NATIONAL HEALTHCARE CORP
Form 10-Q
October 30, 2012

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

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2012
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 incorporation or organization	(I.R.S. Employer Identification No.)

100 E. Vine Street
Murfreesboro, TN

37130
(Address of principal executive offices)
(Zip Code)

(615) 890–2020
Registrant's telephone number, including area code

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

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

Yes [x] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non–accelerated filer or a smaller reporting company. See the definitions of "large accelerated file," "accelerated filer" and "smaller reporting company" in Rule 12b–2 of the Exchange Act. (Check one):

Large Accelerated filer [ ] Accelerated filer [x]

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

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

14,003,006 shares of common stock of the registrant were outstanding as of October 29, 2012.

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

		Page
Item 1.	Financial Statements	3
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	22
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	32
Item 4.	Controls and Procedures	33
	PART II. OTHER INFORMATION	
Item 1.	Legal Proceedings	33
Item 1A	Risk Factors	33
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	34
Item 3.	Defaults Upon Senior Securities	34
Item 5.	Other Information	34
Item 6.	Exhibits	34

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Statements of Income

(Unaudited)

(in thousands, except share and per share amounts)

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Revenues:				
Net patient revenues	$ 175,361	$ 182,134	$ 525,211	$ 536,531
Other revenues	14,007	14,930	42,008	44,264
Net operating revenues	189,368	197,064	567,219	580,795
Cost and Expenses:				
Salaries, wages and benefits	106,844	106,870	318,028	320,425
Other operating	48,519	54,807	149,271	148,084
Facility rent	9,813	10,000	29,507	29,744
Depreciation and amortization	7,402	7,307	22,168	21,344
Interest	119	136	345	333
Total costs and expenses	172,697	179,120	519,319	519,930
Income Before Non–Operating Income	16,671	17,944	47,900	60,865
Non–Operating Income	6,771	5,140	18,546	14,856
Income Before Income Taxes	23,442	23,084	66,446	75,721
Income Tax Provision	(6,209)	(5,873)	(22,923)	(26,175)
Net Income	17,233	17,211	43,523	49,546
Dividends to Preferred Stockholders	(2,167)	(2,167)	(6,503)	(6,503)

Net Income Available to Common Stockholders	$ 15,066	$ 15,044	$ 37,020	$ 43,043
Earnings Per Common Share:				
Basic	$ 1.09	$ 1.09	$ 2.67	$ 3.13
Diluted	$ 1.04	$ 1.05	$ 2.63	$ 3.02
Weighted Average Common Shares Outstanding:				
Basic	13,852,403	13,807,995	13,846,022	13,762,084
Diluted	16,605,285	16,444,749	16,578,535	16,404,305

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

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Statements of Comprehensive Income

(Unaudited – in thousands)

	Three Months Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Net Income	$ 17,233	$ 17,211	$ 43,523	$ 49,546
Other Comprehensive Income (Loss):				
Unrealized gains (losses) on investments in marketable securities	1,223	(4,529)	14,243	(3,992)
Income tax (expense) benefit related to items of other comprehensive income	(465)	1,786	(5,524)	1,599
Other comprehensive income (loss), net of tax	758	(2,743)	8,719	(2,393)
Comprehensive Income	$ 17,991	$ 14,468	$ 52,242	$ 47,153

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Balance Sheets

(in thousands)

	September 30, 2012 *(unaudited)*	December 31, 2011
Assets		
Current Assets:		
Cash and cash equivalents	$ 83,707	$ 61,008
Restricted cash and cash equivalents	35,917	50,587
Marketable equity securities	98,000	85,051
Restricted marketable securities	109,027	83,625
Accounts receivable, less allowance for doubtful accounts of $3,475 and $3,713, respectively	63,080	69,635
Inventories	6,479	7,419
Prepaid expenses and other assets	1,727	1,082
Federal income tax receivable	-	3,779
Total current assets	397,937	362,186
Property and Equipment:		
Property and equipment, at cost	669,084	659,523
Accumulated depreciation and amortization	(247,241)	(229,872)
Net property and equipment	421,843	429,651
Other Assets:		
Deposits	156	397
Goodwill	17,600	20,320
Notes receivable	22,113	22,449
Deferred income taxes	10,353	10,167
Investments in limited liability companies	36,091	20,502
Total other assets	86,313	73,835
Total assets	$ 906,093	$ 865,672

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

The interim condensed consolidated balance sheet at December 31, 2011 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)

	September 30, 2012 *(unaudited)*	December 31, 2011
Liabilities and Stockholders' Equity		
Current Liabilities:		
Trade accounts payable	$ 5,436	$ 9,834
Accrued payroll	50,275	54,063
Amounts due to third party payors	18,758	16,807
Accrued risk reserves	103,202	98,732
Deferred income taxes	19,937	14,526
Other current liabilities	14,748	15,583
Dividends payable	6,413	6,362
Total current liabilities	218,769	215,907
Long–Term Debt	10,000	10,000
Other Noncurrent Liabilities	13,576	16,244
Deferred Revenue	11,246	11,785
Stockholders' Equity:		
Series A Convertible Preferred Stock; $.01 par value; 25,000,000 shares authorized; 10,838,412 and 10,838,490 shares, respectively, issued and outstanding; stated at liquidation of $15.75 per share	170,514	170,515
Common stock, $.01 par value; 30,000,000 shares authorized; 13,992,906 and 13,862,738 shares, respectively, issued and outstanding	139	138
Capital in excess of par value	146,797	139,183
Retained earnings	289,631	265,198
Accumulated other comprehensive income	45,421	36,702
Total stockholders' equity	652,502	611,736
Total liabilities and stockholders' equity	$ 906,093	$ 865,672

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

The interim condensed consolidated balance sheet at December 31, 2011 is taken from the audited consolidated financial statements at that date.

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Statements of Cash Flows

(Unaudited)

	Nine Months Ended September 30	
	2012	2011
Cash Flows From Operating Activities:	*(in thousands)*	
Net income	$ 43,523	$ 49,546
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	22,168	21,344
Provision for doubtful accounts receivable	1,773	1,689
Equity in earnings of unconsolidated investments	(10,079)	(7,203)
Distributions from unconsolidated investments	6,301	4,232
Gains on sale of restricted marketable securities	(934)	(399)
Deferred income taxes	(299)	680
Stock–based compensation	1,925	2,253
Changes in operating assets and liabilities:		
Restricted cash and cash equivalents	(6,270)	(8,027)
Accounts receivable	2,971	7,995
Income tax receivable	3,779	–
Inventories	940	611
Prepaid expenses and other assets	(672)	(950)
Trade accounts payable	(4,288)	(1,498)
Accrued payroll	(3,386)	(2,660)
Amounts due to third party payors	2,238	670
Other current liabilities and accrued risk reserves	3,635	(12,319)
Entrance fee deposits	(1,498)	(1,343)
Other noncurrent liabilities	(2,668)	(1,907)
Deferred income	959	1,060
Net cash provided by operating activities	60,118	53,774
Cash Flows From Investing Activities:		
Additions to property and equipment	(14,888)	(17,881)
Acquisition of non-controlling interest in hospice business	(7,500)	–
Collections of notes receivable, net	336	1,573
Change in restricted cash and cash equivalents	20,940	10,901
Purchase of restricted marketable securities	(65,778)	(48,233)
Sale of restricted marketable securities	42,604	35,858
Net cash used in investing activities	(24,286)	(17,782)
Cash Flows From Financing Activities:		
Tax expense from stock–based compensation	(271)	(40)
Dividends paid to preferred stockholders	(6,503)	(6,503)
Dividends paid to common stockholders	(12,536)	(11,810)
Issuance of common shares	5,960	7,152

