MACE SECURITY INTERNATIONAL INC
Form 10-K
March 24, 2010

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

FORM 10-K

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

For the fiscal year ended December 31, 2009

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

For the transaction period from __ to __
Commission File No. 0-22810

MACE SECURITY INTERNATIONAL, INC.
(Exact name of registrant as specified in its charter)

Delaware	03-0311630
(State or other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

240 Gibraltar Rd., Suite 220, Horsham, PA 19044
(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: (267) 317-4009

Securities Registered Pursuant to Section 12(b) of the Act:

Common Stock, par value $0.01 per share

Name of each exchange on which registered: The NASDAQ Global Market

Securities Registered Pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 (the "Exchange Act") 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 (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark if disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one)
Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company x

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

The aggregate market value of the voting stock held by non-affiliates of registrant on June 30, 2009 was approximately $18,560,000. Such aggregate market value was computed by reference to the closing price of the common stock as reported on the Nasdaq Global Market on June 30, 2009. For purposes of determining this amount only, the registrant has defined affiliates as including (a) the executive officers and directors of the Registrant on June 30, 2009 and (b) each stockholder that had informed registrant that it was the beneficial owner of 10% or more of the outstanding common stock of Registrant on June 30, 2009.

The number of shares of Common Stock, par value $0.01 per share, of registrant outstanding as of March 19, 2010 was 15,913,775.

Mace Security International, Inc. and Subsidiaries

Form 10-K

Year Ended December 31, 2009

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PART I

ITEM 1. BUSINESS

GENERAL

Mace Security International, Inc. (the "Company" or "Mace") was incorporated in Delaware on September 1, 1993. Our operations are currently conducted through two segments: Security and Digital Media Marketing.

Our Security Segment designs, manufactures, assembles, markets and sells a wide range of security products. The products include intrusion fencing, access control, security cameras and security digital recorders. The Security Segment also owns and operates an Underwriters Laboratories ("UL") listed monitoring center that monitors video and security alarms for 300 security dealer clients with over 30,000 end-user accounts. The Security Segment's electronic surveillance products and components are purchased from Asian, European and Israeli manufacturers. Many of our products are designed to our specifications. We sell the electronic surveillance products and components primarily to installing dealers, distributors, system integrators and end users. Other products in our Security Segment are the original less-than-lethal Mace® defense sprays and other security devices such as monitors, high-end digital and machine vision cameras and professional imaging components. The main marketing channels for our products are industry shows, trade publications, catalogs, the internet, telephone orders, distributors and mass merchants.

Our Digital Media Marketing Segment focuses on selling products on third party internet promotional sites. We also have our own internet promotional sites that offers our products, as well as third party products. The products we sell are developed internally. Our promotional site markets and acquires customers for third parties using a proprietary marketing platform. The products we sell on the third party internet promotional sites also utilize our proprietary marketing platform.

We formerly had a Car Wash Segment. At its largest, the Car Wash Segment consisted of fifty seven car washes and five truck washes. As of December 31, 2009, the assets of our former Car Wash Segment consisted of eight car washes, one of which is currently under contract for sale under an Agreement of Sale and one which was sold in March 2010. The sale of our car wash under Agreement of Sale is anticipated to close in the second quarter of 2010. All eight remaining car washes, which made up the Car Wash Segment, have been classified as discontinued operations in the statements of operations and the statements of cash flows with the related assets and liabilities classified as assets and related liabilities held for sale in the December 31, 2009 balance sheet. The car wash operations are no longer reported as a Segment of the Company.

The Company's periodic reports on Forms 10-K and 10-Q and current reports on Form 8-K, as filed with the United States Securities and Exchange Commission (the "SEC"), can be accessed through the Company's website at www.mace.com.

LINES OF BUSINESS

Security Segment. The Security Segment offers for sale a wide variety of security products. The Security Segment also owns and operates a UL listed monitoring center that monitors video and security alarms for over 300 security dealer clients having over 30,000 end-user accounts. Among the products we offer are electronic surveillance products, including intrusion fencing, access control, analog, digital and IP cameras, digital video recorders, security monitors, matrix switching equipment for video distribution, robotic camera dome systems, system controls, and consoles for system assembly markets. Other products offered are Mace® defense sprays, personal alarms, home security alarms, whistles, door jammers, and window and door lock alarms. We also offer the KinderGard® product line of childproof security locks, security literature for the domestic and foreign financial community, state-of-the-art training videos, crisis response materials and TG Guard®, an electronically controlled tear gas system used in prisons,

embassies, and safe rooms.

Our electronic surveillance products and system component requirements are established by our operating and marketing staff in Fort Lauderdale, Florida and manufactured by overseas original equipment manufacturers (“OEM”). Our electronic surveillance products and system components are warehoused and shipped from our facility in Farmers Branch, Texas. Our defense sprays are manufactured by the Company in our Bennington, Vermont facility. The KinderGard® product line is manufactured by a third party utilizing molds primarily owned by the Company. Our defense sprays and the KinderGard® product line are packaged, warehoused, and shipped from our Vermont facility. Our TG Guard® products are also assembled in our Bennington, Vermont facility.

Our electronic surveillance products and components are marketed through several sales channels, such as dealers, system integrators, catalogs, the internet, mass merchants, exhibitions at national trade shows and by telephone orders. We also sell our products by the use of distributors, exhibitions at national trade shows and advertisements in trade publications.

The Security Segment provided 65.8%, 54.6%, and 74.5% of our revenues in fiscal years 2009, 2008, and 2007, respectively.

Digital Media Marketing Segment. The Digital Media Marketing Segment is an e-commerce and online marketing business which has two business divisions: (1) e-commerce, the sale of products on internet promotional sites and (2) online marketing, which publishes internet promotional sites that offer our products and third party products for sale. The segment uses proprietary technologies and software to sell products on the internet. The Company resumed operations of the online marketing division in the first quarter of 2010 and accordingly, these operations are currently a small part of the Digital Media Marketing Segment's business.

Linkstar operates our e-commerce division. The e-commerce division is a direct-response product business that develops, markets and sells products directly to consumers through the internet promotional sites. We reach the customers predominately through online advertising on third-party promotional websites. The products include: Vioderm, an anti-wrinkle skin care product (www.vioderm.com); Purity by Mineral Science, a mineral cosmetic (www.mineralscience.com); TrimDay™, a weight-loss supplement (www.trimday.com); Eternal Minerals, a dead sea spa product line (www.eternalminerals.com); ExtremeBriteWhite, a teeth whitening product (www.extremebritewhite.com); Knockout, an acne product (www.knockoutmyacne.com); Biocol, a natural colon cleanser (www.biocolcleanse.com); Goji Berry Now, a concentrated antioxidant dietary supplement (www.gojiberrynow.com); and PetVitamins, a pet care product line of patented FDA-approved supplements to improve heart and joint health in dogs and cats (www.petvitamins.com). We continuously develop and test product offerings to determine customer acquisition costs and revenue potential, as well as to identify the most efficient marketing programs.

From July 20, 2007 through June 2008, our online marketing division, Promopath, conducted an online affiliate marketing business. Promopath was acquired on July 20, 2007. Promopath located customers or leads for third party clients who hired Promopath. The advertising clients who hired Promopath paid us based on a set fee per customer, prospect or lead acquired. The online media marketing industry refers to the arrangement of acquiring customers, prospects or leads for advertisers on a fee basis per customer as the cost-per-acquisition (“CPA”) model. Promopath helped its advertising clients acquire customers by publishing internet promotional offers for its advertising clients. Promopath also worked with other internet publishers to reach many areas of interactive media. Promopath’s advertising clients were typically established direct-response advertisers with well recognized brands and broad consumer appeal such as NetFlix, Discover credit cards and Bertelsmann Group. Promopath generated CPA revenue, both brokered and through co-partnered sites.

During the third quarter of 2009, management made a decision to reactivate the operations of the Promopath online marketing services to both third party customers as well as to generate customer acquisitions for Linkstar, the Company’s e-commerce division. The Company resumed generating online marketing revenue through Promopath in the first quarter of 2010. The Company is controlling the cost of operating Promopath by limiting the amount Promopath spends on internet addresses which it uses to generate marketing revenues.

In addition to CPA revenue, Promopath generated two other types of revenue streams, list management and lead generation revenue. List management revenue is based on a relationship between a data owner and a list management company. The data owner, Promopath, compiles, collects, owns and maintains a proprietary computerized database composed of consumer information. Promopath, as the data owner, granted a list manager a non-exclusive, non-transferable, revocable worldwide license to manage, make use and have access to the data pursuant to defined terms and conditions for which Promopath is paid revenue. Another type of revenue stream Promopath had was lead generation or cost-per-lead (“CPL”). Advertisers who purchase potential customers, on a CPL basis are interested in collecting data from consumers expressing interest in a product or service. CPL varies from CPA in that no credit card information for the potential customer needs to be provided to the advertiser for the fee to be paid for the lead.

The Digital Media Marketing Segment provided 34.2%, 45.4% and 25.5% of our revenues in fiscal years 2009, 2008 and 2007, respectively.

Discontinued Operations. The Company, through its subsidiaries, owned eight car washes as of December 31, 2009. As of March 19, 2010, the Company owns seven car washes in Texas. The seven locations consist of six full service car washes and one self service car wash location. The full service car washes provide exterior washing and drying, vacuuming of the interior of the vehicle, dusting of dashboards and door panels, and cleaning of all windows and glass. One of the remaining car washes is subject to an Agreement of Sale and is anticipated to close in the second quarter of 2010.

Our car wash operations are not dependent on any one or a small number of customers. The nature of our car wash operations does not result in a backlog of orders at any time, and all of our car wash revenues are derived from sales in the United States. For a discussion of seasonal effects on our car wash operations, see Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations-Seasonality and Inflation.

