HEALTH CARE PROPERTY INVESTORS INC
Form 10-Q
October 30, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**
	For the quarterly period ended September 30, 2006.
	OR
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the transition period from to

Commission file number 1-8895

HEALTH CARE PROPERTY INVESTORS, INC.

(Exact name of registrant as specified in its charter)

Maryland	**33-0091377**
(State or other jurisdiction of incorporation of organization)	(I.R.S. Employer Identification No.)

3760 Kilroy Airport Way, Suite 300
Long Beach, CA 90806
(Address of principal executive offices)

(562) 733-5100
(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 o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of Accelerated Filer and Large Accelerated Filer in Rule 12b-2 of the Exchange Act. (check one):
Large Accelerated Filer x Accelerated Filer o Non-accelerated Filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)
YES o NO x

As of October 23, 2006, there were 164,808,806 shares of $ 1.00 par value common stock outstanding.

HEALTH CARE PROPERTY INVESTORS, INC.

INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements:

Condensed Consolidated Balance Sheets

Condensed Consolidated Statements of Income

Condensed Consolidated Statement of Stockholders Equity

Condensed Consolidated Statements of Cash Flows

Notes to Condensed Consolidated Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

PART II. OTHER INFORMATION

Item 1A. Risk Factors

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Item 5. Other Information

Item 6. Exhibits

Signatures

HEALTH CARE PROPERTY INVESTORS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

	September 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Real estate:		
Buildings and improvements	$ 3,754,173	$ 3,365,869
Developments in process	19,822	22,286
Land	361,391	328,609
Less accumulated depreciation and amortization	657,552	573,767
Net real estate	3,477,834	3,142,997
Loans receivable, net:		
Joint venture partners	7,053	7,006
Others	138,258	179,825
Investments in and advances to unconsolidated joint ventures	49,757	48,598
Accounts receivable, net of allowance of $1,188 and $1,205, respectively	12,676	13,313
Cash and cash equivalents	645,363	21,342
Restricted cash	125,165	2,270
Intangibles, net	58,501	38,804
Real estate held for sale, net	27,964	98,855
Other assets, net	68,930	44,255
Total assets	$ 4,611,501	$ 3,597,265
LIABILITIES AND STOCKHOLDERS EQUITY		
Bank line of credit	$	$ 258,600
Senior unsecured notes	2,471,274	1,462,250
Mortgage debt	452,154	236,096
Accounts payable and accrued liabilities	89,371	68,718
Deferred revenue	31,372	22,551
Total liabilities	3,044,171	2,048,215
Minority interests:		
Joint venture partners	24,848	20,905
Non-managing member unitholders	127,763	128,379
Total minority interests	152,611	149,284
Stockholders equity:		
Preferred stock, $1.00 par value: 50,000,000 shares authorized; 11,820,000 shares issued and outstanding, liquidation preference of $25 per share	285,173	285,173
Common stock, $1.00 par value: 750,000,000 shares authorized; 137,560,108 and 136,193,764 shares issued and outstanding, respectively	137,560	136,194
Additional paid-in capital	1,478,990	1,446,349
Cumulative net income	1,697,419	1,521,146
Cumulative dividends	(2,179,535)	(1,988,248)
Accumulated other comprehensive loss	(4,888)	(848)

Total stockholders equity		1,414,719		1,399,766
Total liabilities and stockholders equity	$	4,611,501	$	3,597,265

See accompanying Notes to Condensed Consolidated Financial Statements.

HEALTH CARE PROPERTY INVESTORS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

(Unaudited)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Revenues and other income:				
Rental revenues and other income	$ 130,952	$ 111,948	$ 376,499	$ 316,796
Equity income (loss) from unconsolidated joint ventures	1,044	(531)	7,580	(232)
Interest and other income	7,601	7,807	29,709	18,998
	139,597	119,224	413,788	335,562
Costs and expenses:				
Interest	36,968	28,262	102,701	76,872
Depreciation and amortization	32,237	26,690	93,683	75,697
Operating	20,105	13,373	56,786	42,062
General and administrative	8,280	7,301	25,218	23,413
Impairments			3,087	
	97,590	75,626	281,475	218,044
Income before minority interests	42,007	43,598	132,313	117,518
Minority interests	(3,511)	(3,415)	(11,458)	(9,593)
Income from continuing operations	38,496	40,183	120,855	107,925
Discontinued operations:				
Operating income	2,594	4,585	10,441	14,444
Gain on sales of real estate, net of impairments	35,728	273	44,977	9,177
	38,322	4,858	55,418	23,621
Net income	76,818	45,041	176,273	131,546
Preferred stock dividends	(5,282)	(5,282)	(15,848)	(15,848)
Net income applicable to common shares	$ 71,536	$ 39,759	$ 160,425	$ 115,698
Basic earnings per common share:				
Continuing operations	$ 0.24	$ 0.26	$ 0.77	$ 0.69
Discontinued operations	0.28	0.03	0.41	0.17
Net income applicable to common shares	$ 0.52	$ 0.29	$ 1.18	$ 0.86
Diluted earnings per common share:				
Continuing operations	$ 0.24	$ 0.26	$ 0.77	$ 0.69
Discontinued operations	0.28	0.03	0.40	0.17
Net income applicable to common shares	$ 0.52	$ 0.29	$ 1.17	$ 0.86
Weighted average shares used to calculate earnings per common share:				