Change in deposits	217	(111)
Net cash used in financing activities	(13,133)	(11,312)
Net Increase in Cash and Cash Equivalents	22,699	24,680
Cash and Cash Equivalents, Beginning of Period	61,008	28,478
Cash and Cash Equivalents, End of Period	$ 83,707	$ 53,158

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

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Statements of Stockholders' Equity

(in thousands, except share and per share amounts)

(unaudited)

	Preferred Stock		Common Stock		Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income	Total Stock–holders' Equity
	Shares	Amount	Shares	Amount				
Balance at January 1, 2011	10,840,608	$ 170,548	13,637,258	$ 136	$ 128,061	$ 226,114	$ 36,287	$ 561,146
Net income	–	–	–	–	–	49,546	–	49,546
Other comprehensive income	–	–	–	–	–	–	(2,393)	(2,393)
Stock–based compensation	–	–	–	–	2,253	–	–	2,253
Tax expense from exercise of stock options	–	–	–	–	(40)	–	–	(40)
Shares sold – options exercised	–	–	194,234	2	7,150	–	–	7,152
Shares issued in conversion of preferred stock to common stock	(2,082)	(33)	503	–	33	–	–	–
Dividends declared to preferred stockholders ($0.60 per share)	–	–	–	–	–	(6,503)	–	(6,503)
	–	–	–	–	–	(12,165)	–	(12,165)

Dividends declared to common stockholders ($0.88 per share)								
Balance at September 30, 2011	10,838,526	$ 170,515	13,831,995	$ 138	$ 137,457	$ 256,992	$ 33,894	$ 598,996
Balance at January 1, 2012	10,838,490	$ 170,515	13,862,738	$ 138	$ 139,183	$ 265,198	$ 36,702	$ 611,736
Net income	–	–	–	–	–	43,523	–	43,523
Other comprehensive income	–	–	–	–	–	–	8,719	8,719
Stock–based compensation	–	–	–	–	1,925	–	–	1,925
Tax expense from exercise of stock options	–	–	–	–	(271)	–	–	(271)
Shares sold – options exercised	–	–	130,150	1	5,959	–	–	5,960
Shares issued in conversion of preferred stock to common stock	(78)	(1)	18	–	1	–	–	–
Dividends declared to preferred stockholders ($0.60 per share)	–	–	–	–	–	(6,503)	–	(6,503)
Dividends declared to common stockholders ($0.90 per share)	–	–	–	–	–	(12,587)	–	(12,587)
Balance at September 30, 2012	10,838,412	$ 170,514	13,992,906	$ 139	$ 146,797	$ 289,631	$ 45,421	$ 652,502

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

NATIONAL HEALTHCARE CORPORATION

Notes to Interim Condensed Consolidated Financial Statements

September 30, 2012

(Unaudited)

Note 1 – Description of Business

National HealthCare Corporation ("NHC" or the "Company") is a leading provider of long–term health care services. We operate or manage, through certain affiliates, 75 long–term health care centers with 9,460 beds in 10 states and provide other services in one additional state. 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, homecare programs, assisted living centers and independent living centers. In addition, we provide insurance services, management and accounting services, and lease properties to operators of long–term health care centers.

Note 2 – Summary of Significant Accounting Policies

The listing below is not intended to be a comprehensive list of all of our significant accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles, with limited need for management's judgment in their application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result. See our audited December 31, 2011 consolidated financial statements and notes thereto which contain accounting policies and other disclosures required by generally accepted accounting principles. Our audited December 31, 2011 consolidated financial statements are available at our web site: www.nhccare.com.

Basis of Presentation

The unaudited condensed consolidated financial statements to which these notes are attached include all normal, recurring adjustments which are necessary to fairly present the financial position, results of operations and cash flows of NHC. All significant intercompany transactions and balances have been eliminated in consolidation. We assume that users of these interim financial statements have read or have access to the audited December 31, 2011 consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies, may be determined in that context. Accordingly, footnotes and other disclosures which would substantially duplicate the disclosure contained in our most recent annual report to stockholders have been omitted. This interim financial information is not necessarily indicative of the results that may be expected for a full year for a variety of reasons.

Estimates and Assumptions

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

Revenue Recognition – Third Party Payors

Approximately 70% of our net patient revenues are derived from Medicare, Medicaid, and other government programs. Amounts earned under these programs are subject to review by the Medicare and Medicaid intermediaries or their agents. In our opinion, adequate provision has been made for any adjustments that may result from these reviews. Any differences between our original estimates of reimbursements and subsequent revisions are reflected in operations in the period in which the revisions are made often due to final determination or the period of

payment no longer being subject to audit or review. We have made provisions of approximately $18,758,000 and $16,807,000 as of September 30, 2012 and December 31, 2011, respectively, for various Medicare and Medicaid current and prior year cost reports and claims reviews.

Revenue Recognition – Private Pay

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

Revenue Recognition – Subordination of Fees and Uncertain Collections

We provide management services to certain long–term care facilities and to others we provide accounting and financial services. We generally charge 6% to 7% of net operating revenues for our management services and a predetermined fixed rate per bed for the accounting and financial services. Our policy is to recognize revenues associated with both management services and accounting and financial services on an accrual basis as the services are provided. However, under the terms of our management contracts, payments for our management services are subject to subordination to other expenditures of the long–term care center being managed. Furthermore, for certain of the third parties with whom we have contracted to provide services and which we have determined that collection is not reasonably assured, our policy is to recognize income only in the period in which the amounts are realized. We may receive payment for the unpaid and unrecognized management fees in whole or in part in the future only if cash flows from the operating and investing activities of the centers or proceeds from the sale of the centers are sufficient to pay the fees. There can be no assurance that such future cash flows will occur. The realization of such previously unrecognized revenue could cause our reported net income to vary significantly from period to period.

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

Accrued Risk Reserves

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

Professional liability remains an area of particular concern to us. The entire long term care industry has seen an increase in personal injury/wrongful death claims based on alleged negligence by nursing homes and their employees in providing care to residents. As of September 30, 2012, we and/or our managed centers are defendants in 21 such claims inclusive of years 2005 through September 30, 2012. It remains possible that those pending matters plus potential unasserted claims could exceed our reserves, which could have a material adverse effect on our consolidated financial position, results of operations and cash flows. It is also possible that future events could cause us to make significant adjustments or revisions to these reserve estimates and cause our reported net income to vary significantly from period to period.

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

Credit Losses

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 and believe our reserves to be adequate.

We monitor and evaluate the carrying amount of our notes receivable in accordance with ASC Topic 310, *Receivables*. 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. 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.

Uncertain Tax Positions

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.

New Accounting Pronouncements

In September 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011–08, which is included in the Codification under ASC 350, “Intangibles – Goodwill and Other.” The revised standard is intended to reduce the cost and complexity of the annual goodwill impairment test by providing entities an option to perform a “qualitative” assessment to determine whether further impairment testing is necessary. This accounting standard update became effective beginning in our first quarter of fiscal 2012. The adoption did not have a material impact on the Company’s consolidated financial statements.

In September 2011, the FASB issued ASU No. 2011–05, which is included in Codification under ASC 220, “Comprehensive Income”. This accounting standard update eliminates the option to present components of other comprehensive income as part of the statement of equity and requires the total of comprehensive income, the components of net income, and the components of other comprehensive income be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. It also requires presentation on the face of the financial statements of reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. This accounting standard update became effective beginning in our first quarter of fiscal 2012. In December 2011, the FASB issued ASU No. 2011–12 which indefinitely defers the guidance related to the presentation of reclassification adjustments only. The adoption of this accounting standard update resulted in financial statement presentation changes only.