BUSINESS STRATEGIES

Security Segment.

Internal Growth. The Security Segment designs, manufacturers, markets and sells a wide range of security products. For the year ended December 31, 2009, revenues from the Security Segment were $18.6 million. The Company began selling electronic surveillance products and system components in August 2002. Revenues from electronic surveillance products and system components have grown from $373,000 of revenue in 2002 to $7.2 million in 2009. Growth has been principally achieved through acquiring businesses and internal growth through development of new product offerings, as well as expanded advertising and marketing efforts. During 2009, the Security Segment added intrusion fencing and access control to its products. In the second quarter of 2009, the Security Segment acquired a UL listed monitoring center. The monitoring center monitors video and security alarms for over 300 security dealer clients which have over 30,000 end-user accounts. The wholesale alarm monitoring company offers our dealers an easy alternative for the monitoring of the video output of our products that the dealers install. By offering video monitoring we hope to be able to increase the loyalty and number of our dealers.

The Company sells its defense sprays in the consumer market under its Mace® brand. Defense sprays are sold in the law enforcement market under the brand name of TakeDown®. The Mace Trademark Corporation, a subsidiary of Mace Security International, Inc., manages the correct use of the Mace® trademark by Mace Security International, Inc. and Armor Holdings, Inc. (See also Trademarks and Patents, page 8). Armor Holdings, Inc has the exclusive right to use the Mace® brand when selling aerosol defense sprays to the law enforcement market, pursuant to an agreement dated July 1998. We believe that the total domestic consumer defense spray market is approximately $18 million to $20 million in annual revenues and that the domestic law enforcement market is approximately $5 million in annual revenues. Our newly developed Pepper Gel® has increased sales in Law Enforcement and Consumer markets. Pepper Gel® has a patent pending in the U.S. Patent and Trademark Office and in the European Union under the Patent Co-operation Treaty (PCT).

During the six months ended December 31, 2008 and throughout 2009, we implemented cost savings measures, including a reduction in employees throughout the Company, and completed a consolidation of our Security Segment's electronic surveillance equipment operations in Fort Lauderdale, Florida and Farmers Branch, Texas. As part of this reorganization, we consolidated our security division's surveillance equipment warehouse operations into our Farmers Branch, Texas facility and sold our Fort Lauderdale, Florida warehouse. Our professional security sales and administrative team has remained in Fort Lauderdale, Florida in a rented facility. Our security catalog sales team was relocated to Florida in the rented facility. The goals of the reorganization were to align our electronic surveillance equipment sales teams to achieve sales growth, gain efficiencies by sharing redundant functions within our security operations such as warehousing, customer service, and accounting services, and to streamline our organization structure and management team for improved long-term growth.

Operating Agreements and Acquisitions. On April 30, 2009, the Company completed the purchase of all the outstanding common stock of Central Station Security Systems, Inc. ("CSSS") from CSSS's shareholders. Total consideration was approximately $3.7 million which consisted of $1.7 million in cash at closing, $224,000 paid subsequent to closing, potential additional payments of up to $1.2 million upon the settlement of certain contingencies as set forth in the Stock Purchase Agreement, $766,000 of which is recorded in accrued expenses and other current liabilities, and $461,000 which is recorded as other non-current liabilities at December 31, 2009, and the assumption of approximately $590,000 of liabilities. CSSS, which is reported within the Company's Security Segment, is a national wholesale monitoring company located in Anaheim, California, with approximately 300 security dealer clients. CSSS owns and operates a UL-listed monitoring center that services over 30,000 end-user accounts. CSSS's primary assets are accounts receivable, equipment, customer contracts, and its business methods. The acquisition of CSSS enables the Company to expand the marketing of its security products through cross-marketing of the

Company's surveillance equipment products to CSSS's dealer base as well as offering monitoring services to the Company's current customers. The purchase price was allocated as follows: approximately (i) $19,000 for cash; (ii) $112,000 for accounts receivable; (iii) $63,000 for prepaid expenses and other assets; (iv) $443,000 for fixed assets and capital leased assets; (v) the assumption of $590,000 of liabilities, and (vi) the remainder, or $3.04 million, allocated to goodwill and other intangible assets. Within the $3.04 million of acquired intangible assets, $1.98 million was assigned to goodwill, which is not subject to amortization expense. The amount assigned to goodwill was deemed appropriate based on several factors, including: (i) multiples paid by market participants for businesses in the security monitoring business; (ii) levels of CSSS's current and future projected cash flows; (iii) the Company's strategic business plan, which included cross-marketing the Company's surveillance equipment products to CSSS's dealer base as well as offering the Company's current customers monitoring services, thus potentially increasing the value of its existing business segment; and (iv) the Company's plan to substitute the cash flows of the Car Wash Segment, which the Company is exiting. The remaining intangible assets were assigned to customer contracts and relationships for $940,000, tradename for $70,000, and a non-compete agreement for $50,000. Customer relationships, tradename and the non-compete agreement, were assigned a life of fifteen, three, and five years, respectively.

On November 23, 2005 we acquired the inventory and customer accounts of Securetek, Inc. which specializes in the sale of electronic surveillance products to security alarm dealers and installers. The acquired businesses were relocated and integrated into our existing security operations.

We regularly evaluate potential acquisitions for the Security Segment to determine if they provide an advantageous opportunity. In evaluating potential acquisitions, we consider: (i) our cash position and the availability of financing at favorable terms; (ii) the potential for operating cost reductions; (iii) marketing advantages by adding new products to the Mace® brand name; (iv) market penetration of existing products; and (v) other relevant factors.

As consideration for acquisitions, we may use combinations of common stock, warrants, cash, and indebtedness. The consideration for each future acquisition will vary on a case-by-case basis depending on our financial interests, the historic operating results of the acquisition target, and the growth potential of the business to be acquired. We expect to finance the cash portion of future acquisitions through our cash reserves, funds provided by operations, loans, and the proceeds of possible future equity sales.

Digital Media Marketing Segment.

Sales. We have been increasing sales and customer acquisition efforts and expenses in our e-commerce division. The Purity cosmetics product line is, to date, our most successful product line and is anticipated to remain stable. We also anticipate additional growth from our 2008 launch of products such as ExtremeBriteWhite, our teeth whitening product; and Knockout, our acne product; our recent launch of new products such as Biocol, a colon cleanser; Goji Berry Now, our antioxidant dietary supplement, and PetVitamins, our pet care supplements, as well as from future planned product lines.

Operating Efficiency. In an effort to streamline and strengthen internal operations, we have consolidated all internal operations of our Digital Media Marketing Segment in our Wexford, Pennsylvania office, a suburb of Pittsburgh, Pennsylvania. We maintain a sales presence throughout the country. In September 2009, we began to lease warehouse space in the York, Pennsylvania area for the Digital Media Marketing Segment’s e-commerce division’s shipping and fulfillment functions which were previously located in Farmers Branch, Texas. The relocation provided savings in operating, overhead, and personnel costs.

Acquisition. On July 20, 2007, the Digital Media Marketing Segment was added to our operations when all of the outstanding common stock of Linkstar was purchased from Linkstar’s shareholders. The acquisition of Linkstar provides us with a presence in the online and digital media services industry. We paid approximately $10.5 million to the Linkstar shareholders, which consisted of $7.0 million in cash at closing, $500,000 of promissory notes bearing a 5% interest rate paid on January 3, 2008 and 1,176,471 unregistered shares of the Company’s common stock. The Company’s stock was issued based on a closing price of $2.55 per share or a total value of $2.9 million.

Discontinued Operations

We acquired our car and truck washes between May 1999 and December 2000 and had reported their results as the Company’s Car Wash Segment. We have made the decision to sell the remaining eight car washes. From December 2005 to March 12, 2010, we have sold 42 car washes including all of our car washes in the Northeast region; Arizona; Florida; Austin, Texas; and San Antonio, Texas. The five truck washes we had owned were sold in 2007.

We currently own seven car washes as of March 19, 2010, all located in Texas. One of the remaining car washes is subject to an Agreement of Sale. We are marketing our car washes individually and in groups. We are considering offers for our car washes and evaluating offers based on whether the purchase price would be sufficient to retire all debt related to the car washes and provide sufficient capital for the growth of our Security and Digital Media

Marketing Segments. We seek to grow the Security and Digital Media Marketing Segments through acquisitions, new product development and new market penetration.

MARKETING

Security Segment. Our electronic surveillance products and components are marketed through several sales channels, such as catalogs, the internet, mass merchants, exhibitions at national trade shows and telephone orders. Our other products are sold through direct marketing, the use of distributors as well as exhibitions at national trade shows and advertisements in trade publications.

Our self defense sprays are available for purchase at mass merchant/department stores, gun shops, sporting goods stores, hardware, auto, convenience and drug stores. In the law enforcement market, our defense sprays, including Pepper Gel®, are sold through direct marketing, the use of independent sales representatives and distributors as well as exhibitions at national trade shows and advertisements in trade publications.

We have a diverse customer base within the Security Segment with no single customer accounting for 5% or more of our consolidated revenues for the fiscal year ended December 31, 2009. We do not believe that the loss of any single Security Segment customer would have a material adverse effect on our business or results of operations.

Digital Media Marketing Segment. E-commerce products and services are marketed on third party promotional internet sites. We are continuing to increase the products offered by our Linkstar e-commerce division, with the successful launch of our mineral cosmetic line, Purity, in late 2007, the launch of Eternal Minerals, a Dead Sea spa product line in the Spring of 2008 and ExtremeBriteWhite, a teeth whitening product in late 2008; and the launch of four new products in 2009, including Knockout, an acne product; Biocol, a natural colon cleanser; Goji Berry Now, a concentrated antioxidant dietary supplement; and PetVitamins, a pet care product line of supplements to improve heart and joint health in dogs and cats. We intend to concentrate on expanding our existing product lines, building brand awareness, and launching three to four new product lines in 2010.