Basic	136,682	135,225	136,402	134,385
Diluted	143,538	136,135	139,195	135,291

See accompanying Notes to Condensed Consolidated Financial Statements.

HEALTH CARE PROPERTY INVESTORS, INC.

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(In thousands)

(Unaudited)

	Preferred Stock		Common Stock		Additional Paid-In	Cumulative		Accumulated Other Comprehensive	
	Shares	Amount	Shares	Amount	Capital	Net Income	Dividends	Loss	Total
December 31, 2005	11,820	$ 285,173	136,194	$ 136,194	$ 1,446,349	$ 1,521,146	$ (1,988,248)	$ (848)	$ 1,399,766
Exercise of stock options			360	360	5,926				6,286
Other issuances of common stock, net			1,006	1,006	20,655				21,661
Net income						176,273			176,273
Preferred stock dividends							(15,848)		(15,848)
Common stock dividends							(175,439)		(175,439)
Amortization of deferred compensation					6,060				6,060
Other comprehensive loss, net								(4,040)	(4,040)
September 30, 2006	11,820	$ 285,173	137,560	$ 137,560	$ 1,478,990	$ 1,697,419	$ (2,179,535)	$ (4,888)	$ 1,414,719

See accompanying Notes to Condensed Consolidated Financial Statements.

HEALTH CARE PROPERTY INVESTORS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended September 30,	
	2006	**2005**
Cash flows from operating activities:		
Net income	$ 176,273	$ 131,546
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of real estate and in-place lease intangibles:		
Continuing operations	93,683	75,697
Discontinued operations	2,142	3,410
Amortization of above and below market lease intangibles, net	(1,383)	(1,708)
Stock-based compensation	6,060	4,779
Debt issuance costs amortization	2,746	2,344
Recovery of loan losses		(56)
Straight-line rents	(7,436)	(4,651)
Equity (income) loss from unconsolidated joint ventures	(7,580)	232
Distributions of earnings from unconsolidated joint ventures	7,580	
Minority interests	11,458	9,593
Gain on sales of securities, net	(1,552)	(2,758)
Impairments	4,711	
Gain on sales of real estate, net	(46,601)	(9,177)
Changes in:		
Accounts receivable	637	1,327
Other assets	(6,898)	(1,405)
Accounts payable, accrued liabilities and deferred revenue	20,653	11,868
Net cash provided by operating activities	254,493	221,041
Cash flows from investing activities:		
Acquisition and development of real estate	(336,709)	(376,713)
Lease commissions and tenant and capital improvements	(12,003)	(4,474)
Net proceeds from sales of real estate	100,217	46,328
Distributions from unconsolidated joint ventures	161	6,712
Proceeds from the sale of securities	5,630	2,858
Purchase of securities	(12,895)	
Principal repayments on loans receivable	45,525	12,589
Investment in loans receivable	(4,005)	(9,787)
(Increase) decrease in restricted cash	(122,895)	2,288
Net cash used in investing activities	(336,974)	(320,199)
Cash flows from financing activities:		
Repayments of bank lines of credit	(258,600)	(130,100)
Repayment of mortgage debt	(20,399)	(15,295)
Issuance of mortgage debt	161,874	
Repayment of senior unsecured notes	(135,000)	(22,500)
Issuance of senior unsecured notes	1,142,877	445,471
Settlement of cash flow hedges	(4,354)	

Net proceeds from the issuance of common stock and exercise of options		21,686		39,788
Dividends paid on common and preferred stock		(191,287)		(185,866)
Net distributions to minority interests		(10,295)		(11,128)
Net cash provided by financing activities		706,502		120,370
Net increase in cash and cash equivalents		624,021		21,212
Cash and cash equivalents, beginning of period		21,342		16,962
Cash and cash equivalents, end of period	$	645,363	$	38,174

See accompanying Notes to Condensed Consolidated Financial Statements.

HEALTH CARE PROPERTY INVESTORS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Business

Health Care Property Investors, Inc. is a real estate investment trust (REIT) that, together with its consolidated entities (collectively, HCP or the Company), invests directly, or through joint ventures and mortgage loans, in healthcare related properties located throughout the United States.