In May 2011, the FASB issued ASU No. 2011–04, which is included in the Codification under ASC 820, “Fair Value Measurement.” The amendments in this update result in common fair value measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards (IFRS). The amendments became effective beginning in our first fiscal quarter of 2012. The adoption did not have a material impact on the Company’s consolidated financial statements.

Note 3 – Other Revenues

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

Other revenues include the following:

	Three Months Ended September 30		Nine Months Ended September 30	
(in thousands)	2012	2011	2012	2011
Management and accounting services fees	$ 5,125	$ 5,913	$ 15,104	$ 16,536
Rental income	4,827	4,866	14,486	14,703
Insurance services	3,972	3,950	11,803	12,046
Other	83	201	615	979
	$ 14,007	$ 14,930	$ 42,008	$ 44,264

Management Fees from National

We manage five long–term care centers owned by National Health Corporation ("National"). During the nine months ended September 30, 2012 and 2011, we recognized management fees and interest on management fees of $2,564,000 and $2,676,000, respectively, from these centers.

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

improved cash flows will occur.

Management Fees from Other Nursing Centers

We continue to manage 15 long–term care centers (excluding the five National centers) for third–party owners where the management fees are recognized only when realized. During the nine months ended September 30, 2012 and 2011, we recognized $4,251,000 and $4,735,000, respectively, of management fees from these 15 long–term care centers.

The unpaid fees from these 15 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 centers. 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 or the proceeds from the sale of the centers are sufficient to pay the fees. There can be no assurance that such future improved cash flows will occur.

Rental Income

The health care properties currently owned and leased to third party operators include nine skilled nursing facilities and four assisted living communities. The rental agreements continue for a five year period ending on December 31, 2015.

Note 4 – Non–Operating Income

Non–operating income is outlined in the table below. Non–operating income includes equity in earnings of unconsolidated investments, dividends and other realized gains and losses on securities, and interest income. Our most significant equity method investment is a 75.1% non–controlling ownership interest in Caris HealthCare L.P. ("Caris"), a business that specializes in hospice care services. See also Note 14 regarding the additional non–controlling ownership interest we obtained in Caris during the nine months ended September 30, 2012.

	Three Months Ended September 30		Nine Months Ended September 30	
(in thousands)	2012	2011	2012	2011
Equity in earnings of unconsolidated investments	$ 4,063	$ 2,464	$ 10,079	$ 7,203
Dividends and other net realized gains and losses on sales of securities	1,607	1,410	5,074	3,928
Interest income	1,101	1,266	3,393	3,725
	$ 6,771	$ 5,140	$ 18,546	$ 14,856

Note 5 – Other Operating Expenses

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

Note 6 – Earnings per Share

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

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

	Three Months Ended September 30		Nine Months Ended September 30	
(in thousands, except for share and per share amounts)	2012	2011	2012	2011
Basic:				
Weighted average common shares outstanding	13,852,403	13,807,995	13,846,022	13,762,084
Net income	$ 17,233	$ 17,211	$ 43,523	$ 49,546
Dividends to preferred stockholders	(2,167)	(2,167)	(6,503)	(6,503)
Net income available to common stockholders	15,066	15,044	37,020	43,043
Earnings per common share, basic	$ 1.09	$ 1.09	$ 2.67	$ 3.13
Diluted:				
Weighted average common shares outstanding	13,852,403	13,807,995	13,846,022	13,762,084
Dilutive effect of stock options	7,912	8,366	8,971	12,431
Dilutive effect of restricted stock	4,641	5,031	5,417	6,303
Dilutive effect of contingent issuable stock	117,000	-	94,796	-
Convertible preferred stock	2,623,329	2,623,357	2,623,329	2,623,487
Assumed average common shares outstanding	16,605,285	16,444,749	16,578,535	16,404,305
Net income available to common stockholders	$ 15,066	$ 15,044	$ 37,020	$ 43,043
Add dilutive preferred stock dividends for effect of assumed conversion of preferred stock	2,167	2,167	6,503	6,503
Net income for diluted earnings per common share	17,233	17,211	43,523	49,546
Earnings per common share, diluted	$ 1.04	$ 1.05	$ 2.63	$ 3.02

In the above table, options to purchase 1,237,144 and 1,439,251 shares of our common stock have been excluded for 2012 and 2011, respectively, due to their anti–dilutive impact.

Note 7 – Investments in Marketable Securities

Our investments in marketable securities are classified as available for sale securities. Realized gains and losses from securities sales are determined on the specific identification of the securities.

Marketable securities and restricted marketable securities consist of the following:

	September 30, 2012		December 31, 2011	
(in thousands)	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Investments available for sale:				
Marketable equity securities	$ 30,176	$ 98,000	$ 30,176	$ 85,051
Restricted investments available for sale:				
Corporate debt securities	47,948	49,381	33,426	34,074
Commercial mortgage–backed securities	29,914	31,079	33,275	33,904
U.S. Treasury securities	20,407	20,877	7,778	8,070
State and municipal securities	7,234	7,690	7,270	7,577
	$ 135,679	$ 207,027	$ 111,925	$ 168,676

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

	September 30, 2012			December 31, 2011		
	Shares	Cost	Fair Value	Shares	Cost	Fair Value
NHI Common Stock	1,630,642	$ 24,734	$ 83,880	1,630,642	$ 24,734	$ 71,716

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

	September 30, 2012		December 31, 2011	
(in thousands)	Cost	Fair Value	Cost	Fair Value
Maturities:				
Within 1 year	$ 9,704	$ 9,802	$ 5,280	$ 5,298
1 to 5 years	61,393	63,606	44,923	45,734
6 to 10 years	34,006	35,215	21,993	22,768
Over 10 years	400	404	9,553	9,825
	$ 105,503	$ 109,027	$ 81,749	$ 83,625

Gross unrealized gains related to available for sale securities are $71,381,000 and $57,138,000 as of September 30, 2012 and December 31, 2011, respectively. Gross unrealized losses related to available for sale securities are $33,000 and $387,000 as of September 30, 2012 and December 31, 2011, respectively.

Proceeds from the sale of investments in restricted marketable securities during the nine months ended September 30, 2012 and 2011 were $42,604,000 and $35,858,000, respectively. Investment gains of $934,000 and $399,000 were realized on these sales during the nine months ended September 30, 2012 and 2011, respectively.

Note 8 – Fair Value Measurements

The accounting standard for fair value measurements provides a framework for measuring fair value and requires expanded disclosures regarding fair value measurements. Fair value is defined as the price that would be received for

an asset or the exit price that would be paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants on the measurement date. This accounting standard establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs, where available. The following summarizes the three levels of inputs that may be used to measure fair value:

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

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

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

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

Valuation of Marketable Securities

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

We validated the prices provided by our broker by reviewing their pricing methods and obtained market values from other pricing sources. We also analyzed the pricing data and confirmed that the relevant markets are active. After completing our validation procedures, we did not adjust or override any fair value measurements provided by our broker as of September 30, 2012. We did not have any transfers of assets between Level 1 and Level 2 of the fair value measurement hierarchy during the nine months ended September 30, 2012.

Other

The carrying amounts of cash and cash equivalents, restricted cash and cash equivalents, accounts receivable, and accounts payable approximate fair value due to their short–term nature. The estimated fair value of notes receivable approximates the carrying value based principally on their underlying interest rates and terms, maturities, collateral and credit status of the receivables. Our long–term debt approximates fair value due to variable interest rates, but fair value is also determined using Level 2 inputs through alternative pricing sources. At September 30, 2012, there were no material differences between the carrying amounts and fair values of NHC’s financial instruments.

