

HEALTH CARE PROPERTY INVESTORS INC
Form 10-Q
August 09, 2006

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006.

OR

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

For the transition period from to

Commission file number 1-8895

HEALTH CARE PROPERTY INVESTORS, INC.

(Exact name of registrant as specified in its charter)

Maryland

(State or other jurisdiction of
incorporation of organization)

33-0091377

(I.R.S. Employer
Identification No.)

**3760 Kilroy Airport Way, Suite 300
Long Beach, CA 90806**

(Address of principal executive offices)

(562) 733-5100

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject

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to such filing requirements for the past 90 days: YES NO

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

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

As of July 31, 2006, there were 137,301,582 shares of \$ 1.00 par value common stock outstanding.

HEALTH CARE PROPERTY INVESTORS, INC.

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HEALTH CARE PROPERTY INVESTORS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

	June 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Real estate:		
Buildings and improvements	\$ 3,734,016	\$ 3,424,857
Developments in process	21,862	22,286
Land	352,437	334,750
Less accumulated depreciation and amortization	657,182	600,562
Net real estate	3,451,133	3,181,331
Loans receivable, net:		
Joint venture partners	7,006	7,006
Others	138,681	179,825
Investments in and advances to unconsolidated joint ventures	51,142	48,598
Accounts receivable, net of allowance of \$1,373 and \$1,205, respectively	12,422	13,313
Cash and cash equivalents	21,476	21,342
Restricted cash	2,375	2,270
Intangibles, net	60,849	38,804
Real estate held for sale, net	45,746	60,521
Other assets, net	67,775	44,255
Total assets	\$ 3,858,605	\$ 3,597,265
LIABILITIES AND STOCKHOLDERS EQUITY		
Bank line of credit	\$ 265,100	\$ 258,600
Senior unsecured notes	1,476,587	1,462,250
Mortgage debt	454,802	236,096
Accounts payable and accrued liabilities	76,782	68,718
Deferred revenue	35,973	22,551
Total liabilities	2,309,244	2,048,215
Minority interests:		
Joint venture partners	23,893	20,905
Non-managing member unitholders	133,821	128,379
Total minority interests	157,714	149,284
Stockholders equity:		
Preferred stock, \$1.00 par value: 50,000,000 shares authorized; 11,820,000 shares issued and outstanding, liquidation preference of \$25 per share	285,173	285,173
Common stock, \$1.00 par value: 750,000,000 shares authorized; 137,049,212 and 136,193,764 shares issued and outstanding, respectively	137,049	136,194
Additional paid-in capital	1,464,181	1,446,349
Cumulative net income	1,620,601	1,521,146

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Cumulative dividends	(2,115,671)	(1,988,248)
Accumulated other comprehensive income (loss)	314		(848)
Total stockholders' equity	1,391,647		1,399,766	
Total liabilities and stockholders' equity	\$ 3,858,605		\$ 3,597,265	

See accompanying Notes to Condensed Consolidated Financial Statements.

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HEALTH CARE PROPERTY INVESTORS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues and other income:				
Rental revenues and other income	\$ 131,008	\$ 110,137	\$ 251,469	\$ 210,697
Equity income from unconsolidated joint ventures	2,714	88	6,536	299
Interest and other income	6,360	6,012	22,107	11,191
	140,082	116,237	280,112	222,187
Costs and expenses:				
Interest	33,640	25,372	65,733	48,610
Depreciation and amortization	31,838	26,671	62,233	49,846
Operating	19,118	15,388	36,682	28,689
General and administrative	8,434	8,827	16,826	16,146
Impairments	4,711		4,711	
	97,741	76,258	186,185	143,291
Income before minority interests	42,341	39,979	93,927	78,896
Minority interests	(4,170)	(3,031)	(7,947)	(6,178)
Income from continuing operations	38,171	36,948	85,980	72,718
Discontinued operations:				
Operating income	1,114	1,933	2,602	4,883
Gain on sales of real estate, net	2,282	4,166	10,873	8,904
	3,396	6,099	13,475	13,787
Net income	41,567	43,047	99,455	86,505
Preferred stock dividends	(5,283)	(5,283)	(10,566)	(10,566)
Net income applicable to common shares	\$ 36,284	\$ 37,764	\$ 88,889	\$ 75,939
Basic earnings per common share:				
Continuing operations	\$ 0.24	\$ 0.24	\$ 0.55	\$ 0.46
Discontinued operations	0.03	0.04	0.10	0.11
Net income applicable to common shares	\$ 0.27	\$ 0.28	\$ 0.65	\$ 0.57
Diluted earnings per common share:				
Continuing operations	\$ 0.24	\$ 0.23	\$ 0.55	\$ 0.46
Discontinued operations	0.02	0.05	0.10	0.10
Net income applicable to common shares	\$ 0.26	\$ 0.28	\$ 0.65	\$ 0.56

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Weighted average shares used to calculate earnings per common share:

Basic	136,484	134,445	136,262	133,968
Diluted	137,192	135,214	137,024	134,871

See accompanying Notes to Condensed Consolidated Financial Statements.