(2) Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, the unaudited condensed consolidated financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, filed with the Securities and Exchange Commission (SEC).

Use of Estimates

Management is required to make estimates and assumptions in the preparation of financial statements in conformity with GAAP. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ.

Principles of Consolidation

The consolidated financial statements include the accounts of HCP, its wholly owned subsidiaries and its controlled, through voting rights or other means, joint ventures. All material intercompany transactions and balances have been eliminated in consolidation.

The Company applies Financial Accounting Standards Board (FASB) Interpretation No. 46R, *Consolidation of Variable Interest Entities*, as revised (FIN 46R), for entities in which control is achieved through means other than voting rights (variable interest entities or VIEs) and for the determination of which business enterprise is the primary beneficiary of the VIE. A variable interest entity is broadly defined as an entity where either (i) the equity investors as a group, if any, do not have a controlling financial interest or (ii) the equity investment at risk is insufficient to finance that entity s activities without additional financial support. The Company consolidates investments in VIEs when it is determined that the Company is the primary beneficiary of the VIE at either the creation of the variable interest entity or upon the occurrence of a reconsideration event.

The Company applies Emerging Issues Task Force (EITF) Issue 04-5, *Investor s Accounting for an Investment in a Limited Partnership When the Investor is the Sole General Partner and the Limited Partners Have Certain Rights* (EITF 04-5), in determining what rights held by the limited partner(s) preclude consolidation in circumstances in which the sole general partner would otherwise consolidate the limited partnership in accordance with GAAP. The assessment of limited partners rights and their impact on the presumption of control of the limited partnership by the sole general partner should be made when an investor becomes the sole general partner and should be reassessed if (i) there is a change to the terms or in the exercisability of the rights of the limited partners, (ii) the sole general partner increases or decreases its ownership of limited partnership interests, or (iii) there is an increase or decrease in the number of outstanding limited partnership interests. This EITF issue also applies to managing members in limited liability companies.

Investments in entities which the Company does not consolidate but for which the Company has the ability to exercise significant influence over operating and financial policies are reported under the equity method of accounting. Generally, under the equity method of accounting, the Company s share of the investee s earnings or losses is included in the Company s operating results.

Revenue Recognition

Rental income from tenants is recognized in accordance with GAAP, including SEC Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB 104). For leases with minimum scheduled rent increases, the Company recognizes income on a straight-line basis over the lease term when collectibility is reasonably assured. Recognizing rental income on a straight-line basis for leases results in recognized revenue exceeding amounts contractually due from tenants. Such cumulative excess amounts are included in other assets and were approximately $27 million and $18 million, net of allowances, at September 30, 2006 and December 31, 2005, respectively. In the event the Company determines that collectibility of straight-line rents is not reasonably assured, the Company limits future recognition to amounts contractually owed, and, where appropriate, the Company establishes an allowance for estimated losses. Certain leases provide for additional rents based upon a percentage of the facility s revenue in excess of specified base periods or other thresholds. Such revenue is deferred until the related thresholds are achieved.

The Company monitors the liquidity and creditworthiness of its tenants and borrowers on an ongoing basis. The evaluation considers industry and economic conditions, property performance, security deposits and guarantees, and other matters. The Company establishes provisions and maintains an allowance for estimated losses resulting from the possible inability of its tenants and borrowers to make payments sufficient to recover recognized assets. For straight-line rent amounts, the Company s assessment is based on income recoverable over the term of the lease. At September 30, 2006 and December 31, 2005, the Company had an allowance of $26 million and $22 million, respectively, included in other assets, as a result of the Company s determination that collectibility is not reasonably assured for certain straight-line rent amounts.

Loans Receivable

Loans receivable are classified as held-to-maturity because the Company has the positive intent and ability to hold the securities to maturity. Held-to-maturity securities are stated at amortized cost. The Company recognizes interest income on loans, including the amortization of discounts and premiums, using the effective interest method.

Real Estate

Real estate, consisting of land, buildings, and improvements, is recorded at cost. The Company allocates acquisition costs to the acquired tangible and identified intangible assets and liabilities, primarily lease intangibles, based on their estimated fair values in accordance with Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*.

The Company assesses fair value based on estimated cash flow projections that utilize appropriate discount and/or capitalization rates, third party appraisals and available market information. Estimates of future cash flows are based on a number of factors including historical operating results, known and anticipated trends, and market and economic conditions. The fair value of the tangible assets of an acquired property considers the value of the property as if it were vacant.