The following table summarizes fair value measurements by level at September 30, 2012 and December 31, 2011 for assets and liabilities measured at fair value on a recurring basis *(in thousands)*:

		Fair Value Measurements Using		
September 30, 2012	Fair Value	Quoted Prices in Active Markets For Identical Assets	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

			(Level 1)				
Cash and cash equivalents	$	83,707	$	83,707	$	–$	–
Restricted cash and cash equivalents		35,917		35,917		–	–
Marketable equity securities		98,000		98,000		–	–
Corporate debt securities		49,381		–		49,381	–
Commercial mortgage–backed securities		31,079		–		31,079	–
U.S. Treasury securities		20,877		20,877		–	–
State and municipal securities		7,690		–		7,690	–
Total financial assets	$	326,651	$	238,501	$	88,150$	–

			Fair Value Measurements Using				
December 31, 2011		Fair Value		Quoted Prices in Active Markets For Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash and cash equivalents	$	61,008	$	61,008	$	– $	–
Restricted cash and cash equivalents		50,587		50,587		–	–
Marketable equity securities		85,051		85,051		–	–
Corporate debt securities		34,074		–		34,074	–
Commercial mortgage–backed securities		33,904		–		33,904	–
U.S. Treasury securities		8,070		8,070		–	–
State and municipal securities		7,577		–		7,577	–
Total financial assets	$	280,271	$	204,716	$	75,555$	–

Note 9 – Long–Term Debt

Long–term debt consists of the following:

	Weighted Average	Maturities	Long–Term Debt

	Interest Rate		9/30/12	12/31/11
			(dollars in thousands)	
Revolving Credit Facility, interest payable monthly	Variable, 0.9%	2013	$ –	$ –
Unsecured term note payable to National, interest payable quarterly, principal payable at maturity	Variable, 2.8%	2018	10,000	10,000
			10,000	10,000
Less current portion			–	–
			$ 10,000	$ 10,000

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

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

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

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

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

17

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

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

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

Note 11 – Stock–Based Compensation

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

The 2005 and 2010 Stock–Based Compensation Plans

The Compensation Committee of the Board of Directors ("the Committee") has the authority to select the participants to be granted options; to designate whether the option granted is an incentive stock option ("ISO"), a non–qualified option, or a stock appreciation right; to establish the number of shares of common stock that may be issued upon exercise of the option; to establish the vesting provision for any award; and to establish the term any award may be outstanding. The exercise price of any ISO's granted will not be less than the fair market value of the shares of common stock on the date granted and the term of an ISO may not be any more than ten years. The exercise price of any non–qualified options granted will not be less than the fair market value of the shares of common stock on the date granted unless so determined by the Committee.

In May 2005, our stockholders approved the 2005 Stock Option, Employee Stock Purchase, Physician Stock Purchase and Stock Appreciation Rights Plan ("the 2005 Plan") pursuant to which 1,200,000 shares of our common stock were available to grant as stock–based payments to key employees, directors, and non–employee consultants. At September 30, 2012, 115,620 shares were available for future grants under the 2005 Plan.

In May 2010, our stockholders approved the 2010 Omnibus Equity Incentive Plan ("the 2010 Plan") pursuant to which 1,200,000 shares of our common stock were available to grant as stock–based payments to key employees, directors, and non–employee consultants. The shares granted during the nine months ended September 30, 2012 consisted of 45,000 shares to the Directors and 19,144 shares through the Employee Stock Purchase Plan. At September 30, 2012, 469,904 shares were available for future grants under the 2010 Plan.

Compensation expense is recognized only for the awards that ultimately vest. Stock–based compensation totaled $1,925,000 and $2,253,000 for the nine months ended September 30, 2012 and 2011, respectively. At September 30, 2012, we had $6,545,000 of unrecognized compensation cost related to unvested stock–based compensation awards, which consisted of $6,007,000 for stock options and $538,000 for restricted stock. This expense will be recognized over the remaining weighted average vesting period, which is approximately 3.4 years for stock options and 1.6 years for restricted stock. Stock–based compensation is included in "Salaries, wages and benefits" in the interim condensed consolidated statements of income.

Stock Options

The following table summarizes the significant assumptions used to value the options granted for the nine months ended September 30, 2012 and for the year ended December 31, 2011.

	2012	2011
Risk–free interest rate	0.27%	2.02%
Expected volatility	39.0%	23.7%
Expected life, in years	2.1 years	4.8 years
Expected dividend yield	2.91%	3.62%

The following table summarizes our outstanding stock options for the nine months ended September 30, 2012 and for the year ended December 31, 2011.

	Number of Shares		Weighted Average Exercise Price		Aggregate Intrinsic Value
Options outstanding at January 1, 2011	472,327	$	43.07	$	–
Options granted	1,264,719		46.58		–
Options exercised	(224,969)		37.30		–
Options cancelled or expired	(30,000)		44.25		–
Options outstanding at December 31, 2011	1,482,077		46.92		–
Options granted	64,244		44.26		–
Options exercised	(130,150)		45.79		–
Options cancelled or expired	(85,620)		52.50		–
Options outstanding at September 30, 2012	1,330,551	$	46.54	$	1,934,000
Options exercisable at September 30, 2012	228,407	$	46.13	$	706,000

Options Outstanding September 30, 2012	Exercise Prices	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life in Years
48,407	$37.70	$37.70	1.6
1,192,144	$42.99–$46.69	$46.53	3.4
90,000	$51.50	$51.50	0.6
1,330,551		$46.54	3.0

Restricted Stock

The following table summarizes our restricted stock activity for the nine months ended September 30, 2012 and for the year ended December 31, 2011.

	Number of Shares		Weighted Average Grant Date Fair Value		Aggregate Intrinsic Value
Non–vested restricted shares at January 1, 2011	30,000	$	34.46	$	–
Award shares granted	–		–		–
Award shares vested	(6,000)		34.46		–
Non–vested restricted shares at December 31, 2011	24,000		34.46		–
Award shares granted	–		–		–
Award shares vested	(6,000)		34.46		–
Non–vested restricted shares at September 30, 2012	18,000	$	34.46	$	239,000

The weighted average remaining contractual life of restricted stock at September 30, 2012 is 1.6 years.

Note 12 – Accounting for Uncertainty in Income Taxes

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

At September 30, 2012, we had $11,908,000 of unrecognized tax benefits, composed of $8,204,000 of deferred tax assets and $3,704,000 of permanent differences. Accrued interest and penalties of $1,668,000 relate to unrecognized tax benefits at September 30, 2012. Unrecognized tax benefits of $3,704,000, net of federal benefit, at September 30, 2012, attributable to permanent differences, would favorably impact our effective tax rate if recognized. Accrued interest and penalties of $1,341,000 relate to these permanent differences at September 30, 2012. We do not expect to recognize significant increases or decreases in unrecognized tax benefits within the twelve months beginning September 30, 2012, except for the effect of decreases related to the lapse of statute of limitations estimated at $2,995,000, composed of temporary differences of $2,010,000, and permanent tax differences of $985,000. Interest and penalties of $575,000 relate to these temporary and permanent difference changes within 12 months beginning September 30, 2012.

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

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

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

Note 13 – 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 $103,202,000 and $98,732,000 at September 30, 2012 and December 31, 2011, respectively. This liability is classified as a current liability based on the uncertainty regarding the timing of potential payments. The liability is included in accrued risk reserves in the interim condensed consolidated balance sheets and is subject to adjustment for actual claims incurred. It is possible that these claims plus unasserted claims could exceed our insurance coverages and our reserves, which could have a material adverse effect on our consolidated financial position, results of operations and cash flows.

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

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

Workers' Compensation

For workers' compensation, we utilize a wholly–owned Tennessee domiciled property/casualty insurance company to write coverage for NHC affiliates and for third–party customers. Policies are written for a duration of twelve months and cover only risks related to workers' compensation losses. All customers are companies which operate in the 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 are covered by reinsurance.