PRODUCTION AND SUPPLIES

Security Segment. Our electronic surveillance products and system component requirements are established at our Fort Lauderdale, Florida facility and are manufactured principally in Korea, China, Israel and England by original equipment manufacturers (“OEM”). The electronic surveillance products and components meeting our requirements are labeled, packaged, and shipped ready for sale to our warehouse in Farmers Branch, Texas.

Substantially all of the manufacturing processes for our defense sprays are performed at our leased Bennington, Vermont facility. Defense spray products are manufactured on an aerosol filling machine. Most products are packaged in sealed, tamper-resistant "clamshells." KinderGard ®, a product line of childproof locks, and TG Guard®, an electronic tear gas security system, are primarily manufactured by unrelated companies and are assembled and packaged on-site at our Vermont facility. There are numerous potential suppliers of the components and parts required in the production process. We have developed strong long-term relationships with many of our suppliers, including the following: Moldamatic, Inc., Amber International, Inc., and Springfield Printing, Inc. In addition, we purchase for resale a variety of products produced by others including whistles and window and door alarms.

Digital Media Marketing Segment. Linkstar, our e-commerce division, and Promopath, our digital marketing division, are located in Wexford, Pennsylvania, a suburb of Pittsburgh. Shipping and fulfillment for the e-commerce division is performed in a third party fulfillment center located in York, Pennsylvania. The products sold by the e-commerce division are manufactured within the United States as well as China and other foreign countries. The packaging of products is also currently obtained through suppliers in the United States and China.

COMPETITION

Security Segment. Our video systems and security products components face competition from many larger companies such as Sony, Panasonic, Security Equipment Corp. and others. A number of these competitors have significantly greater financial, marketing, and other resources than us. Our high-end digital and machine vision camera operation, IVS, is a large distributor of Sony® products. Customers of IVS who achieve a high Sony® product purchasing level, qualify for purchasing directly from Sony®. IVS occasionally loses high volume customers to Sony. Additionally, our foreign manufacturers of electronic surveillance products also sell directly to our customer base. We also compete with numerous well-established, smaller, local or regional firms. Increased competition from these companies could have an adverse effect on our electronic surveillance products sales.

Our security monitoring company is in a highly competitive industry. Monitoring accounts are difficult to obtain, as there is a natural resistance by dealers to move their end user accounts. There are many national and local monitoring companies that compete aggressively on price.

There continues to be a number of companies marketing personal defense sprays to civilian consumers such as Armor Holdings, Inc. We continue to offer defense spray products that we believe distinguish themselves through brand name recognition and superior product features and formulations. This segment experienced increased sales in aerosols in each of the three years ending December 31, 2009, 2008 and 2007 and increased sales in TG Guard systems in 2007. We attribute the increased sales to improved marketing, including improvements in our website, and development of new products such as our Mace Pepper Gun®, our Mace Pepper Gel®, our Hot Pink Mace Defense Spray™ and our Night Defender Pepper Gel Defense Spray™.

Digital Media Marketing Segment. Linkstar, our e-commerce division, competes with product development and marketing companies, both on and offline. Our success relies on creating innovative products attractive to consumers and being able to gain and protect market share for successful product lines. We compete with numerous well-established national and regional companies such as ValueClick, Think Partnership, Syndero, Intelligent Beauty, Guthy-Renker, and Bare Escentuals. Promopath, our online marketing division, has recently restarted its third party business in addition to placing Linkstar's e-commerce products on third-party promotional websites.

TRADEMARKS AND PATENTS

Security Segment. We began marketing products in 1993 under the Mace® brand name and related trademarks pursuant to an exclusive license for sales of defense sprays to the consumer market in the continental United States and a non-exclusive license for sales to the consumer market worldwide. We subsequently purchased outright the Mace® brand name and related trademarks (Pepper Mace®, Chemical Mace®, Mace . . . Just in Case®, CS Mace™ and Magnum Mace™). In conjunction with this purchase, we acquired a non-exclusive worldwide license to promote a patented pepper spray formula in both the consumer and law enforcement markets. We have patents pending for our new less-than-lethal gel products in the United States and also in several foreign jurisdictions. We have recently obtained trademarks for Mace Pepper Gel® and have filed trademark applications for Hot Pink Mace Defense Spray™, Night Defender Pepper Gel Defense Spray™ and the Sportsman Scent System®. Additionally, we have been issued a patent on the locking mechanism for our Mark VI defense spray unit. Additionally, we have recently received a patent internationally for a non-irritant gel formulation.

In July 1998, in connection with the sale of our Law Enforcement Division, we transferred our Mace® brand trademark and all related trademarks, and a patent (No. 5,348,193) to our wholly-owned subsidiary, Mace Trademark Corp. The purchaser of our Law Enforcement division received a 99 year license to use the Mace® brand, certain other such trademarks and the patents in the law enforcement market only.

We also have various other patents and trademarks for the devices we sell, including trademarks and/or patents for the Big Jammer® door brace, Screecher®, Peppergard®, Mace (Mexico)®, Viper® defense spray, KinderGard®, TG Guard®, Take Down®, Muzzle®, Pepper Mace®, MSI and Design®, Mace® Community (European Union) Trademark, Pepper Gel®, and Take Down Extreme®. We also license the pending patent for our new Pepper Gun product.

Additional trademarks used in our Security Segment are: SecurityandMore.com®, Industrial Vision Source®, Easy Watch®, Focus Vision 4 Observation System (Stylized)®, SmartChoice®, MaceLock™, MaceTrac™ and MaceVision™.

The Company has expanded the Mace® trademark to cover new electronic surveillance products.

We believe these Mace-related trademarks provide us with a competitive advantage.

Digital Media Marketing Segment. We are applying for trademarks and service marks for the brands we sell on the internet.

GOVERNMENT REGULATION/ENVIRONMENTAL COMPLIANCE

Security Segment. The distribution, sale, ownership, and use of consumer defense sprays are legal in some form in all fifty states and the District of Columbia. However, in some states, sales to minors are prohibited and in several states (MA, MI, NY and WI, for example) sales are highly regulated. Among the typical regulations are the following, which list is not all inclusive: Massachusetts requires both the seller and possessor to be licensed; Michigan does not allow the sale of combinations of tear gas and pepper sprays; and New York requires sellers to be licensed firearms

dealers or pharmacists. There are often restrictions on sizes, labeling and packaging that may vary from state to state. We have been able to sell our defense sprays consistent with the requirements of state laws. We believe we are in material compliance with all federal, state, and local laws that affect the sale and marketing of our defense spray business. There can be no assurance, however, that broader or more severe restrictions will not be enacted that would have an adverse impact on the sale of defense sprays. Additionally, certain states require licenses for the sale of our security equipment. We have obtained all required licenses.

During January 2008, the Environmental Protection Agency (the “EPA”) conducted a site investigation at the Company’s Bennington, Vermont location and the building within which the facility is located. The Company leases 33,476 square feet of the building from Vermont Mill Properties, Inc. (“Vermont Mill”). The site investigation was focused on whether hazardous substances were being improperly stored. After the site investigation, the EPA notified the Company and the building owner that remediation of certain hazardous wastes were required. The EPA, the Company and the building owner entered into an Administrative Consent Order under which the hazardous materials and waste were remediated. All remediation required by the Administrative Consent Order was completed within the time allowed by the EPA and a final report regarding the remediation was submitted to the EPA in October 2008, as required by the Administrative Consent Order. On September 29, 2009 the EPA accepted the final report. On February 23, 2010 the EPA issued the Company an invoice for $240,096 representing the total of the EPA's oversight costs that the Company and Vermont Mill is obligated to pay under the Administrative Consent Order. The Company and Vermont Mill are in discussions to determine what portion of the invoice each will pay. The Company is estimating that it will pay approximately $190,000 of this invoice. A total estimated cost of approximately $786,000 relating to the remediation, which includes disposal of the waste materials, as well as expenses incurred to engage environmental engineers and legal counsel and reimbursement of the EPA’s costs, has been recorded through December 31, 2009. This amount represents management’s best estimate of probable loss. Approximately $596,000 has been paid to date, leaving an accrual balance of $190,000 at December 31, 2009 for the estimated share of the Company's EPA costs.

The United States Attorney for the District of Vermont ("U.S. Attorney") is conducting an investigation of the Company relating to possible violations of the Resource Conservation and Recovery Act ("RCRA") at the Vermont location. The Company believes the investigation is focused on the Company allegedly not disposing of hazardous materials and waste at the Vermont location, as required by various environmental laws. In connection with the investigation, a search of the Company's Bennington, Vermont location and the building in which the facility is located occurred in February 2008. On May 2, 2008, the U.S. Attorney issued a grand jury subpoena to the Company. The subpoena required the Company to provide the U.S. Attorney documents related to the storage, disposal and transportation of materials at the Bennington, Vermont location. The Company supplied the documents and is fully cooperating with the U.S. Attorney's investigation. During the fourth quarter of 2009, the U.S. Attorney interviewed a Company employee before a grand jury. The Company believes that the U.S. Attorney is actively pursuing an investigation of possible criminal violations. The Company has made no provision for any future costs associated with the investigation.