The Company records acquired above- and below-market leases at their fair value using a discount rate which reflects the risks associated with the leases acquired, equal to the difference between (i) the contractual amounts to be paid pursuant to each in-place lease and (ii) management s estimate of fair market lease rates for each corresponding in-place lease, measured over a period equal to the remaining term of the lease for above-market leases and the initial term plus the term for any below-market fixed rate renewal options for below-market leases. Other intangible

assets acquired include amounts for in-place lease values that are based on the Company s evaluation of the specific characteristics of each tenant s lease. Factors to be considered include estimates of carrying costs during hypothetical expected lease-up periods, market conditions, and costs to execute similar leases. In estimating carrying costs, the Company includes real estate taxes, insurance and other operating expenses, and estimates of lost rentals at market rates during the expected lease-up periods, depending on local market conditions. In estimating costs to execute similar leases, the Company considers leasing commissions, legal and other related costs.

Real estate assets and related intangibles are periodically reviewed for potential impairment by comparing the carrying amount to the expected undiscounted future cash flows to be generated from the assets. If the sum of the expected future net undiscounted cash flows is less than the carrying amount of the property, the Company will recognize an impairment loss by adjusting the asset s carrying amount to its estimated fair value. Fair value for properties to be held and

used is based on the present value of the future cash flows expected to be generated from the asset. Properties held for sale are recorded at the lower of their carrying amount or fair value less costs to dispose.

Developments in process are carried at cost, which includes pre-construction costs essential to the development of the property, construction costs, capitalized interest, and other costs directly related to the property. Capitalization of interest ceases when the property is ready for service, which generally is near the date that a certificate of occupancy is obtained. Expenditures for tenant improvements and leasing commissions are capitalized and amortized over the terms of the respective leases. Repairs and maintenance costs are expensed as incurred.

The Company computes depreciation on properties using the straight-line method over the assets estimated useful lives. Depreciation is discontinued when a property is identified as held for sale. Buildings and improvements are depreciated over useful lives ranging up to 45 years. Above-and below-market rent intangibles are amortized primarily to revenue over the remaining noncancellable lease terms and bargain renewal periods. Other in-place lease intangibles are amortized to expense over the remaining lease terms and bargain renewal periods. At September 30, 2006 and December 31, 2005, lease intangible assets, net were $58.5 million and $38.8 million, respectively. At September 30, 2006 and December 31, 2005, lease intangible liabilities, net were $13.0 million and $5.3 million, respectively, and are included in deferred revenue.

Income Taxes

The Company has elected and believes it operates so as to qualify as a REIT under Sections 856 to 860 of the Internal Revenue Code of 1986, as amended (the Code). Under the Code, the Company generally is not subject to federal income tax on its taxable income distributed to stockholders if certain distribution, income, asset, and shareholder tests are met. A REIT must distribute at least 90% of annual taxable income to stockholders.

Certain activities the Company undertakes must be conducted by entities which elect to be treated as taxable REIT subsidiaries (TRSs). TRSs are subject to both federal and state income taxes. The Company s income tax expense for the nine months ended September 30, 2006 and 2005 was insignificant.

Discontinued Operations

Certain long lived assets are classified as discontinued operations in accordance with SFAS No. 144*, Accounting for the Impairment or Disposal of Long-Lived Assets (SFAS No. 144)*. Long-lived assets to be disposed of are reported at the lower of their carrying amount or their fair value less costs to sell. Further, depreciation of these assets ceases at the time the assets are classified as discontinued operations. Discontinued operations is defined in SFAS No. 144 as a component of an entity that has either been disposed of or is deemed to be held for sale if both the operations and cash flows of the component have been or will be eliminated from ongoing operations as a result of the disposal transaction, and the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.

The Company periodically sells assets based on market conditions and the exercise of purchase options by tenants. The operating results of properties meeting the criteria established in SFAS No. 144 are reported as discontinued operations in the Company s consolidated statements of income. Discontinued operations for the three and nine months ended September 30, 2006, include 20 and 28 properties with revenues of $3.2 million and $12.6 million, respectively. The Company had 38 and 46 properties classified as discontinued operations for the three and nine

months ended September 30, 2005, with revenues of $5.7 and $18.3 million, respectively. During the nine months ended September 30, 2006 and 2005, 12 properties were sold in each period, with net gains on real estate dispositions of $46.6 million and $9.2 million, respectively. At September 30, 2006 and December 31, 2005, the number of assets held for sale was 16 and 28 with carrying amounts of $28.0 million and $98.9 million, respectively, and are included in real estate held for sale, net on the Company s consolidated balance sheets.

Stock-Based Compensation

On January 1, 2002, the Company adopted the fair value method of accounting for stock-based compensation in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* (SFAS No. 148). The fair value provisions of SFAS No. 123 were adopted prospectively with the fair value of all new stock option grants recognized as compensation expense beginning January 1, 2002. Since only new grants are accounted for under the fair value method, stock-based

compensation expense is less than that which would have been recognized if the fair value method had been applied to all awards. Compensation expense for awards with graded vesting is generally recognized ratably over the period from the date of grant to the date when the award is no longer contingent on the employee providing additional services.