For these workers' compensation insurance operations, the premium revenues reflected in the interim condensed consolidated statements of income within "Other Revenues" for the nine months ended September 30, 2012 and 2011, respectively, are $4,094,000 and $3,894,000. Associated losses and expenses are reflected in the interim condensed consolidated statements of income as "Salaries, wages and benefits."

General and Professional Liability Lawsuits and Insurance

The long term care industry has experienced increases in both the number of personal injury/wrongful death claims and in the severity of awards based upon alleged negligence by nursing facilities and their employees in providing care to residents. As of September 30, 2012, we and/or our managed centers are currently defendants in 21 such claims covering the years 2005 through September 30, 2012.

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

Insurance coverage for all years includes both primary policies and excess policies. Beginning in 2003, both primary and excess coverage is provided through our wholly–owned insurance company. The primary coverage is in the amount of $1.0 million per incident, $3.0 million per location with an annual primary policy aggregate limit that is adjusted on an annual basis. The excess coverage is $7.5 million annual excess in the aggregate applicable to years 2005–2007, $9.0 million annual excess in the aggregate for years 2008–2010 and $4.0 million excess per occurrence for 2011–2012.

Beginning in 2008 and continuing through September 30, 2012, additional insurance is purchased through third party providers that serve to supplement the coverage provided through our wholly–owned captive insurance company.

For these professional liability insurance operations, the premium revenues reflected in the interim condensed consolidated statements of income as "Other Revenues" for the nine months ended September 30, 2012 and 2011, respectively, are $3,152,000 and $3,287,000. Associated losses and expenses including those for self–insurance are included in the interim condensed consolidated statements of income as "Other operating costs and expenses".

Litigation

On September 4, 2012, SeniorTrust of Florida, Inc. ("SeniorTrust"), a Tennessee non-profit corporation, and ten non-profit limited liability company subsidiaries of SeniorTrust (the "SeniorTrust Subsidiaries") filed a lawsuit against the Company and another party. NHC continues to provide management services to SeniorTrust and to the SeniorTrust Subsidiaries. NHC has provided management services to these entities since 2005.

The complaint of SeniorTrust and the SeniorTrust Subsidiaries alleges that the Company and another party exercised dominion and control over SeniorTrust, the SeniorTrust Subsidiaries and their board of directors for a period prior to sometime in 2008 and that the Company and another party used that control to cause one of

SeniorTrust Subsidiaries to enter into sale, purchase, financing and management transactions with the Company and another party on terms adverse to SeniorTrust and one or more SeniorTrust Subsidiaries. As part of its complaint, SeniorTrust and the SeniorTrust Subsidiaries seek a declaratory judgment and assert claims for breach of fiduciary duty, fraud, conflict of interest, conversion, and unjust enrichment. They claim that they have sustained substantial compensatory and punitive damages.

The Company adamantly denies the claims made by SeniorTrust and the SeniorTrust Subsidiaries and intends to vigorously defend against their complaint.

Other Matters

On July 24, 2009, the Company received a civil investigative demand from the Tennessee Attorney General's Office, requesting production of documents related to NHC's business relationships with non–profit entities. The Company has responded to the demand and complied as required with the terms of the demand.

Note 14 – Assignment of Hospice Business and Additional Ownership Acquisition in Caris

On January 1, 2012, we assigned our membership interest in Solaris Hospice to Caris in exchange for an additional 2.7% limited partnership interest. At January 1, 2012, the carrying value of the assets and liabilities of the eight Solaris Hospice entities was $4,311,000. In accordance with ASC 810, *Consolidation*, the carrying values were reclassified to "investments in limited liability companies" in our interim condensed consolidated balance sheets. Of the carrying values that were reclassified, $2,945,000 was previously recorded goodwill.

On June 1, 2012, we acquired an additional 7.5% limited partnership interest in Caris for $7.5 million. As of September 30, 2012, we have a 75.1% non–controlling ownership interest in the equity method investment.

Consolidation Considerations

Due to our increased ownership percentage in Caris, we have considered whether Caris should be consolidated by NHC under the guidance provided in ASC Topic 810, *Consolidation*. We do not consolidate Caris because (1) Caris' equity at risk is sufficient to finance its activities without additional subordinated financial support, (2) the general

partner of the Partnership has the power to direct the activities that most significantly impact the economic performance of Caris, and (3) the equity holders of Caris possess the characteristics of a controlling financial interest, including voting rights that are proportional to their economic interests. Supporting the assertions above is the following: (1) the ownership percentage of the general partner did not change and remains equally divided between NHC and another party, (2) the general partner manages and controls the Partnership with full and complete discretion, and (3) the limited partners have no right or power to take part in the control of the business of the Partnership, which is where our ownership percentage increase occurred.

Item 2.

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

Overview

National HealthCare Corporation ("NHC" or the "Company") is a leading provider of long–term health care services. We operate or manage, through certain affiliates, 75 long–term health care centers with 9,460 beds in 10 states and provide other services in one additional state. 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, homecare programs, assisted living centers and independent living centers. In addition, we provide insurance services, management and accounting services, and lease properties to operators 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.

Medicare Reimbursement Rate Changes

In July 2011, the Centers for Medicare and Medicaid Services ("CMS") announced a final rule reducing Medicare skilled nursing facility PPS payments in fiscal year 2012 by $3.87 billion, or 11.1% lower than payments for fiscal year 2011. We estimated the resulting decrease in revenue from the fiscal year 2012 Medicare rate changes to be approximately $24,000,000 annually, or $6,000,000 quarterly. Furthermore, changes in government requirements for providing therapy services were estimated to increase our operating costs by approximately $6,000,000 annually, or $1,500,000 per quarter. We implemented and continue to implement cost saving measures to help mitigate a portion of the revenue decrease and cost increase, but we are also committed to maintaining the quality of care to our patients.

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

Development and Growth

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

Type of Operation	Description	Size	Location	Placed in Service
Assisted Living	New Facility	75 Units	Columbia, SC	May, 2011

Assisted Living	Addition	46 Units	Franklin, TN	June, 2011
Hospice	Acquisition	Additional 7.5% interest in Caris HealthCare LP	Knoxville, TN	December, 2011
Hospice	Acquisition	Additional 7.5% interest in Caris HealthCare LP	Knoxville, TN	June, 2012

In August 2012, we began construction on a 90–bed skilled nursing facility in Tullahoma, Tennessee. This facility is expected to be completed during the third quarter of 2013. Also, in the fourth quarter of 2012, we expect to begin construction on a 50–bed skilled nursing addition to NHC Lexington in Lexington, South Carolina. In 2013 we expect to begin construction on a 92-bed skilled nursing facility in Sumner County, Tennessee.

During 2012, we will apply for Certificates of Need for additional beds in our markets and also evaluate the feasibility of expansion into new markets by building private pay health care centers or by the purchase of existing health care centers. We will also evaluate the feasibility of construction of new assisted living facilities in select markets.

Accrued Risk Reserves

Our accrued professional liability reserves, workers’ compensation reserves and health insurance reserves totaled $103,202,000 at September 30, 2012 and are a primary area of management focus. We have set aside

restricted cash and cash equivalents and marketable securities to fund substantially all of our professional liability and workers' compensation liabilities.

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

Application of Critical Accounting Policies

There have been no significant changes during the nine month period ended September 30, 2012 to the items we disclosed as our critical accounting policies and estimates in our discussion and analysis of financial condition and results of operations in our December 31, 2011 Annual Report on Form 10–K filed with the SEC.

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 sought to achieve a balanced federal budget by, among other things, reducing federal spending on Medicare and Medicaid to various providers. The Balanced Budget Act of 1997 defined the Medicare Prospective Payment System ("PPS") and this system has subsequently been refined in 1999, 2000, 2005, 2006 and 2010.