Digital Media Marketing Segment. We believe that we currently comply with all state and federal laws within our online marketing practices. However, the online marketing segment has come under increased scrutiny by the Federal Trade Commission ("FTC") and several state Attorney Generals with regard to online lead generation practices. Because our online marketing and e-commerce sites could be impacted, we are closely monitoring any changes to state or federal laws and FTC guidelines. In addition, any changes to laws impacting the import or sale of any products within our e-commerce division could adversely impact revenues, although we believe this to be of minimal risk in the near future.

Divestitures:

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

(5) Summarized Financial Information of Equity Affiliates

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

At March 31, 2015, we have non-controlling equity investments or commitments in five jointly-owned LLCs which own MOBs. We accounted for these LLCs on an unconsolidated basis pursuant to the equity method since they are not variable interest entities. The majority of these LLCs are joint-ventures between us and non-related parties that manage and hold minority ownership interests in the entities. Each LLC is generally self-sustained from a cash flow perspective and generates sufficient cash flow to meet its operating cash flow requirements and service the third-party debt (if applicable) that is non-recourse to us. Although there is typically no ongoing financial support required from us to these entities since they are cash-flow sufficient, we may, from time to time, provide funding for certain purposes such as, but not limited to, significant capital expenditures, leasehold improvements and debt financing. Although we are not obligated to do so, if approved by us at our sole discretion, additional cash fundings are typically advanced as equity or member loans. These LLCs maintain property insurance on the properties.

The following property table represents the five LLCs in which we own a noncontrolling interest and were accounted for under the equity method as of March 31, 2015 and December 31, 2014:

Name of LLC/LP	Ownership	Property Owned by LLC
Suburban Properties	33%	Suburban Medical Plaza II
Brunswick Associates (a.)	74%	Mid Coast Hospital MOB
Arlington Medical Properties (b.)	75%	Saint Mary s Professional Office Building
Grayson Properties (c.)	95%	Texoma Medical Plaza
FTX MOB Phase II (d.)	95%	Forney Medical Plaza II

(a.) This LLC has a third-party term loan of $8.9 million, which is non-recourse to us, outstanding as of March 31, 2015.

(b.) We have funded $5.2 million in equity as of March 31, 2015 and are committed to invest an additional $1.2 million. This LLC has a third-party term loan of $23.1 million, which is non-recourse to us, outstanding as of March 31, 2015.

(c.) We have funded $2.7 million in equity as of March 31, 2015, and are committed to fund an additional $300,000. This building is on the campus of a UHS hospital and has tenants that include subsidiaries of UHS. This LLC has a third-party term loan of $14.8 million, which is non-recourse to us, outstanding as of March 31, 2015

(d.) We have committed to invest up to $2.5 million in equity and debt financing, of which $1.5 million has been funded as of March 31, 2015. This LLC has a third-party term loan of $5.5 million, which is non-recourse to us, outstanding as of March 31, 2015.

Effective August 1, 2014, we purchased the minority ownership interests, ranging from 5% to 15%, held by third-party members in six LLCs in which we previously held noncontrolling majority ownership interests, as noted in the table below. As a result of these minority ownership purchases, we now own 100% of each of these LLCs and began to account for them on a consolidated basis effective August 1, 2014. Prior to August 1, 2014, these LLCs were accounted for on an unconsolidated basis pursuant to the equity method.

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

Below are the condensed combined statements of income (unaudited) for the LLCs accounted for under the equity method at March 31, 2015 and 2014. The combined statements of income for the three months ended March 31, 2014 include the financial results for the six LLCs that we began to account for on a consolidated basis as of August 1, 2014, as discussed above.

	Three Months Ended March 31, (amounts in thousands)	
	2015	2014(b.)
Revenues	$ 3,585	$ 4,909
Operating expenses	1,337	1,971
Depreciation and amortization	580	896
Interest, net	619	1,318
Net income	$ 1,049	$ 724
Our share of net income (a.)	$ 592	$ 593

(a.) Our share of net income for the three months ended March 31, 2014 includes interest income earned by us on various advances made to LLCs of approximately $352,000. There were no advances outstanding during the first quarter of 2015, therefore there was no interest income earned by us for the three months ended March 31, 2015.

(b.) As mentioned above, we began to account for six LLCs on a consolidated basis as of August 1, 2014. Prior to August 1, 2014, the financial results of these entities were accounted for under the equity method on an unconsolidated basis. The three months ended March 31, 2014, include the financial results of the six mentioned LLCs.

Below are the condensed combined balance sheets (unaudited) for the five above-mentioned LLCs in which we hold noncontrolling ownership interests and that were accounted for under the equity method as of March 31, 2015 and December 31, 2014:

	March 31, 2015	December 31, 2014
	(amounts in thousands)	
Net property, including CIP	$ 61,971	$ 62,450
Other assets	5,872	7,367
Total assets	$ 67,843	$ 69,817
Liabilities	$ 2,453	$ 3,348
Mortgage notes payable, non-recourse to us	52,383	52,728
Equity	13,007	13,741
Total liabilities and equity	$ 67,843	$ 69,817
Our share of equity in LLCs	$ 7,945	$ 8,605

As of March 31, 2015, and December 31, 2014, aggregate principal amounts due on mortgage notes payable by unconsolidated LLCs, which are accounted for under the equity method and are non-recourse to us, are as follows (amounts in thousands):

Name of LLC	Mortgage Loan Balance (a.) 3/31/2015	12/31/2014	Maturity Date
Arlington Medical Properties (b.)	$ 23,089	$ 23,287	October, 2015
FTX MOB Phase II (c.)	5,518	5,548	August, 2017
Grayson Properties (d.)	14,836	14,893	September, 2021
Brunswick Associates (e.)	8,940	9,000	December, 2024
	$ 52,383	$ 52,728	

(a.) All mortgage loans, other than construction loans, require monthly principal payments through maturity and include a balloon principal payment upon maturity.
(b.) We believe the terms of this loan are within current market underwriting criteria. At this time, we expect to refinance this loan during 2015 for three to ten year terms at the then current market interest rates. In the unexpected event that we are unable to refinance this loan on reasonable terms, we will explore other financing alternatives, including, among other things, increasing our equity investment in the property utilizing funds borrowed under our revolving credit agreement.
(c.) This loan was converted from a construction loan to a term loan in August, 2014, pursuant to the terms of the loan agreement.
(d.) This loan was refinanced in September, 2014, for a seven year term, at a fixed rate of 5.034%. This loan includes two one-year extension options.
(e.) This loan was refinanced in December, 2014, for a ten year term, at a fixed rate of 1.50% for the initial six months, and a fixed rate of 3.64% commencing July 1, 2015 through December 31, 2024.

Pursuant to the operating and/or partnership agreements of most of the five LLCs in which we continue to hold non-controlling majority ownership interests, the third-party member and the Trust, at any time, have the right to make an offer (Offering Member) to the other member(s) (Non-Offering Member) in which it either agrees to: (i) sell the entire ownership interest of the Offering Member to the Non-Offering Member (Offer to Sell) at a price as determined by the Offering Member (Transfer Price), or; (ii) purchase the entire ownership interest of the Non-Offering Member (Offer to Purchase) at the equivalent proportionate Transfer Price. The Non-Offering Member has 60 to 90 days to either: (i) purchase the entire ownership interest of the Offering Member at the Transfer Price, or; (ii) sell its entire ownership interest to the Offering Member at the equivalent proportionate Transfer Price. The closing of the transfer must occur within 60 to 90 days of the acceptance by the Non-Offering Member.

(6) Recent Accounting Pronouncements

In April 2015, the Financial Accounting Standards Board (FASB) issued an update to the accounting standard relating to the presentation of debt issuance costs. Under the new guidance, debt issuance costs related to a recognized debt liability will be presented on the balance sheet as a direct deduction from the debt liability. This amendment becomes effective for annual periods beginning on or after December 15, 2015, and interim periods beginning on or after

December 15, 2015; however, early adoption is permitted. We do not expect the adoption of this guidance to have a material impact on our condensed consolidated financial statements.

In February 2015, the FASB issued ASU 2015-02, *Amendments to the Consolidation Analysis*, which amends the consolidation requirements in Accounting Standards Codification (ASC) 810, *Consolidation*. ASU 2015-02 makes targeted amendments to the current consolidation guidance, which could change consolidation conclusions. This guidance will be effective for us beginning in our first quarter of 2016 and early adoption is permitted. We do not expect the adoption of this guidance to have a material impact on our condensed consolidated financial statements.

(7) Debt and Financial Instruments

Debt:

On March 27, 2015, we entered into a new $185 million revolving credit agreement (Credit Agreement). The Credit Agreement, which will mature in four years, replaced our previous revolving credit facility which was scheduled to mature on July 24, 2015. The Credit Agreement includes a $50 million sub limit for letters of credit and a $20 million sub limit for swingline/short-term loans. The Credit Agreement also provides a one-time option to extend the maturity date for an additional one year period, and an option to increase the total facility borrowing capacity up to an additional $50 million, subject to lender agreement. Borrowings under the new facility are guaranteed by certain subsidiaries of the Trust. In addition, borrowings under the new facility are secured by first priority security interests in and liens on all equity interests in the Trust s wholly-owned subsidiaries.

Borrowings made pursuant to the Credit Agreement will bear interest, at our option, at one, two, three, or six month LIBOR plus an applicable margin ranging from 1.50% to 2.00% or at the Base Rate plus an applicable margin ranging from 0.50% to 1.00%. The Credit Agreement defines Base Rate as the greatest of: (a) the administrative agent s prime rate; (b) the federal funds effective rate

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plus 1/2 of 1%, and; (c) one month LIBOR plus 1%. A commitment fee of 0.20% to 0.40% (depending on our total leverage ratio) will be charged on the average unused portion of the revolving credit commitments. The margins over LIBOR, Base Rate and the commitment fee are based upon our ratio of debt to total capital. At March 31, 2015, the applicable margin over the LIBOR rate was 1.625%, the margin over the Base Rate was 0.625%, and the commitment fee was 0.25%.