SFAS No. 123R, *Share-Based Payments* (SFAS No. 123R), which is a revision of SFAS No. 123*,* was issued in December 2004. Generally, the approach in SFAS No. 123R is similar to that in SFAS No. 123. However, SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. On January 1, 2006, the Company adopted SFAS No. 123R using the modified prospective application transition method which provides for only current and future period stock-based awards to be measured and recognized at fair value. The adoption of SFAS No. 123R did not have a significant impact on the Company s financial position or results of operations since the fair value provisions of SFAS No. 123 were adopted prospectively on January 1, 2002.

The following table reflects net income and earnings per share, adjusted as if the fair value based method had been applied to all outstanding stock awards (in thousands, except per share amounts):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	$ 45,041	$ 131,546
Add: Stock-based compensation expense included in reported net income	1,581	4,779
Deduct: Stock-based employee compensation expense determined under the fair value based method	(1,660)	(5,018)
Pro forma net income	$ 44,962	$ 131,307
Earnings per share:		
Basic as reported	$ 0.29	$ 0.86
Basic pro forma	$ 0.29	$ 0.86
Diluted as reported	$ 0.29	$ 0.86
Diluted pro forma	$ 0.29	$ 0.85

Cash and Cash Equivalents

Cash and cash equivalents represent short-term investments with original maturities of three months or less when purchased.

Restricted Cash

Restricted cash generally consists of amounts held by mortgage lenders to provide for future real estate tax expenditures and tenant improvements and security deposits. On September 30, 2006, restricted cash included amounts deposited into escrow in connection with the redemption of $120 million of the Company s senior unsecured notes due January 2007. The notes were redeemed on October 4, 2006.

Derivatives

The Company applies SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended by SFAS No. 137, SFAS No. 138 and SFAS No. 148 (SFAS No. 133), which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and hedging activities. It requires the recognition of all derivative instruments as assets or liabilities in the Company s condensed consolidated balance sheets at fair value. Changes in the fair value of derivative instruments that are not designated as hedges or that do not meet the hedge accounting criteria of SFAS No. 133 are recognized in earnings. For derivatives designated as hedging instruments in qualifying cash flow hedges, the effective portion of changes in fair value of the derivatives is recognized in accumulated

other comprehensive income (loss) whereas the ineffective portion is recognized in earnings.

The Company formally documents all relationships between hedging instruments and hedged items, as well as its risk-management objectives and strategy for undertaking various hedge transactions. This process includes linking all derivatives that are designated as cash flow hedges to specific assets and liabilities in the consolidated balance sheet. The Company also assesses and documents, both at the hedging instrument s inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in cash flows associated with the hedged items. When it is determined that a derivative ceases to be highly effective as a hedge, the Company discontinues hedge accounting prospectively.

Marketable Securities

The Company classifies its existing marketable equity securities as available-for-sale in accordance with the provisions of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS No. 115). These securities are carried at market value, with unrealized gains and losses reported in stockholders equity as a component of accumulated other comprehensive income (loss). Gains or losses on securities sold are based on the specific identification method. During the nine months ended September 30, 2006 and 2005, the Company received proceeds from the sale of securities for $5.6 million and $2.9 million and recognized gains of approximately $1.6 million and $2.8 million, respectively.

All debt securities are classified as held-to-maturity because the Company has the positive intent and ability to hold the securities to maturity. Held-to-maturity securities are stated at amortized cost, adjusted for amortization of premiums and accretion of discounts to maturity.

Segment Reporting

The Company reports its consolidated financial statements in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS No. 131). The Company s segments are based on the Company s method of internal reporting which classifies its operations by leasing activities. The Company s segments include: medical office buildings (MOBs) and triple-net leased facilities.

New Accounting Pronouncements

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS No. 154), which replaces Accounting Principles Board Opinion No. 20, *Accounting Changes* and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principles. It requires retrospective application to prior periods financial statements of changes in accounting principles, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. This statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 did not have a significant impact on the Company s financial position or results of operations.