Federal Health Care Reform

In March 2010, President Obama signed into law the Patient Protection and Affordable Care Act ("PPACA" or, commonly, "ACA") and the Health Care and Education Reconciliation Act of 2010 ("HCERA"), which represents significant changes to the current U.S. health care system (collectively the "Acts"). The primary goals of the Acts are

to: (1) expand coverage to Americans without health insurance, (2) reform the delivery system to improve quality and drive efficiency, (3) and to lower the overall costs of providing health care. The timeline of the enacted provisions span over several years – some of the provisions were effective immediately in 2010 and others will be phased in through 2020. We have evaluated the Acts as they currently stand and do not expect material effects on our results of operations, liquidity and cash flows in 2012.

In August 2011 and pursuant to the Budget Control Act of 2011, Congress created a 12–member bipartisan committee called the Joint Select Committee on Deficit Reduction, or the Joint Committee. The Joint Committee was charged with issuing a formal recommendation by November 23, 2011 on how to reduce the federal deficit by at least $1.5 trillion over the next ten years. The Committee concluded their work in November and was not able to reach a bipartisan agreement before the Committee's deadline period. This failure by the Committee is scheduled to trigger automatic reductions in discretionary and mandatory spending starting in 2013, including reductions of not more than 2% to payments to Medicare providers. We are unable to predict the financial impact, if enacted, of the automatic payment cuts beginning in 2013. However, such impact may be adverse and material to our future results of operations and cash flows.

In June 2012, the U.S. Supreme Court issued its ruling on the constitutionality of a key provision in the ACA, which is the requirement that every American maintain a minimum level of health coverage or pay a penalty beginning in 2014. The Supreme Court upheld the constitutionality of the "individual mandate", holding that the penalty for not doing so could reasonably be interpreted as a tax, which the Constitution permits. The ruling also permits the federal government to pursue a broad expansion of the Medicaid program, but the ruling gives the states the maximum flexibility on whether to do so. In preparation for the Medicaid coverage expansion to occur in 2014, the current Administration is expected to release a host of regulations and an array of new taxes and fees. It is

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uncertain at this time the effect the Acts, their modifications, or Medicaid expansion will have on our future results of operations or cash flows.

Medicare

In July 2011, CMS issued a final rule providing a net 11.1% reduction in PPS payments to skilled nursing facilities for CMS's fiscal year 2012 (which began October 1, 2011) as compared to PPS payments in CMS's fiscal year 2011. The final 2012 CMS rule also adjusted the method by which group therapy is counted for reimbursement purposes, and changes the timing in which patients who are receiving therapy must be reassessed for purposes of determining their RUG category. We anticipated that, assuming other factors remained constant, the resulting decrease in revenue from the fiscal year 2012 Medicare rate changes would be approximately $24,000,000 annually, or $6,000,000 per quarter. Furthermore, changes in government requirements for providing therapy services were estimated to increase our operating costs by approximately $6,000,000 annually, or $1,500,000 per quarter. We implemented and continue to implement cost saving measures to help mitigate the effects of a portion of the revenue decrease and cost increase, but we are also committed to maintaining the quality of care to our patients.

For the first nine months of 2012, our average Medicare per diem rate decreased 6.9% compared to the same period in 2011. The decrease is due to the October 1, 2011 rate reductions, but partially offset by the increased acuity levels of the patients in our skilled nursing centers. The PPS rates had a net market basket increase of 2.3% for CMS’s fiscal year 2011.

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

Effective January 1, 2012, CMS issued a final ruling for homecare programs which stated an approximate 2.4% rate reduction from the 2011 HH PPS rates. The 2.4% rate reduction impacts individual providers unevenly. Per the final ruling, providers with high volume of therapy cases may see greater net rate reductions while others with non–therapy patients may see a negligible overall reduction in revenue or a slight increase. We estimate the effect of the revenue decrease for NHC homecare programs to be approximately $2,600,000 annually, or $650,000 per quarter.

Medicaid

Beginning January 1, 2012, the state of Tennessee implemented a 4.25% rate reduction for their Medicaid program. On May 14, 2012 and effective retroactively to January 1, 2012, Tennessee's legislation voted to restore 1.75% of the 4.25% rate reduction; thus leaving a net 2.5% rate reduction for the first six months of 2012. Effective July 1, 2012 and for the fiscal year 2013, the state of Tennessee implemented specific individual nursing facility rate increases. We estimate the resulting increase in revenue for the fiscal year 2013 will be approximately $3,500,000 annually, or $875,000 per quarter.

In February 2012 and effective retroactively to October 1, 2011, the state of Missouri's Medicaid program announced a net $6.00 per patient day increase in their Medicaid rates. We estimate the resulting increase in revenue will be approximately $1,720,000 annually, or $430,000 per quarter. There will be no rate increase or decrease implemented as of October 1, 2012 for the Medicaid program in the state of Missouri.

There was no rate increase or decrease implemented for the fiscal year beginning October 1, 2011 for the Medicaid program in the state of South Carolina. Effective October 1, 2012 and for the fiscal year 2013, South Carolina implemented specific individual nursing facility rate increases. We estimate the resulting increase in revenue beginning October 1, 2012 will be approximately $1,660,000 annually, or $415,000 per quarter.

For the first nine months of 2012, our average Medicaid per diem overall increased by 0.8% compared to the same period in 2011. We face challenges with respect to states' Medicaid payments because many states 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. 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.

Results of Operations

Three Months Ended September 30, 2012 Compared to Three Months Ended September 30, 2011

Results for the three month period ended September 30, 2012 include a 3.9% decrease in net operating revenues and a 1.6% increase in income before income taxes compared to the same period in 2011.

The total census at owned and leased long–term health care centers for the quarter averaged 89.7% compared to an average of 90.5% for the same quarter a year ago.

Medicare and Managed Care per diem rates decreased 8.6% and 3.0%, respectively, compared to the quarter a year ago. Medicaid and private pay per diem rates increased 2.4% and 2.6%, respectively, compared to the quarter a year ago. The Medicare per diem rate decrease is due to the 11.1% rate reduction in fiscal year 2012, but is partially offset by the increased acuity levels of our patients.

Net patient revenues decreased $6,773,000 or 3.7% compared to the same period last year. In addition to our Medicare per diem rates decreasing, the remaining decrease in net patient revenues is due from the assignment of our Solaris Hospice business to Caris effective January 1, 2012. There was $3,514,000 of net patient revenues recorded for the Solaris Hospice entities for the three months ended September 30, 2011. The increase in our earnings in equity recorded from Caris is presented in “non–operating income” in our interim condensed consolidated statements of income.

Other revenues decreased $923,000 or 6.2% in the three month 2012 period to $14,007,000 from $14,930,000 in the 2011 three–month period. The decrease in other revenues is primarily due to the decreased collections of management and accounting services fees of $788,000, as further detailed in Note 3 of our interim condensed consolidated financial statements.

Total costs and expenses for the 2012 third quarter compared to the 2011 third quarter decreased $6,423,000 or 3.6% to $172,697,000 from $179,120,000. Salaries, wages and benefits, the largest operating costs of our company, decreased $26,000 to $106,844,000 from $106,870,000. Other operating expenses decreased $6,288,000 or 11.5% to $48,519,000 for the 2012 period compared to $54,807,000 for the 2011 period. Facility rent expense decreased $187,000 or 1.9% to $9,813,000. Depreciation and amortization increased 1.3% to $7,402,000.

The increase in salaries, wages and benefits is primarily due to the increased costs for therapist services of $1,550,000. The assignment of our Solaris Hospice entities to Caris decreased salaries and wages $1,516,000 compared to same period a year ago, which offset the increase in therapy services.