At March 31, 2015, we had $116.0 million of outstanding borrowings and $5.9 million of letters of credit outstanding against our revolving credit agreement. We had $63.1 million of available borrowing capacity, net of the outstanding borrowings and letters of credit outstanding as of March 31, 2015. At December 31, 2014, we had $89.8 million of outstanding borrowings and $6.3 million of letters of credit outstanding against our previous $150 million revolving credit agreement (which was replaced in March, 2015, as discussed above). We had $54.0 million of available borrowing capacity, net of the outstanding borrowings and letters of credit outstanding as of December 31, 2014. There are no compensating balance requirements.

The Credit Agreement contains customary affirmative and negative covenants, including limitations on certain indebtedness, liens, acquisitions and other investments, fundamental changes, asset dispositions and dividends and other distributions. The Credit Agreement also contains restrictive covenants regarding the Trust s ratio of total debt to total assets, the fixed charge coverage ratio, the ratio of total secured debt to total asset value, the ratio of total unsecured debt to total unencumbered asset value, and minimum net worth, as well as customary events of default, the occurrence of which may trigger an acceleration of amounts outstanding under the Credit Agreement. We are in compliance with all of the covenants at March 31, 2015. We also believe that we would remain in compliance if the full amount of our commitment was borrowed.

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

	Covenant	March 31, 2015
Tangible net worth	$ 125,000	$ 177,689
Total leverage	< 60%	48.9%
Secured leverage	< 30%	23.2%
Unencumbered leverage	< 60%	38.8%
Fixed charge coverage	> 1.50x	3.1x

We have fifteen mortgages, all of which are non-recourse to us, included on our condensed consolidated balance sheet as of March 31, 2015, with a combined outstanding balance of $117.1 million (excluding net debt premium of $468,000 at March 31, 2015). The following table summarizes our outstanding mortgages, excluding net debt premium, at March 31, 2015 (amounts in thousands):

Facility Name	Outstanding Balance (in thousands)(a)	Interest Rate	Maturity Date
Desert Valley Medical Center floating rate mortgage loan (b.)	$ 3,833	3.42%	October, 2015
	5,969	3.69%	October, 2015

Palmdale Medical Plaza fixed rate mortgage loan (b.)			
Summerlin Hospital Medical Office Building III floating rate mortgage loan	10,942	3.42%	December, 2016
Peace Health fixed rate mortgage loan	21,132	5.64%	April, 2017
Auburn Medical II floating rate mortgage loan	7,126	2.92%	April, 2017
Medical Center of Western Connecticut fixed rate mortgage loan	4,754	6.00%	June, 2017
Summerlin Hospital Medical Office Building II fixed rate mortgage loan	11,653	5.50%	October, 2017
Phoenix Children s East Valley Care Center fixed rate mortgage loan	6,451	5.88%	December, 2017

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Facility Name	Outstanding Balance (in thousands)(a)	Interest Rate	Maturity Date
Centennial Hills Medical Office Building floating rate mortgage loan	10,566	3.42%	January, 2018
Sparks Medical Building/Vista Medical Terrace floating rate mortgage loan	4,446	3.42%	February, 2018
Rosenberg Children s Medical Plaza fixed rate mortgage loan	8,439	4.85%	May, 2018
Vibra Hospital-Corpus Christi fixed rate mortgage loan	2,880	6.50%	July, 2019
700 Shadow Lane and Goldring MOBs fixed rate mortgage loan	6,559	4.54%	June, 2022
BRB Medical Office Building fixed rate mortgage loan	6,630	4.27%	December, 2022
Tuscan Professional Building fixed rate mortgage loan	5,759	5.56%	June, 2025
Total	$ 117,139		

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

(b) We expect this loan to be refinanced for three to ten year terms at the then current market interest rates. In the unexpected event that we are unable to refinance this loan on reasonable terms, we will explore other financing alternatives, including, among other things, utilizing funds borrowed under our revolving credit facility.

The mortgages are secured by the real property of the buildings as well as property leases and rents. The mortgages have a combined fair value of approximately $119 million as of March 31, 2015. Changes in market rates on our fixed rate debt impacts the fair value of debt, but it has no impact on interest incurred or cash flow.

At December 31, 2014, we had sixteen mortgages, all of which were non-recourse to us, included in our consolidated balance sheet. The combined outstanding balance of these sixteen mortgages was $122.9 million (excluding net debt premium of $523,000 at December 31, 2014), and had a combined fair value of approximately $124.7 million at December 31, 2014.

Financial Instruments:

During the third quarter of 2013, we entered into an interest rate cap on a total notional amount of $10 million whereby we paid a premium of $136,000. During the first quarter of 2014, we entered into two additional interest rate cap agreements on a total notional amount of $20 million whereby we paid premiums of $134,500. In exchange for the premium payments, the counterparties agreed to pay us the difference between 1.50% and one-month LIBOR if one-month LIBOR rises above 1.50% during the term of the cap. From inception through March 31, 2015, no payments have been made to us by the counterparties pursuant to the terms of these caps which expire in January, 2017.

(8) Segment Reporting

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

Our portfolio is located throughout the United States, however, we do not distinguish or group our operations on a geographical basis for purposes of allocating resources or measuring performance. We review operating and financial data for each property on an individual basis; therefore, we define an operating segment as our individual properties. Individual properties have been aggregated into one reportable segment based upon their similarities with regard to both the nature and economics of the facilities, tenants and operational processes, as well as long-term average financial performance.

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

Overview

We are a real estate investment trust (REIT) that commenced operations in 1986. We invest in healthcare and human service related facilities currently including acute care hospitals, rehabilitation hospitals, sub-acute facilities, surgery centers, free-standing emergency departments, childcare centers and medical office buildings (MOBs). As of March 31, 2015, we have sixty-one real estate investments located in eighteen states consisting of:

- six hospital facilities consisting of three acute care, one rehabilitation and two sub-acute;
- three free-standing emergency departments (FEDs);
- forty-eight medical office buildings, including five owned by unconsolidated limited liability companies (LLCs), and;
- four pre-school and childcare centers.

Forward Looking Statements and Certain Risk Factors

You should carefully review all of the information contained in this Quarterly Report, and should particularly consider any risk factors that we set forth in this Quarterly Report and in other reports or documents that we file from time to time with the Securities and Exchange Commission (the SEC). In this Quarterly Report, we state our beliefs of future events and of our future financial performance. In some cases, you can identify those so-called forward-looking statements by words such as may, will, should, could, would, predicts, potential, continue, expects, intends, plans, believes, estimates, appears, projects and similar expressions, as well as statements in future t should be aware that those statements are only our predictions. Actual events or results may differ materially. In evaluating those statements, you should specifically consider various factors, including the risks outlined herein and in our Annual Report on Form 10-K for the year ended December 31, 2014 in *Item 1A Risk Factors* and in *Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Forward Looking Statements*. Those factors may cause our actual results to differ materially from any of our forward-looking statements.

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

- a substantial portion of our revenues are dependent upon one operator, Universal Health Services, Inc. (UHS). We cannot assure you that subsidiaries of UHS will renew the leases on our three acute care hospitals and two FEDs at existing lease rates or fair market value lease rates. In addition, if subsidiaries of

UHS exercise their options to purchase the respective leased hospital facilities upon expiration of the lease terms, our future revenues and results of operations could decrease if we were unable to earn a favorable rate of return on the sale proceeds received, as compared to the rental revenue currently earned pursuant to these leases;

in certain of our markets, the general real estate market has been unfavorably impacted by increased competition/capacity and decreases in occupancy and rental rates which may adversely impact our operating results and the underlying value of our properties;

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

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

lost revenues resulting from the exercise of purchase options, lease expirations and renewals, loan repayments and other restructuring;

our ability to continue to obtain capital on acceptable terms, including borrowed funds, to fund future growth of our business;

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

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

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

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

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

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

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

there have been several attempts in Congress to repeal or modify various provisions of the Patient Protection and Affordable Care Act (the PPACA). We cannot predict whether or not any of these proposed changes to the PPACA will become law and therefore can provide no assurance that changes to the PPACA, as currently implemented, will not have a material adverse effect on the future operating results of the tenants/operators of our properties and, thus, our business. In addition, a case currently pending before The Supreme Court of the United States, *King vs. Burwell*, challenges the federal government s ability to subsidize premiums paid by certain eligible individuals that obtain health insurance policies through federally facilitated exchanges. A number of our properties are located in states that utilize federally facilitated exchanges. The Supreme Court of the United States decision in this case could result in an increased number of uninsured patients in the states that utilize federally facilitated exchanges which would have an adverse impact on the future operating results of the tenants/operators of our facilities located in these states and, thus, our business;

the issues facing the health care industry that affect the operators of our facilities, including UHS, such as: changes in, or the ability to comply with, existing laws and government regulations; unfavorable changes in

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

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

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

two of our MOBs, which are located in California, could not obtain earthquake insurance at rates which are economically beneficial in relation to the risks covered;

competition for our operators from other REITs;