In April 2006 the FASB issued FASB Staff Position FIN 46R-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46R* (FSP FIN 46R-6). FSP FIN 46R-6 addresses how variability should be considered when applying FIN 46R. Variability affects the determination of whether an entity is a VIE, which interests are variable interests, and which party, if any, is the primary beneficiary of the VIE that is required to be consolidated. FSP FIN 46R-6 clarifies that the design of the entity also should be considered when identifying which interests are variable interests. FSP FIN 46R-6 must be applied prospectively to all entities in which the Company first becomes involved, beginning September 1, 2006. Early application is permitted. The Company does not expect that the adoption of FSP FIN 46R-6 will have a material effect on the Company s financial position or results of operations.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). This interpretation, among other things, creates a two step approach for evaluating uncertain tax positions. Recognition (step one) occurs when an enterprise concludes that a tax position, based solely on its technical merits, is more-likely-than-not to be sustained upon examination. Measurement (step two) determines the amount of benefit that more-likely-than-not will be realized upon settlement. Derecognition of a tax position that was previously recognized would occur when a company

subsequently determines that a tax position no longer meets the more-likely-than-not threshold of being sustained. FIN 48 specifically prohibits the use of a valuation allowance as a substitute for derecognition of tax positions, and it has expanded disclosure requirements. FIN 48 is effective for fiscal years beginning after December 15, 2006, in which the impact of adoption should be accounted for as a cumulative effect adjustment to the beginning balance of retained earnings. The Company is evaluating FIN 48 and has not yet determined the impact the adoption will have on the Company s financial position or results of operations.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) Topic 1N, *Financial Statements Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). The SEC staff is providing guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. The SEC staff indicates that registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. If correcting a misstatement in the current year would materially misstate the current year s income statement, the SEC staff indicates that the prior year financial statements should be adjusted. These adjustments to prior year financial statements are necessary even though such adjustments were appropriately viewed as immaterial in the prior year. If the Company determines that an adjustment to prior year financial statements is required upon adoption of SAB 108 and does not elect to restate its previous financial statements, then it must recognize the cumulative effect of applying SAB 108 in fiscal 2007 beginning balances of the affected assets and liabilities with a corresponding adjustment to the fiscal 2007 opening balance in retained earnings. The Company does not expect that the impact of the guidance will have a material effect on the Company s financial position or results of operations.

Reclassifications

Certain reclassifications have been made for comparative financial statement presentation.

(3) Mergers with CNL Retirement Properties, Inc. and CNL Retirement Corp.

On May 1, 2006, HCP entered into a definitive merger agreement with CNL Retirement Properties, Inc (CRP). In connection with the proposed merger with CRP, HCP also entered into a definitive merger agreement with respect to CNL Retirement Corp. (CRC), the external advisor to CRP. On October 5, 2006, HCP closed its merger with CRP for aggregate consideration of approximately $5.3 billion. In the merger, HCP paid an aggregate of $2.9 billion of cash, issued 22.9 million shares of common stock, and assumed or refinanced approximately $1.7 billion of CRP s outstanding debt. Simultaneously, with the closing of the merger with CRP, HCP also closed its merger with CRC for aggregate consideration of approximately $120 million. In the CRC merger, HCP issued 4.4 million shares.

In connection with the CRP merger, HCP also obtained from a syndicate of banks a bridge loan, a term loan, and a revolving credit facility providing for aggregate borrowings of $3.4 billion.

See Note 8 for additional information on the new bridge, term and revolving credit facilities.

(4) Operator Concentration

Tenet Healthcare Corporation (Tenet) (NYSE: THC) and Brookdale Senior Living Inc. (Brookdale) (NYSE: BKD), or American Retirement Corporation (NYSE: ARC) prior to Brookdale s acquisition of ARC on July 25, 2006, accounted for 10% and 8%, respectively, of the Company s revenue during the nine months ended September 30, 2006, and accounted for 12% and 9% respectively, of the Company s revenue during the nine months ended September 30, 2005. The carrying amount of the Company s real estate assets leased to Tenet and Brookdale at September 30, 2006, was $335.2 million and $365.2 million, respectively.

These companies are publicly traded and are subject to the informational filing requirements of the Securities and Exchange Act of 1934, as amended. Accordingly, each is required to file periodic reports on Form 10-K and Form 10-Q with the SEC.

Certain operators of the Company s properties are experiencing financial, legal and regulatory difficulties. The loss of a significant operator or a combination of smaller operators could have a material impact on the Company s financial position or results of operations.

(5) Acquisitions and Dispositions

A summary of acquisitions through September 30, 2006, follows (in thousands):

	Consideration				Assets Acquired	
Acquisitions (1)	**Cash Paid**	**Real Estate**	**Debt Assumed**	**DownREIT Units (2)**	**Real Estate**	**Net Intangibles**
Medical office buildings	$ 141,405	$	$ 11,928	$ 5,523	$ 147,478	$ 11,378
Senior housing facilities	128,753	16,600	61,393		202,070	4,676
Hospitals	17,410				17,037	373
Other healthcare facilities	31,072				28,308	2,764
	$ 318,640	$ 16,600	$ 73,321	$ 5,523	$ 394,893	$ 19,191

A summary of fiscal year 2005 acquisitions follows (in thousands):

	Consideration			Assets Acquired	
Acquisitions (1)	**Cash Paid**	**Debt Assumed**	**DownREIT Units (2)**	**Real Estate**	**Net Intangibles**
Medical office buildings	$ 96,863	$ 61,424	$ 10,967	$ 154,182	$ 15,072
Senior housing facilities	313,744	52,060	19,431	379,745	5,490
	$ 410,607	$ 113,484	$ 30,398	$ 533,927	$ 20,562

(1) Includes transaction costs, if any.