The decrease in other operating expenses is primarily due to the cost saving measures implemented at our skilled nursing facilities ($1,929,000). We also had favorable results within our accrued risk reserves of $2,495,000 compared to the same period a year ago. The assignment of our Solaris Hospice entities to Caris decreased other operating expenses $1,538,000 compared to the same period a year ago.

Non–operating income increased by $1,631,000 to $6,771,000 in the three month 2012 period in comparison to $5,140,000 for the three month 2011 period, as further detailed in Note 4 to our interim condensed consolidated financial statements. The increase ($1,623,000) is primarily due to our investment in Caris, including our increased non–controlling ownership interest effective January 1, 2012 and June 1, 2012.

The income tax provision for the three months ended September 30, 2012 is $6,209,000 (an effective income tax rate of 26.5%). The income tax provision and effective tax rate for the three months ended September 30, 2012 were unfavorably impacted by adjustments to unrecognized tax benefits of $193,000 and permanent differences including nondeductible expenses of $208,000 resulting in an increase in the provision. The income tax provision and effective tax rate for 2012 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of $3,187,000 or 13.6% of income before taxes in 2012. The income tax provision for the three months ended September 30, 2011 was $5,873,000 (an effective tax rate of 25.4%). The income tax provision and effective tax rate for the three months ended September 30, 2011 were unfavorably impacted by adjustments to unrecognized tax benefits resulting in an increase in the provision of $23,000 or 0.1% of income before taxes. The income tax provision and effective tax rate for 2011 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of $3,226,000 or 14% of income before taxes in 2011.

Nine Months Ended September 30, 2012 Compared to Nine Months Ended September 30, 2011

Results for the nine month period ended September 30, 2012 include a 2.3% decrease in net operating revenues and a 12.2% decrease in income before income taxes compared to the same period in 2011. For comparative purposes, other operating expenses for the 2011 nine month period included favorable results within our accrued risk reserves of $10,500,000. Excluding this adjustment, the nine months ended September 30, 2012 would have reflected an increase in income before income taxes of $1,225,000, or 1.9%, over the same period in 2011.

The total census at owned and leased long–term health care centers for the nine months averaged 90.3% compared to an average of 90.7% for the same period a year ago.

Medicare and Managed Care per diem rates decreased 6.9% and 2.8%, respectively, compared to the nine month period a year ago. Medicaid and private pay per diem rates increased 0.8% and 2.4%, respectively, compared to the nine month period a year ago. The Medicare per diem rate decrease is due to the 11.1% rate reduction in fiscal year 2012, but is partially offset by the increased acuity levels of our patients.

Net patient revenues decreased $11,320,000 or 2.1% compared to the same period last year. In addition to our Medicare per diem rates decreasing, the remaining decrease in net patient revenues is due from the assignment of our Solaris Hospice business to Caris effective January 1, 2012. There was $10,242,000 of net patient revenues recorded for the Solaris Hospice entities for the nine months ended September 30, 2011. The increase in our earnings in equity recorded from Caris is presented in "non–operating income" in our interim condensed consolidated statements of income. The two newly constructed assisted living communities that were placed in service during the second quarter of 2011 helped increase net patient revenues approximately $3,610,000.

Other revenues decreased $2,256,000 or 5.1% in the 2012 nine month period to $42,008,000 from $44,264,000 in the 2011 nine month period. The decrease in other revenues is primarily due to the decreased collections of management and accounting services fees of $1,432,000, as further detailed in Note 3 of our interim condensed consolidated financial statements.

Total costs and expenses for the 2012 nine months compared to the 2011 period decreased $611,000 or 0.1% to $519,319,000 from $519,930,000. Salaries, wages and benefits, the largest operating costs of our company, decreased $2,397,000 or 0.7% to $318,028,000 from $320,425,000. Other operating expenses increased $1,187,000 or 0.8% to $149,271,000 for the 2012 period compared to $148,084,000 for the 2011 period. Facility rent expense decreased $237,000 or 0.8% to $29,507,000. Depreciation and amortization increased 3.9% to $22,168,000.

The decrease in salaries, wages and benefits is primarily due to the cost saving measures implemented at our skilled nursing facilities ($5,829,000). The assignment of our Solaris Hospice entities to Caris also decreased salaries and wages $4,447,000 compared to same period in 2011. We had increased costs for therapist services of $6,144,000, which offsets these decreases.

As discussed above, the increase in other operating expenses is primarily due to the 2011 nine month period having a favorable adjustment within the accrued risk reserves of $10,500,000, thus lowering the prior year expense by this amount. Excluding this adjustment, other operating expenses for the 2012 nine month period would

have decreased $9,313,000. The decrease in other operating expenses is primarily due to the assignment of our Solaris Hospice entities to Caris, which decreased expenses $4,311,000 compared to same period in 2011. Our skilled nursing centers also decreased other operating expenses ($2,406,000) and we had favorable results within our accrued risk reserves ($3,129,000) compared to the same period a year ago.

Non–operating income increased by $3,690,000 to $18,546,000 in the 2012 nine month period in comparison to $14,856,000 for the same period a year ago, as further detailed in Note 4 to our interim condensed consolidated financial statements. The increase ($2,910,000) is primarily due to our investment in Caris, including our increased non–controlling ownership interest effective January 1, 2012 and June 1, 2012.

The income tax provision for the nine months ended September 30, 2012 is $22,923,000 (an effective income tax rate of 34.5%). The income tax provision and effective tax rate for the nine months ended September 30, 2012 were unfavorably impacted by adjustments to unrecognized tax benefits of $218,000 and permanent differences including nondeductible expenses of $348,000 resulting in an increase in the provision. The income tax provision and effective tax rate for 2012 were favorably impacted by statute of limitations expirations resulting in a benefit to the provision of $3,187,000 or 4.8% of income before taxes in 2012. The income tax provision for the nine months ended September 30, 2011 was $26,175,000 (an effective tax rate of 34.6%). The income tax provision and effective tax rate for the nine months ended September 30, 2011 were favorably impacted by adjustments to unrecognized tax benefits resulting in a decrease in the provision of $45,000 or 0.1% of income before taxes. The income tax provision and effective tax rate for the nine months ended September 30, 2011 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of $3,226,000 or 4.3% of income before taxes in 2011.

Liquidity, Capital Resources, and Financial Condition

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

	Nine Months Ended			
	September 30		Nine Month Change	
	2012	2011	$	%
Cash and cash equivalents at beginning of period	$ 61,008	$ 28,478	$ 32,530	114.2%

Cash provided by operating activities	60,118	53,774	6,344	11.8%
Cash used in investing activities	(24,286)	(17,782)	(6,504)	(36.6)%
Cash used in financing activities	(13,133)	(11,312)	(1,821)	(16.1)%
Cash and cash equivalents at end of period	$ 83,707	$ 53,158	$ 30,549	57.5%

Operating Activities

Net cash provided by operating activities for the nine months ended September 30, 2012 was $60,118,000 as compared to $53,774,000 in the same period last year. Cash provided by operating activities consisted of net income of $43,523,000, adjustments for non–cash items of $20,855,000, and $4,260,000 used for working capital.

Cash used for working capital primarily consisted of an increase of restricted cash and cash equivalents of $6,270,000 and decreases in accounts payable of $4,288,000. The increase in restricted cash and cash equivalents is from NHC and other healthcare entities paying insurance premiums into NHC insurance companies, which restrict the cash payment. The decrease in accounts payable is due to the timing of payments.

Investing Activities

Cash used in investing activities totaled $24,286,000 and $17,782,000 for the nine months ended September 30, 2012 and 2011, respectively. Cash used for property and equipment additions was $14,888,000 for the nine months ended September 30, 2012 and $17,881,000 in the comparable period in 2011. In June 2012, we acquired an additional 7.5% non-controlling ownership interest in Caris for $7,500,000. Cash provided by net collections of notes receivable was $336,000 in 2012 compared to $1,573,000 in 2011. Purchases and sales of restricted marketable securities resulted in a net use of cash of $2,234,000 for the 2012 period compared to $1,474,000 for the 2011 period.

