 30, 2008 are as follows (in thousands):

	Total	Less than 1 year	1-3 Years	3-5 Years	After 5 Years
Long-term debt principal	\$ 30,502	\$ 2	\$ 20,500		\$ 10,000
Long-term debt - interest	5,235	988	893	850	2,231
Obligations to complete construction	279	279			
Obligation to purchase senior secured notes from financial institutions	1,030	1,030			
Operating leases	435,833	28,948	61,460	67,400	278,025
Total Contractual Cash Obligations	\$ 472,879	\$ 31,247	\$ 82,853	\$ 68,250	\$ 290,256

We have guaranteed debt obligations of certain other entities totaling approximately \$1,030,000. These guarantees are included in the table above; however, we do not anticipate material obligations under these commitments.

Income taxes payable for uncertain tax positions under FIN 48 of \$3,664,000, attributable to permanent differences, at September 30, 2008 has not been included in the above table because of the inability to estimate the period in which it is expected to occur. See Note 2 of the Consolidated Financial Statements for a discussion on income taxes.

Our current cash on hand, marketable securities, short term notes receivable, operating cash flows, and as needed, our borrowing capacity are expected to be adequate to meet these contractual obligations and to finance our operating requirements, growth and development plans.

We started paying quarterly dividends in the second quarter of 2004 and anticipate the continuation of dividend payments as approved quarterly by the Board of Directors.

### Guarantees and Contingencies

#### *Debt Guarantees*

In addition to our primary debt obligations, which are included in our consolidated financial statements, we have guaranteed certain of the debt obligations of National and the ESOP. This guarantee, which is not included as debt obligations in our consolidated financial statements, totals \$1,030,000 at September 30, 2008.

The \$1,030,000 of guarantees of debt of National and the ESOP relates to senior secured notes held by financial institutions. The total outstanding balance of National and the ESOP's obligations under these senior secured notes is \$1,030,000. None of this obligation has been included in our debt obligations because we are not a direct obligor on this indebtedness. The \$1,030,000, which is not included in our debt obligations because we are not a direct obligor, is due from NHI to National and the ESOP.

The \$1,030,000 guarantee described above has cross-default provisions with other debt of National and the ESOP. We currently believe that National and the ESOP are in compliance with the terms of their debt agreements.

As of September 30, 2008, our maximum potential loss related to debt guarantees and financial guarantees is \$1,030,000.





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New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value measurements. The new FASB rule does not supersede all applications of fair value in other pronouncements, but creates a fair value hierarchy and prioritizes the inputs to valuation techniques for use in most pronouncements. It requires companies to assess the significance of an input to the fair value measurement in its entirety. Statement 157 also requires companies to disclose information to enable users of financial statements to assess the inputs used to develop the fair value measurements. SFAS 157 is effective for fiscal periods beginning after November 15, 2007 and interim periods within those fiscal years, with the following exception. FASB Staff Position (FSP) FAS 157-2, *Effective Date of FASB Statement No. 157*, defers the effective date to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The implementation of FAS 157 for financial assets and financial liabilities did not have a material impact on the Company's consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115*. This Statement amends FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, with respect to accounting for a transfer to the trading category for all entities with available-for-sale and trading securities electing the fair value option. This statement allows companies to elect fair value accounting for many financial instruments and other items that currently are not required to be accounted as such, allows different applications for electing the option for a single item or groups of items, and requires disclosures to facilitate comparisons of similar assets and liabilities that are accounted for differently in relation to the fair value option. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The implementation of FAS 159 did not have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* which replaces SFAS No. 141, *Business Combinations*. This Statement establishes principles and requirements for how the acquirer (i) recognizes

and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (ii) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (iii) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company will adopt this standard at the beginning of the Company's fiscal year ending December 31, 2009 for all prospective business acquisitions. The Company has not determined the effect that the adoption of SFAS 141(R) will have on its consolidated financial statements, but the impact will be limited to any future acquisitions beginning in fiscal year 2009.

In December 2007, the FASB issued SFAS No. 160 *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51*. This Statement requires all entities to report noncontrolling interests in subsidiaries as equity in the consolidated financial statements. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company will adopt this Statement effective January 1, 2009. The Company has not determined the effect that the adoption of SFAS No. 160 will have on its consolidated results of operations or financial position.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, *The Hierarchy of Generally Accepted Accounting Principles* ( SFAS No. 162 ). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP in the United States ( the GAAP hierarchy ). The current GAAP hierarchy is set forth in the AICPA Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles* ( SAS No. 69 ). The FASB believes the GAAP

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hierarchy should be directed to entities because it is the entity (not its auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB and has issued SFAS No. 162 to achieve that result. SFAS No. 162 is effective 60 days following the SEC's approval of the Public Accounting Oversight Board amendments to SAS No. 69. We do not expect the adoption of SFAS No. 162 to have an impact on our consolidated financial position, results of operations, or cash flows.