(2) Non-managing member LLC units.

During the nine months ended September 30, 2006, the Company acquired properties aggregating $414.1 million, including the following significant acquisitions:

On July 28, 2006, the Company acquired two assisted living facilities, in exchange for three assisted living facilities valued at approximately $20 million, and $37 million in cash. The two acquired properties have an initial effective lease term of ten years, with two ten-year renewal options, and an initial contractual annual lease rate of 7.0% with escalators based on the properties' revenue growth. The acquired properties are included in a new master lease that contains six properties leased to the operator.

On June 1, 2006, the Company acquired two senior housing properties for $27 million, through a sale-leaseback transaction. These facilities have an initial lease term of fifteen years, with two ten-year renewal options. The initial annual lease rate is approximately 9.0% with annual escalators based on the Consumer Price Index (CPI) that have a floor of 2.75%.

On May 31, 2006, the Company acquired nine assisted living and independent living facilities for $99 million, including assumed debt valued at $61 million, through a sale-leaseback transaction. These facilities have an initial lease term of ten years, with two ten-year renewal options. The initial annual lease rate is approximately 8.0% with annual CPI-based escalators.

During the three months ended March 31, 2006, the Company acquired 13 medical office buildings for $138 million, including DownREIT units valued at $6 million, in related transactions. The 13 buildings, with 730,000 rentable square feet, have an initial yield of 7.3%.

On February 24, 2006, the Company acquired two medical office buildings for approximately $21 million including assumed debt valued at $12 million. The two buildings, with 157,000 rentable square feet, have an initial yield of 8.0%.

On February 8, 2006, the Company acquired four laboratory, office and biotechnology manufacturing buildings located in San Diego, California for $30 million. The initial yield on these buildings is 6.1%, with the stabilized yield expected to be 8.3%. The buildings include approximately 158,000 rentable square feet.

During the nine months ended September 30, 2006, the Company sold 12 properties for $116.8 million and recognized gains of approximately $46.6 million, which includes one building, sold on July 25, 2006, for $73 million with a gain of approximately $32 million.

See Note 17 for a discussion of acquisitions and dispositions subsequent to September 30, 2006.

(6) Investments in and Advances to Unconsolidated Joint Ventures

HCP Medical Office Portfolio, LLC

On October 24, 2006, the Company entered into a definitive agreement to acquire the interest held by affiliate of General Electric Company (GE) in HCP Medical Office Portfolio, LLC (HCP MOP), for $141 million. The closing of the transaction is subject to certain customary conditions. Upon the closing of this acquisition, expected to occur on or before November 30, 2006, HCP will be the sole owner of the venture and its fifty-nine medical office buildings (MOB) with approximately 4 million rentable square feet.

HCP MOP is a joint venture formed in June 2003 between the Company and GE. HCP MOP is engaged in the acquisition, development and operation of MOB properties. The Company has a 33% ownership interest therein and is the managing member. Activities of the joint venture requiring equity capital are generally funded on a transactional basis by the members in proportion to their ownership interests. Cash distributions are made to the members in proportion to their ownership interests until GE s cumulative return, as defined, exceeds specified thresholds. Thereafter, the Company will be entitled to an additional promoted interest. In addition, the joint venture agreement includes buy/sell provisions and imposes certain restrictions on the transfer of the Company s joint venture interests by the Company and GE to third parties.

The Company uses the equity method of accounting for its investment in HCP MOP because it exercises significant influence through voting rights and its position as managing member. However, the Company does not consolidate HCP MOP since it does not control, through voting rights or other means, the joint venture as GE has substantive participating decision-making rights and has the majority of the economic interest. The accounting policies of HCP MOP are the same as those described in the summary of significant accounting policies (see Note 2).