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

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

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

our majority ownership interests in five LLCs in which we hold non-controlling equity interests. In addition, pursuant to the operating and/or partnership agreements of most of the five LLCs in which we continue to hold non-controlling majority ownership interests, the third-party member and the Trust, at any time, have the right to make an offer (Offering Member) to the other member(s) (Non-Offering Member) in which it either agrees to: (i) sell the entire ownership interest of the Offering Member to the Non-Offering Member (Offer to Sell) at a price as determined by the Offering Member (Transfer Price), or; (ii) purchase the entire ownership interest of the Non-Offering Member (Offer to Purchase) at the equivalent proportionate Transfer Price. The Non-Offering Member has 60 to 90 days to either: (i) purchase the entire ownership interest of the Offering Member at the Transfer Price, or; (ii) sell its entire ownership interest to the Offering Member at the equivalent proportionate Transfer Price. The closing of the transfer must occur within 60 to 90 days of the acceptance by the Non-Offering Member;

fluctuations in the value of our common stock, and;

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

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

Critical Accounting Policies and Estimates

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

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

The minimum rent for all hospital facilities is fixed over the initial term or renewal term of the respective leases. Rental income recorded by our properties, including our consolidated and unconsolidated MOBs, relating to leases in excess of one year in length, is recognized using the straight-line method under which contractual rents are recognized evenly over the lease term regardless of when payments are due. The amount of rental revenue resulting from straight-line rent adjustments is dependent on many factors including

the nature and amount of any rental concessions granted to new tenants, stipulated rent increases under existing leases, as well as the acquisitions and sales of properties that have existing in-place leases with terms in excess of one year. As a result, the straight-line adjustments to rental revenue may vary from period-to-period. Bonus rents are recognized when earned based upon increases in each facility s net revenue in excess of stipulated amounts. Bonus rentals are determined and paid each quarter based upon a computation that compares the respective facility s current quarter s net revenue to the corresponding quarter in the base year. Tenant reimbursements for operating expenses are accrued as revenue in the same period the related expenses are incurred.

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

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

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

Assessment of the recoverability by us of certain lease related costs must be made when we have reason to believe that a tenant might not be able to perform under the terms of the lease as originally expected. This requires us to make estimates as to the recoverability of such costs. If we determine that the intangible assets are not recoverable from future cash flows, the excess of carrying value of the intangible asset over its estimated fair value is charged to income.

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

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

losses of some of the LLC investments may be allocated disproportionately as compared to ownership interests after specified preferred return rate thresholds have been satisfied.

At March 31, 2015, we have non-controlling equity investments or commitments in five jointly-owned LLCs which own medical office buildings. These LLCs are included in our financial statements for all periods presented on an unconsolidated basis pursuant to the equity method since they are not variable interest entities. These LLCs are joint-ventures between us and non-related parties that manage and hold minority ownership interests in the entities. Each LLC is generally self-sustained from a cash flow perspective and generates sufficient cash flow to meet its operating cash flow requirements and service the third-party debt (if applicable) that is non-recourse to us. Although there is typically no ongoing financial support required from us to these entities since they are cash-flow sufficient, we may, from time to time, provide funding for certain purposes such as, but not limited to, significant capital expenditures, leasehold improvements and debt financing. Although we are not obligated to do so, if approved by us at our sole discretion, additional cash fundings are typically advanced as equity or member loans.

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

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

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

Relationship with Universal Health Services, Inc. (UHS) and Related Party Transactions UHS is our principal tenant and through UHS of Delaware, Inc., a wholly owned subsidiary of UHS, serves as our advisor (the Advisor) under an Advisory Agreement dated December 24, 1986 between the Advisor and us (the Advisory Agreement). Our officers are all employees of UHS (through UHS of Delaware, Inc.) and although as of March 31, 2015 we had no salaried employees, our officers do receive stock-based compensation from time-to-time.

Pursuant to the Advisory Agreement, the Advisor is obligated to present an investment program to us, to use its best efforts to obtain investments suitable for such program (although it is not obligated to present any particular investment opportunity to us), to provide administrative services to us and to conduct our day-to-day affairs. All transactions between us and UHS must be approved by the Trustees who are unaffiliated with UHS (the Independent Trustees). In performing its services under the Advisory Agreement, the Advisor may utilize independent professional services, including accounting, legal, tax and other services, for which the Advisor is reimbursed directly by us. The Advisory Agreement may be terminated for any reason upon sixty days written notice by us or the Advisor. The Advisory Agreement expires on December 31 of each year; however, it is renewable by us, subject to a determination by the Independent Trustees, that the Advisor s performance has been satisfactory. In December of 2014, based upon a review of our advisory fee and other general and administrative expenses, as compared to an industry peer group, the Advisory Agreement was renewed for 2015 pursuant to the same terms as the Advisory Agreement in place during 2014.

The combined revenues generated from the leases on the UHS hospital facilities comprised approximately 25% and 29% of our consolidated revenues for the three months ended March 31, 2015 and 2014, respectively. Including 100% of the revenues generated at the unconsolidated LLCs in which we have various non-controlling equity interests ranging from 33% to 95%, the leases on the UHS hospital facilities accounted for approximately 20% and 22% of the combined consolidated and unconsolidated revenue for the three months ended March 31, 2015 and 2014, respectively. In addition, fifteen MOBs and FEDs, that are either wholly or jointly-owned by UHT, include tenants which are subsidiaries of UHS. The leases to the hospital facilities of UHS are guaranteed by UHS and cross-defaulted with one another.

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

During the third quarter of 2014, a wholly-owned subsidiary of UHS provided notification to us that, upon expiration of The Bridgeway s lease term which occurred in December, 2014, it intended to exercise its option to purchase the real property of the facility. Pursuant to the terms of the lease, we and the wholly-owned subsidiary of UHS were both required to obtain independent appraisals of the property to determine its fair market value. On December 31, 2014, The Bridgeway, a 103-bed behavioral health facility located in North Little Rock, Arkansas, was sold to UHS for $17.3 million. During each of the three years ended December 31, 2014, our revenues, net cash provided by operating activities and funds from operations have included approximately $1.1 million earned annually in connection with The Bridgeway s lease.

During the first quarter of 2015, we purchased from wholly-owned subsidiaries of UHS, the real property of two newly-constructed and recently opened FEDs located in Weslaco and Mission, Texas. Each FED consists of approximately 13,600 square feet and is operated by wholly-owned subsidiaries of UHS. In connection with these acquisitions, ten-year lease agreements with six, 5-year renewal terms have been executed with UHS for each FED. The first four, 5-year renewal terms (covering years 2025 through 2044) include 2% annual lease rate increases, computed on accumulative and compounded basis, and the last two, 5-year renewal terms (covering the years 2045 through 2054) will be at the then fair market value lease rates. UHS has the option to purchase the leased properties upon the expiration of the fixed term and each five-year extended term at the fair market value at that time. The leases on the FEDs are cross-defaulted with one another. The aggregate acquisition cost of these facilities was approximately $12.8 million, and the aggregate rental revenue earned by us at the commencement of the leases is approximately $900,000 annually.

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

Results of Operations

Effective August 1, 2014, we purchased the minority ownership interests, ranging from 5% to 15%, held by third-party members in six LLCs in which we previously held noncontrolling majority ownership interests. As a result of these minority ownership purchases, we now own 100% of each of these six LLCs and our Condensed Consolidated Statement of Income for the three months ended March 31, 2015 includes the revenues and expenses associated with each of these properties. Prior to August 1, 2014, these LLCs were accounted for on an unconsolidated basis pursuant to the equity method, as discussed above.

The table below provides supplemental financial information related to each of the above-mentioned entities for the three-month period ended March 31, 2014, and also presents the first quarter of 2014 on an As Adjusted financial statement presentation basis similar to the presentation applied for each entity for the three-month period ended March 31, 2015. Other than increased depreciation and amortization expense resulting from the amortization of the intangible assets recorded in connection with these transactions, there was no material impact to our net income as a result of the consolidation of these LLCs.

Three Months Ended March 31, 2015 as compared to Three Months Ended March 31, 2014:

	As reported in Condensed Consolidated Statements of Income for the Three Months Ended March 31, 2015	As reported in Condensed Consolidated Statements of Income for the Three Months Ended March 31, 2014	Three months ended March 31, 2014 Statements of Income Adjustments (a.)	As Adjusted Three Months Ended March 31, 2014	As Adjusted Variance
Revenues	$ 16,202	$ 14,288	$ 1,498	$ 15,786	$ 416
Expenses:					
Depreciation and amortization	5,523	4,826	311	5,137	(386)
Advisory fees to UHS	666	610	0	610	(56)
Other operating expenses	4,722	3,933	701	4,634	(88)
Transaction costs	57	62	0	62	5
	10,968	9,431	1,012	10,443	(525)
Income before equity in income of unconsolidated LLCs, interest expense and gains	5,234	4,857	486	5,343	(109)
Equity in income of unconsolidated LLCs	592	593	(205)	388	204
Gains on fair value recognition resulting from purchase of minority interests in	0	316	0	316	(316)

majority-owned LLCs					
Interest expense, net	(2,130)	(1,992)	(281)	(2,273)	143
Net income	$ 3,696	$ 3,774	$ 0	$ 3,774	$ (78)

(a.) Adjustments consist of revenues and expenses for the three months ended March 31, 2014, for the six LLCs that we began consolidating effective August 1, 2014, as mentioned above.

For the three months ended March 31, 2015, net income was $3.7 million as compared to $3.8 million during the comparable prior year quarter. The $78,000 decrease in net income during the first quarter of 2015, as compared to the comparable prior year quarter, was attributable to:

a decrease of $316,000 due to the gains recorded during the first quarter of 2014, on fair value recognition in connection with the purchase of minority interests in majority-owned LLCs, as discussed above;

a decrease of approximately $386,000 attributable to a net increase in depreciation and amortization expense primarily resulting from the fair value recognition recorded in connection with our acquisition of minority ownership interests in various LLCs in August, 2014;

an increase of $143,000 attributable to a decrease in interest expense (As Adjusted) due primarily to the repayment of two mortgages during the third quarter of 2014 and the first quarter of 2015 utilizing funds borrowed under our revolving credit facility which bear interest at a comparatively lower interest rate;

an increase of $68,000 in bonus rental earned on the hospital facilities leased to wholly-owned subsidiaries of UHS;

an increase of $204,000 (As Adjusted) in equity in income of unconsolidated LLCs, resulting from combined net increases at various unconsolidated properties, and;

other combined net increases of approximately $209,000, including increases in net income at various consolidated properties.