Forward Looking Statements

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

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

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

C

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

C

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

C

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

C

liabilities and other claims asserted against us, including patient care liabilities, as well as the resolution of current litigation (see Note 9: Guarantees and Contingencies);

C

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

C

the ability to attract and retain qualified personnel;

C

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

C

the competitive environment in which we operate;

C

the ability to maintain and increase census levels; and

C

demographic changes.

NATIONAL HEALTHCARE CORPORATION

September 30, 2008

(unaudited)

See the notes to the quarterly financial statements, and AItem 1. Business@ as is found in our 2007 Annual Report on Form 10 K for a discussion of various governmental regulations and other operating factors relating to the healthcare industry and the risk factors inherent in them. This may be found on our web site at [www.nhccare.com](http://www.nhccare.com). You should carefully consider these risks before making any investment in the Company. These risks and uncertainties are not the only ones facing us. There may be additional risks that we do not presently know of or that we currently deem immaterial. If any of the risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our shares of stock could decline, and you may lose all or part of your investment. Given these risks and uncertainties, we can give no assurances that these forward looking statements will, in fact, transpire and, therefore, caution investors not to place undue reliance on them.

**Item 3.**

**Quantitative and Qualitative Disclosure About Market Risk.**

*Interest Rate Risk*

Our cash and cash equivalents consist of highly liquid investments with an original maturity of less than three months. As a result of the short term nature of our cash instruments, a hypothetical 10% change in interest rates would have no material impact on our future earnings and cash flows related to these instruments. Approximately \$13.8 million of our notes receivable bear interest at fixed interest rates. As the interest rates on these notes receivable are fixed, a hypothetical 10% change in interest rates would have no impact on our future earnings and cash flows related to these instruments. Approximately \$7.6 million of our notes receivable bear interest at variable rates (generally at prime plus 2%). Because the interest rates of these instruments are variable, a hypothetical 10% change in interest rates would result in a related increase or decrease in annual interest income of approximately \$48,000. As of September 30, 2008, all of our long term debt bears interest at variable interest rates. Because the interest rates of these instruments are variable, a hypothetical 10% change in interest rates would result in a related increase or decrease in annual interest expense of approximately \$75,000.

*Equity Price Risk*

We consider our investments in marketable securities as Available for sale securities and unrealized gains and losses, net of applicable income taxes, are recorded in stockholders' equity in accordance with Statement of Financial Accounting Standards No. 115. The investments in marketable securities are recorded at their fair market value based on quoted market prices. Thus, there is exposure to equity price risk, which is the potential change in fair value due to a change in quoted market price. Hypothetically, a 10% change in quoted market prices would result in a related 10% change in the fair value of our investments in marketable securities.

Subsequent to September 30, 2008, the credit and liquidity crisis in the United States and throughout the global financial system triggered significant events and substantial volatility in world financial markets and the banking system that have had a significant negative impact on foreign and domestic financial markets. As a result, our investment portfolio has incurred a significant decline in fair value since December 31, 2007. However, because the values of our individual investments have and will fluctuate in response to changing market conditions, the amount of losses that will be recognized in subsequent periods, if any, cannot be determined.

*Investment in Enhanced Cash Fund*

Please see Note 5 *Investment in Enhanced Cash Fund and Application of Critical Accounting Policies* regarding market risk related to our investment in an enhanced cash fund.

NATIONAL HEALTHCARE CORPORATION

September 30, 2008

(unaudited)

**Item 4. Controls and Procedures.**

As of September 30, 2008, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer (ACEO@) and Principal Accounting Officer (APAO@), of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and PAO, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2008. There have been no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1.

Legal Proceedings.

For a discussion of prior, current and pending litigation of material significance to NHC, please see Note 9 of this Form 10 Q.

Item 1A.

Risk Factors.

During the nine months ended September 30, 2008, there were no material changes to the risk factors that were disclosed in Item 1A of National HealthCare Corporation's Annual Report on Form 10 K for the year ended



December 31, 2007.

Item 2.

Unregistered Sales of Equity Securities and Use of Proceeds. Not applicable

Item 3.

Defaults Upon Senior Securities. None

Item 4.

Submission of Matters to Vote of Security Holders. None.

Item 5.

Other Information. None

Item 6.

Exhibits.

(a)

List of exhibits

Exhibit No. Description

- |      |                                                                                                            |
|------|------------------------------------------------------------------------------------------------------------|
| 31.1 | Rule 13a 14(a)/15d 14(a) Certification of Chief Executive Officer                                          |
| 31.2 | Rule 13a 14(a)/15d 14(a) Certification of Principal Financial Officer                                      |
| 32   | Certification pursuant to 18 U.S.C. Section 906 by Chief Executive Officer and Principal Financial Officer |



NATIONAL HEALTHCARE CORPORATION

September 30, 2008

(unaudited)

SIGNATURES

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

NATIONAL HEALTHCARE CORPORATION

(Registrant)

Date: November 6, 2008      /s/ Robert G. Adams  
Robert G. Adams  
President  
Chief Executive Officer

Date: November 6, 2008      /s/ Donald K. Daniel  
Donald K. Daniel  
Senior Vice President and Controller  
(Principal Financial Officer)