Summarized unaudited condensed financial information of HCP MOP is as follows (In thousands):

Balance Sheets	September 30, 2006	December 31, 2005
Real estate, at cost	$ 398,920	$ 390,840
Less accumulated depreciation and amortization	30,006	21,342
Net real estate	368,914	369,498
Real estate held for sale, net	171	78,811
Other assets, net	30,147	36,790
Total assets	$ 399,232	$ 485,099
Mortgage debt and notes payable	$ 262,840	$ 270,466
Mortgage debt on assets held for sale		58,232
Other liabilities	20,189	21,439
GE s capital	77,856	90,424
HCP s capital	38,347	44,538
Total liabilities and members capital	$ 399,232	$ 485,099

Statements of Operations (in thousands)	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30 2006	Nine Months Ended September 30 2005
Revenues and other income	$ 19,514	$ 17,524	$ 57,539	$ 52,791
Discontinued operations	1,779	(859)	19,805	(726)
Net income (loss)	2,680	(1,540)	22,176	(1,655)
HCP s equity income (loss)	1,072	(511)	7,495	(549)
Fees earned by HCP	663	775	2,630	2,326
Distributions received by HCP	8,313	1,560	13,529	4,942

The Company has not guaranteed any indebtedness or other obligations of HCP MOP. Generally, the Company may only be required to provide additional funding to HCP MOP under limited circumstances as specified in the related agreements. At September 30, 2006, investments in and advances to unconsolidated joint ventures include outstanding advances to HCP MOP of $4.3 million.

In August and September 2005, ten medical office buildings owned by HCP MOP, principally in Louisiana and the surrounding area, sustained varying degrees of damage due to hurricanes Katrina and Rita. Four of the buildings have incurred substantial damage and are a total loss. For the years ended December 31, 2005 and 2004, the four buildings generated revenues for HCP MOP of $0.9 million and $1.4 million, respectively. As of December 31, 2005, the $3.8 million carrying value of these four buildings was written off and an equal amount was recorded as a receivable for the expected insurance proceeds. At December 31, 2005, the remaining six buildings had resumed operations with repairs completed as of June 30, 2006. Revenues of HCP MOP for the six facilities were $2.9 million and $4.2 million for the nine months ended September 30, 2006 and 2005, respectively.

Repairs and other related expenditures for damages caused by hurricanes Katrina and Rita during the nine months ended September 30, 2006, were approximately $2.1 million, and were added to the expected insurance receivable. The Company has property, business interruption and other related insurance coverage to mitigate the financial impact of these types of events; such coverage is subject to various limits and deductible provisions based on the terms of the policies. Any excess insurance recovery above the carrying value of the assets is expected to be recognized by HCP MOP as a gain at the time the claims are settled with the insurance carrier. For the nine months ended September 30, 2006, HCP MOP received $6.3 million in proceeds from its insurance carriers, including $1.2 million in excess of insurance receivable.

During the nine months ended September 30, 2006, HCP MOP sold 34 MOBs with 1.4 million of rentable square feet for $100.7 million, net of transaction costs, and recognized aggregate gains of approximately $19.7 million. In connection with these transactions, approximately $64.9 million of HCP MOP s mortgage debt was either repaid or assumed by the purchasers.

Other Unconsolidated Joint Ventures

The Company owns interests in the following entities, which are accounted for on the equity method of accounting at September 30, 2006 (in thousands):

Entity	Investment (1)	Ownership (2)(3)
Arborwood Living Center, LLC	$ 803	45%
Edgewood Assisted Living Center, LLC	(432)	45%
Greenleaf Living Center, LLC	424	45%

Seminole Shores Living Center, LLC	(888)	50%
Suburban Properties, LLC	5,690	66%

(1) Represents the Company s investment in the identified unconsolidated joint venture. Negative investment amounts are included in accounts payable and accrued liabilities in the Company s consolidated balance sheet. See Note 2 regarding the Company s policy for accounting for joint venture interests.

(2) The Company s ownership interest and economic interest are substantially the same.

(3) The Company is not the general partner or managing member of any of the joint ventures.

Summarized unaudited condensed combined financial information for the other unconsolidated joint ventures follows (in thousands):

Balance Sheets	September 30, 2006	December 31, 2005
Real estate, net	$ 21,179	$ 14,708
Other assets, net	2,099	1,407
Total assets	$ 23,278	$ 16,115
Notes payable	$ 25,367	$ 15,449
Accounts payable	868	55
Other partners capital	(875)	351
HCP s capital	(2,082)	260
Total liabilities and partners capital	$ 23,278	$ 16,115

Statements of Operations	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Revenues and other income	$ 1,138	$ 814	$ 3,221	$ 4,365
Net income (loss)	$ 70	$ 32	$ 287	$ 333
HCP s equity income (loss)	$ (28)	$ (20)	$ 85	$ 317
Distributions received	$ 248	$	$ 439	$ 359

As of September 30, 2006, the Company has guaranteed approximately $7.2 million of a total of $15.4 million of notes payable for four of these joint ventures.

(7) Loans Receivable

Loans receivable consist of the following (in thousands):

	September 30, 2006			December 31, 2005		
	Secured	Unsecured	Total	Secured	Unsecured	Total
Joint venture partners	$	$ 7,053	$ 7,053	$	$ 7,006	$ 7,006
Others	138,026	1,296	139,322	175,426	6,663	182,089
Loan loss allowance						