Total revenues increased by $416,000 (As Adjusted) during the three months ended March 31, 2015 as compared to the comparable period of 2014. The increase in revenues during the first quarter of 2015, as compared to the comparable period of 2014, was primarily due to the revenues generated at MOBs acquired during the third quarter of 2014 and the first quarter of 2015, an increase in bonus rental revenue, as mentioned above, partially offset by the revenues generated during the first quarter of 2014 related to The Bridgeway which was divested in December, 2014.

Included in our other operating expenses are expenses related to the consolidated medical office buildings, which totaled $4.3 million and $4.1 million (As Adjusted) for the three-month periods ended March 31, 2015 and 2014, respectively. A large portion of the expenses associated with our consolidated medical office buildings is passed on directly to the tenants either directly as tenant reimbursements of common area maintenance expenses or included in base rental amounts. Tenant reimbursements for operating expenses are accrued as revenue in the same period the related expenses are incurred and are included as tenant reimbursement revenue in our condensed consolidated statements of income.

Funds from operations (FFO) is a widely recognized measure of performance for Real Estate Investment Trusts (REITs). We believe that FFO and FFO per diluted share, and adjusted funds from operations (AFFO) and AFFO per diluted share, which are non-GAAP financial measures (GAAP is Generally Accepted Accounting Principles in the United States of America), are helpful to our investors as measures of our operating performance. We compute FFO, as reflected below, in accordance with standards established by the National Association of Real Estate Investment Trusts (NAREIT), which may not be comparable to FFO reported by other REITs that do not compute FFO in accordance with the NAREIT definition, or that interpret the NAREIT definition differently than we interpret the definition. AFFO was also computed for the three-month periods ended March 31, 2015 and 2014, as reflected below, since we believe it is helpful to our investors since it adjusts for the effect of the transaction costs related to acquisitions. FFO/AFFO do not represent cash generated from operating activities in accordance with GAAP and should not be considered to be an alternative to net income determined in accordance with GAAP. In addition, FFO/AFFO should not be used as: (i) an indication of our financial performance determined in accordance with GAAP; (ii) an alternative to cash flow from operating activities determined in accordance with GAAP; (iii) a measure of our liquidity, or; (iv) an indicator of funds available for our cash needs, including our ability to make cash distributions to shareholders.

Below is a reconciliation of our reported net income to FFO and AFFO for the three-month periods ended March 31, 2015 and 2014 (in thousands):

	Three Months Ended March 31,	
	2015	2014
Net income	$ 3,696	$ 3,774
Depreciation and amortization expense on consolidated investments	5,410	4,752
Depreciation and amortization expense on unconsolidated affiliates	410	673
Gains on fair value recognition resulting from the purchase of minority interests in majority-owned LLCs	0	(316)
Funds From Operations	$ 9,516	$ 8,883
Transaction costs	57	62
Adjusted Funds From Operations	$ 9,573	$ 8,945

Our FFO increased by $633,000 during the three-month period ended March 31, 2015, as compared to the comparable period of 2014. The $633,000 increase in FFO during the first quarter of 2015 as compared to the first quarter of 2014 was attributable to: (i) the $78,000 decrease in net income, as discussed above, offset by; (ii) the $316,000 gain recorded during the three months ended March 31, 2014, as discussed above, which was deducted for FFO purposes during the first quarter of 2014, plus; (iii) a $395,000 net increase in the depreciation and amortization expense incurred at our properties (on a consolidated and unconsolidated basis).

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Our AFFO increased by $628,000 during the three-month period ended March 31, 2015, as compared to the comparable period of 2014. The $628,000 increase in AFFO during the first quarter of 2015, as compared to the first quarter of 2014, was due to the $633,000 increase in FFO, as discussed above, offset by a $5,000 change in transaction costs incurred during each quarter.

Liquidity and Capital Resources

Net cash provided by operating activities

Net cash provided by operating activities was $8.2 million and $7.0 million during the three-month periods ended March 31, 2015 and 2014, respectively. The $1.2 million net increase was attributable to:

- a favorable change of $922,000 due to an increase in net income plus/minus the adjustments to reconcile net income to net cash provided by operating activities (depreciation and amortization, amortization of debt net premium, stock-based compensation, gains on purchase of minority interests in majority-owned LLCs and income in excess of cash distributions from LLCs), as discussed above in Results of Operations;

- a favorable change of $471,000 in accrued expenses and other liabilities, primarily resulting from the timing of payments of accrued expenses, and;

- other combined net unfavorable changes of $130,000.

Net cash used in investing activities

Net cash used in investing activities was $20.5 million during the three months ended March 31, 2015 as compared to $7.9 million during the three months ended March 31, 2014.

During the three-month period ended March 31, 2015, we funded: (i) $321,000 in equity investments in various unconsolidated LLCs; (ii) $2.2 million in capital additions to real estate investments primarily for tenant improvements at various MOBs; (iii) $16.8 million to acquire the real estate assets of a medical office building and two free-standing emergency departments, as discussed above, and; (iv) $2.3 million payment of a note payable related to the purchase of third-party minority ownership interests in six majority-owned LLCs during the third quarter of 2014, as discussed above. In addition, during the three-month period ended March 31, 2015, we received $1.0 million of cash proceeds in connection with the refinancing of third-party debt by a majority-owned LLC in which we hold a noncontrolling ownership interest.

During the three-month period ended March 31, 2014, we funded: (i) $442,000 in equity investments in various unconsolidated LLCs; (ii) $641,000 in capital additions to real estate investments primarily for tenant improvements at various MOBs; (iii) $7.1 million to acquire the real estate assets of two medical office buildings in a single transaction, as discussed above, and; (iv) $170,000 to acquire the minority interests in two majority-owned LLCs, as discussed above. In addition, during the three-month period ended March 31, 2014, we received $406,000 of cash distributions in excess of income from our unconsolidated LLCs.

Net cash provided by financing activities

Net cash provided by financing activities was $12.3 million during the three months ended March 31, 2015, as compared to $1.2 million during the three months ended March 31, 2014.

During the three-month period ended March 31, 2015, we: (i) received $26.3 million of additional net borrowings on our revolving line of credit, and; (ii) received $1.2 million of net cash from the issuance of shares of beneficial interest in late December, 2014, (as discussed below). Additionally, during the three months ended March 31, 2015, we paid: (i) $5.7 million on mortgages and other notes payable that are non-recourse to us, (including the pay-off of the $4.9 million outstanding mortgage on the Spring Valley Medical Office Building utilizing funds borrowed under our revolving credit facility); (ii) $913,000 of financing costs paid on the new revolving credit facility, and; (iii) $8.4 million of dividends.

During the three-month period ended March 31, 2014, we: (i) received $7.6 million of additional net borrowings on our revolving line of credit, and; (ii) generated $2.5 million of net cash from the issuance of shares of beneficial interest. Additionally, during the three months ended March 31, 2014, we paid: (i) $796,000 on mortgage and other notes payable that are non-recourse to us, and; (ii) $8.1 million of dividends.

During the fourth quarter of 2013, we commenced an at-the-market (ATM) equity issuance program, pursuant to the terms of which we may sell, from time-to-time, common shares of our beneficial interest up to an aggregate sales price of $50 million to or through Merrill Lynch, Pierce, Fenner and Smith, Incorporated (Merrill Lynch), as sales agent and/or principal. The common shares will be offered pursuant to the Registration Statement filed with the Securities and Exchange Commission, which became effective in November, 2012.

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There were no shares issued pursuant to the ATM program during the first quarter of 2015. Since inception of this ATM program, we have issued 580,900 shares at an average price of $45.97 per share, which generated approximately $25.6 million of net proceeds (net of approximately $1.1 million, consisting of compensation of $667,000 to Merrill Lynch as well as $391,000 of other various fees and expenses). Included in the above was approximately $1.1 million of the net cash proceeds (net of approximately $29,000 of compensation to Merrill Lynch) related to shares issued in late December, 2014 which were received by us during the first quarter of 2015.

Additional cash flow and dividends paid information for the three-month periods ended March 31, 2015 and 2014:

As indicated on our condensed consolidated statement of cash flows, we generated net cash provided by operating activities of $8.2 million and $7.0 million during the three-month periods ended March 31, 2015 and 2014, respectively. As also indicated on our statement of cash flows, noncash expenses such as depreciation and amortization expense, stock-based compensation expense, the gain recorded during the first three months of 2014, as well as the income in excess of cash distributions from LLCs are the primary differences between our net income and net cash provided by operating activities during each period. In addition, as reflected in the cash flows from investing activities section, we received $406,000 during the three months ended March 31, 2014, of cash distributions in excess of income from various unconsolidated LLCs which represents our share of the net cash flow distributions from these entities. The cash distributions in excess of income represent operating cash flows net of capital expenditures and debt repayments made by the LLCs.

We generated $8.2 million and $7.4 million of net cash during the three months ended March 31, 2015 and 2014, respectively, related to the operating activities of our properties recorded on a consolidated and an unconsolidated basis. We paid dividends of $8.4 million and $8.1 million during the three months ended March 31, 2015 and 2014, respectively. During the first three months of 2015, the $8.2 million of net cash generated related to the operating activities of our properties was approximately $200,000 less than the $8.4 million of dividends paid during the period. During the first three months of 2014, the $7.4 million of net cash generated related to operating activities of our properties was approximately $700,000 less than the $8.1 million of dividends paid during the period.