Financing Activities

Net cash used in financing activities totaled $13,133,000 and $11,312,000 for the nine months ended September 30, 2012 and 2011, respectively. Cash used for dividend payments to common and preferred stockholders totaled $19,039,000 in the current year period compared to $18,313,000 for the same period a year ago. In the current period, $5,960,000 of cash was provided by the issuance of common stock. In the prior period, cash of $7,152,000 was provided by the issuance of common stock.

Table of Contractual Cash Obligations

Our contractual cash obligations for periods subsequent to September 30, 2012 are as follows *(in thousands)*:

	Total	1 year	1–3 Years	3–5 Years	After 5 Years
Long–term debt – principal	$ 10,000	$ –	$ –	$ –	$ 10,000
Long–term debt – interest	1,450	276	553	553	68
Operating leases	311,725	33,700	67,400	67,400	143,225
Obligations to complete construction	9,145	9,145	–	–	–
Total contractual cash obligations	$ 332,320	43,121	67,953	67,953	153,293

Other noncurrent liabilities for uncertain tax positions of $3,704,000, attributable to permanent differences, at September 30, 2012 has not been included in the above table because of the inability to estimate the period in which the tax payment is expected to occur. See Note 12 of the interim condensed consolidated financial statements for a discussion on income taxes.

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

Short–term liquidity

We expect to meet our short–term liquidity requirements primarily from our cash flows from operating activities. In addition to cash flows from operations, our current cash on hand of $83,707,000 at September 30, 2012, marketable securities of $98,000,000 at September 30, 2012 and as needed, our borrowing capacity, are expected to be adequate to meet our contractual obligations and to finance our operating requirements and our growth and development plans in the next twelve months. We currently do not have any funds drawn against our revolving credit agreement and the amount of $75,000,000 is available to be drawn for general corporate purposes, including working capital and acquisitions.

Long–term liquidity

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

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

Commitment and Contingencies

Litigation

On September 4, 2012, SeniorTrust of Florida, Inc. ("SeniorTrust"), a Tennessee non-profit corporation, and ten non-profit limited liability company subsidiaries of SeniorTrust (the "SeniorTrust Subsidiaries") filed a lawsuit against the Company and another party. NHC continues to provide management services to SeniorTrust and to the SeniorTrust Subsidiaries. NHC has provided management services to these entities since 2005.

The complaint of SeniorTrust and the SeniorTrust Subsidiaries alleges that the Company and another party exercised dominion and control over SeniorTrust, the SeniorTrust Subsidiaries and their board of directors for a period prior to sometime in 2008 and that the Company and another party used that control to cause one of SeniorTrust Subsidiaries to enter into sale, purchase, financing and management transactions with the Company and another party on terms adverse to SeniorTrust and one or more SeniorTrust Subsidiaries. As part of its complaint, SeniorTrust and the SeniorTrust Subsidiaries seek a declaratory judgment and assert claims for breach of fiduciary duty, fraud, conflict of interest, conversion, and unjust enrichment. They claim that they have sustained substantial compensatory and punitive damages.

The Company adamantly denies the claims made by SeniorTrust and the SeniorTrust Subsidiaries and intends to vigorously defend against their complaint.

Governmental Regulations

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

Acquisitions

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

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covering such matters, there can be no assurance that any specific matter will be covered by such indemnifications, or if covered, that such indemnifications will be adequate to cover potential losses and fines.

Inflation

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

Other Matters

On July 24, 2009, the Company received a civil investigative demand from the Tennessee Attorney General's Office, requesting production of documents related to NHC's business relationships with non–profit entities. The Company has responded to the demand and complied as required with the terms of the demand.

New Accounting Pronouncements

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

Forward–Looking Statements

References throughout this document to the Company include National HealthCare Corporation and its wholly–owned subsidiaries. In accordance with the Securities and Exchange Commissions "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 on 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 stateme

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:

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

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

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

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

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

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the ability to attract and retain qualified personnel;

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

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the ability to refinance existing debt on favorable terms;

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the competitive environment in which we operate;

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the ability to maintain and increase census levels; and

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demographic changes.

See the notes to the quarterly financial statements, and "Item 1. Business" in our 2011 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. You should carefully consider these risks before making any investment in the Company. These risks and uncertainties are not the only ones facing us. There may be additional risks that we do not presently know of or that we currently deem immaterial. If any of the risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our shares of stock could decline, and you may lose all or part of your investment. Given these risks and uncertainties, we can give no assurances that these forward–looking statements will, in fact, transpire and, therefore, caution investors not to place undue reliance on them.

Item 3.

Quantitative and Qualitative Disclosures About Market Risk.

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

Interest Rate Risk

The fair values of our fixed–income investments fluctuate in response to changes in market interest rates. Increases and decreases in prevailing interest rates generally translate into decreases and increases, respectively, in the fair values of those instruments. Additionally, the fair values of interest rate sensitive instruments may be affected by the creditworthiness of the issuer, prepayment options, the liquidity of the instrument and other general market conditions. At September 30, 2012, we have available for sale debt securities in the amount of $109,027,000. The fixed maturity portfolio is comprised of investments with primarily short–term and intermediate–term maturities. The portfolio composition allows flexibility in reacting to fluctuations of interest rates. The fixed maturity portfolio allows our insurance company subsidiaries to achieve an adequate risk–adjusted return while maintaining sufficient liquidity to meet obligations.

As of September 30, 2012, both our long–term debt and revolving credit facility bear interest at variable interest rates. Currently, we have long–term debt outstanding of $10.0 million and the revolving credit facility is zero. However, we do intend to borrow funds on our credit facility in the future. Based on a hypothetical credit facility borrowing of $75.0 million and our outstanding long–term debt, a 1% change in interest rates would change our annual interest cost by approximately $850,000.

Approximately $5.5 million of our notes receivable bear interest at variable rates (generally at the prime rate plus 2%). Because the interest rates of these instruments are variable, a hypothetical 1% change in interest rates would result in a related increase or decrease in interest income of approximately $55,000.

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

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

Credit Risk

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

Equity Price and Concentration Risk

Our available for sale equity securities are recorded at their fair market value based on quoted market prices. Thus, there is exposure to equity price risk, which is the potential change in fair value due to a change in quoted market prices. At September 30, 2012, the fair value of our equity marketable securities is approximately $98,000,000. Of the $98.0 million equity securities portfolio, our investment in National Health Investors, Inc. ("NHI") comprises approximately $83.9 million, or 85.6%, of the total fair value. We manage our exposure to NHI by closely monitoring the financial condition, performance, and outlook of the company. Hypothetically, a 10% change in quoted market prices would result in a related increase or decrease in the fair value of our equity investments of approximately $9.8 million. At September 30, 2012, our equity securities had unrealized gains of $71.3 million. Of the $71.3 million of unrealized gains, $59.1 million is related to our investment in NHI.

Item 4. Controls and Procedures.

As of September 30, 2012, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO") and Principal Accounting Officer ("PAO"), of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and PAO, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2012. There have been no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2012 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 13 of this Form 10–Q.

Item 1A. Risk Factors.

During the nine months ended September 30, 2012, 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, 2011.

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

Item 3. Defaults Upon Senior Securities. 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
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

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

NATIONAL HEALTHCARE CORPORATION
(Registrant)

Date: October 30, 2012

/s/ Robert G. Adams

Robert G. Adams
Chief Executive Officer

Date: October 30, 2012

/s/ Donald K. Daniel

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