As indicated in the cash flows from investing activities and cash flows from financing activities sections of the statements of cash flows, there were various other sources and uses of cash during the three months ended March 31, 2015 and 2014. Therefore, the funding source for our dividend payments is not wholly dependent on the operating cash flow generated by our properties in any given period. Rather, our dividends, as well as our capital reinvestments into our existing properties, acquisitions of real property and other investments are funded based upon the aggregate net cash inflows or outflows from all sources and uses of cash from the properties we own either in whole or through LLCs, as outlined above.

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

Included in the various sources of cash were: (i) cash distributions of refinancing proceeds from an LLC ($1.1 million for the three months ended March 31, 2015); (ii) net borrowings on our revolving credit agreement ($26.3 million and $7.6 million for the three months ended March 31, 2015 and 2014, respectively), and; (iii) net cash generated in connection with the issuance of shares of beneficial interest ($1.2 million and $2.5 million for the three months ended March 31, 2015 and 2014, respectively).

In addition to the dividends paid, the following were also included in the various uses of cash: (i) investments in LLCs ($321.00 and $442,000 for the three months ended March 31, 2015 and 2014, respectively); (ii) net real estate additions ($2.2 million and $641,000 for the three months ended March 31, 2015 and 2014, respectively); (iii) repayments of mortgage and other notes payable ($5.7 million and $796,000 for the three months ended March 31, 2015 and 2014, respectively); (iv) financing cost paid on new Revolving Credit Facility ($913,000 for the three months ended March 31, 2015); (v) Payments made in connection with acquisition of minority interests in majority-owned LLCs, ($2.3 million and $170,000 for the three months ended March 31, 2015 and 2014, respectively), and; (vi) acquisitions of properties ($16.8 million and $7.1 million for the three months ended March 31, 2015 and 2014, respectively).

We expect to finance all capital expenditures and acquisitions and pay dividends utilizing internally generated and additional funds. Additional funds may be obtained through: (i) borrowings under our existing $185 million revolving credit facility agreement (which has $63.1 million of available borrowing capacity, net of outstanding borrowings and letters of credit, as of March 31, 2015); (ii) the issuance of equity pursuant to an at-the-market equity issuance program; (iii) borrowings under or refinancing of existing third-party debt pursuant to mortgage and construction loan agreements entered into by our LLCs, and/or; (iv) the issuance of other long-term debt.

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

Credit facilities and mortgage debt

On March 27, 2015, we entered into a new $185 million revolving credit agreement (Credit Agreement). The Credit Agreement, which will mature in four years, replaced our previous revolving credit facility which was scheduled to mature on July 24, 2015. The Credit Agreement includes a $50 million sub limit for letters of credit and a $20 million sub limit for swingline/short-term loans. The Credit Agreement also provides a one-time option to extend the maturity date for an additional one year period, and an option to increase the total facility borrowing capacity up to an additional $50 million, subject to lender agreement. Borrowings under the new facility are guaranteed by certain subsidiaries of the Trust. In addition, borrowings under the new facility are secured by first priority security interests in and liens on all equity interests in the Trust s wholly-owned subsidiaries. Borrowings made pursuant to the Credit Agreement will bear interest, at our option, at one, two, three, or six month LIBOR plus an applicable margin ranging from 1.50% to 2.00% or at the Base Rate plus an applicable margin ranging from 0.50% to 1.00%. The Credit Agreement defines Base Rate as the greatest of: (a) the administrative agent s prime rate; (b) the federal funds effective rate plus 1/2 of 1%, and; (c) one month LIBOR plus 1%. A commitment fee of 0.20% to 0.40% (depending on the Trust s total leverage ratio) will be charged on the average unused portion of the revolving credit commitments. The margins over LIBOR, Base Rate and the commitment fee are based upon our ratio of debt to total capital. At March 31, 2015, the applicable margin over the LIBOR rate was 1.625%, the margin over the Base Rate was 0.625%, and the commitment fee was 0.25%.

At March 31, 2015, we had $116 million of outstanding borrowings and $5.9 million of letters of credit outstanding against our revolving credit agreement. We had $63.1 million of available borrowing capacity, net of the outstanding borrowings and letters of credit outstanding as of March 31, 2015. There are no compensating balance requirements.

On February 10, 2015, we borrowed an additional $4.9 million under our previous revolving credit agreement, which was utilized to repay the outstanding mortgage balance on the Spring Valley Medical Office Building. The mortgage loan on this property matured on February 10, 2015.

The Credit Agreement contains customary affirmative and negative covenants, including limitations on certain indebtedness, liens, acquisitions and other investments, fundamental changes, asset dispositions and dividends and other distributions. The Credit Agreement also contains restrictive covenants regarding the Trust s ratio of total debt to total assets, the fixed charge coverage ratio, the ratio of total secured debt to total asset value, the ratio of total unsecured debt to total unencumbered asset value, and minimum net worth, as well as customary events of default, the

occurrence of which may trigger an acceleration of amounts outstanding under the Credit Agreement. We are in compliance with all of the covenants at March 31, 2015. We also believe that we would remain in compliance if the full amount of our commitment was borrowed.

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

	Covenant	March 31, 2015
Tangible net worth	$ 125,000	$ 177,689
Total leverage	< 60%	48.9%
Secured leverage	< 30%	23.2%
Unencumbered leverage	< 60%	38.8%
Fixed charge coverage	> 1.50x	3.1x

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We have fifteen mortgages, all of which are non-recourse to us, included on our condensed consolidated balance sheet as of March 31, 2015, with a combined outstanding balance of $117.1 million (excluding net debt premium, of $468,000 at March 31, 2015). The following table summarizes our outstanding mortgages, excluding net debt premium, at March 31, 2015 (amounts in thousands):

Facility Name	Outstanding Balance (in thousands)(a)	Interest Rate	Maturity Date
Desert Valley Medical Center floating rate mortgage loan (b.)	$ 3,833	3.40%	October, 2015
Palmdale Medical Plaza fixed rate mortgage loan (b.)	5,969	3.69%	October, 2015
Summerlin Hospital Medical Office Building III floating rate mortgage loan	10,942	3.42%	December, 2016
Peace Health fixed rate mortgage loan	21,132	5.64%	April, 2017
Auburn Medical II floating rate mortgage loan	7,126	2.92%	April, 2017
Medical Center of Western Connecticut fixed rate mortgage loan	4,754	6.00%	June, 2017
Summerlin Hospital Medical Office Building II fixed rate mortgage loan	11,653	5.50%	October, 2017
Phoenix Children s East Valley Care Center fixed rate mortgage loan	6,451	5.88%	December, 2017

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Facility Name	Outstanding Balance (in thousands)(a)	Interest Rate	Maturity Date
Centennial Hills Medical Office Building floating rate mortgage loan	10,566	3.42%	January, 2018
Sparks Medical Building/Vista Medical Terrace floating rate mortgage loan	4,446	3.42%	February, 2018
Rosenberg Children s Medical Plaza fixed rate mortgage loan	8,439	4.85%	May, 2018
Vibra Hospital-Corpus Christi fixed rate mortgage loan	2,880	6.50%	July, 2019
700 Shadow Lane and Goldring MOBs fixed rate mortgage loan	6,559	4.54%	June, 2022
BRB Medical Office Building fixed rate mortgage loan	6,630	4.27%	December, 2022
Tuscan Professional Building fixed rate mortgage loan	5,759	5.56%	June, 2025
Total	$ 117,139		

(a) Amortized principal payments are made on a monthly basis.
(b) We expect this loan to be refinanced for three to ten year terms at the then current market interest rates. In the unexpected event that we are unable to refinance this loan on reasonable terms, we will explore other financing alternatives, including, among other things, utilizing funds borrowed under our revolving credit facility.

Off Balance Sheet Arrangements

As of March 31, 2015, we are party to certain off balance sheet arrangements consisting of standby letters of credit and equity and debt financing commitments. Our outstanding letters of credit at March 31, 2015 totaled $5.9 million consisting of: (i) $2.1 million related to Centennial Hills Medical Properties; (ii) $1.1 million related to Palmdale Medical Properties; (iii) $1.2 million related to Banburry Medical Properties; (iv) $1.0 million related to FTX MOB Phase II, LP; and; (v) $478,000 related to Arlington Medical Properties.

Acquisition and Divestiture Activity

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Reference is made to Item 7A in our Annual Report on Form 10-K for the year ended December 31, 2014. There have been no material changes in the quantitative and qualitative disclosures during the first three months of 2015.

Item 4. Controls and Procedures

As of March 31, 2015, under the supervision and with the participation of our management, including the Trust s Chief Executive Officer (CEO) and Chief Financial Officer (CFO), we performed an evaluation of the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act

of 1934, as amended (the 1934 Act).

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

There have been no changes in our internal control over financial reporting or in other factors during the first quarter of 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

UNIVERSAL HEALTH REALTY INCOME TRUST

Item 1A. Risk Factors

Our Annual Report on Form 10-K for the year ended December 31, 2014 includes a listing of risk factors to be considered by investors in our securities. There have been no material changes in our risk factors from those set forth in our Annual Report on Form 10-K for the year ended December 31, 2014.

Item 6. Exhibits

(a.) Exhibits:

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

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Signatures

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

Date: May 8, 2015

UNIVERSAL HEALTH REALTY INCOME TRUST

(Registrant)

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

President and Chief Executive Officer

(Principal Executive Officer)

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

(Principal Financial Officer)

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EXHIBIT INDEX

Exhibit No.	Description
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