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HEALTH CARE PROPERTY INVESTORS, INC.**CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY****(In thousands)****(Unaudited)**

	Preferred Stock		Common Stock		Additional	Cumulative	Dividends	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount	Shares	Amount	Paid-In Capital	Net Income			
December 31, 2005	11,820	\$ 285,173	136,194	\$ 136,194	\$ 1,446,349	\$ 1,521,146	\$ (1,988,248)	\$ (848)	\$ 1,399,766
Exercise of stock options			287	287	4,175				4,462
Other issuances of common stock, net			568	568	9,409				9,977
Net income						99,455			99,455
Preferred stock dividends							(10,566))	(10,566)
Common stock dividends							(116,857))	(116,857)
Amortization of deferred compensation					4,248				4,248
Other comprehensive income, net								1,162	1,162
June 30, 2006	11,820	\$ 285,173	137,049	\$ 137,049	\$ 1,464,181	\$ 1,620,601	\$ (2,115,671)	\$ 314	\$ 1,391,647

See accompanying Notes to Condensed Consolidated Financial Statements.

HEALTH CARE PROPERTY INVESTORS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended June 30,	
	2006	2005
Cash flows from operating activities:		
Net income	\$ 99,455	\$ 86,505
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of real estate and in-place lease intangibles:		
Continuing operations	62,233	49,846
Discontinued operations	804	1,532
Amortization of above and below market lease intangibles, net	(921)	(1,427)
Stock-based compensation	4,248	3,198
Debt issuance costs amortization	1,804	1,573
Recovery of loan losses		(56)
Straight-line rents	(4,721)	(2,742)
Equity income from unconsolidated joint ventures	(6,536)	(299)
Distributions of earnings from unconsolidated joint ventures	5,623	299
Minority interests	7,947	6,178
Impairments	4,711	
Gain on sales of real estate, net	(10,873)	(8,904)
Changes in:		
Accounts receivable	891	1,205
Other assets	(282)	(324)
Accounts payable, accrued liabilities and deferred revenue	9,484	3,573
Net cash provided by operating activities	173,867	140,157
Cash flows from investing activities:		
Acquisition and development of real estate	(264,133)	(130,620)
Lease commissions and tenant and capital improvements	(8,093)	(1,464)
Net proceeds from sales of real estate	27,609	41,587
Distributions from (contributions to) unconsolidated joint ventures	(563)	8,000
Purchase of securities	(12,895)	
Principal repayments on loans receivable	44,298	11,661
Investment in loans receivable	(3,154)	(6,634)
Increase in restricted cash	(105)	(13,311)
Net cash used in investing activities	(217,036)	(90,781)
Cash flows from financing activities:		
Borrowings (repayments) under bank lines of credit	6,500	(184,800)
Repayment of mortgage debt	(19,373)	(2,927)
Issuance of mortgage debt	161,874	
Repayment of senior unsecured notes	(135,000)	(10,000)
Issuance of senior unsecured notes	148,606	247,357
Net proceeds from the issuance of common stock and exercise of options	14,237	34,324
Dividends paid on common and preferred stock	(127,423)	(123,454)

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Distributions to minority interests	(6,118)	(7,948)
Net cash provided by (used in) financing activities	43,303	(47,448)
Net increase in cash and cash equivalents	134	1,928
Cash and cash equivalents, beginning of period	21,342	16,962
Cash and cash equivalents, end of period	\$ 21,476	\$ 18,890

See accompanying Notes to Condensed Consolidated Financial Statements.

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HEALTH CARE PROPERTY INVESTORS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Business

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

(2) Summary of Significant Accounting Policies

Basis of Presentation

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

Use of Estimates

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

Principles of Consolidation

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

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

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

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

Revenue Recognition

Rental income from tenants is recognized in accordance with GAAP, including SEC Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB 104). For leases with minimum scheduled rent increases, the Company recognizes income on a straight-line basis over the lease term when collectibility is reasonably assured. Recognizing rental income on a straight-line basis for leases results in recognized revenue exceeding amounts contractually due from tenants. Such cumulative excess amounts are included in other assets and were approximately \$25 million and \$19 million, net of allowances, at June 30, 2006 and December 31, 2005, respectively. In the event the Company determines that collectibility of straight-line rents is not reasonably assured, the Company limits future recognition to amounts contractually owed, and, where appropriate, the Company establishes an allowance for estimated losses. Certain leases provide for additional rents based upon a percentage of the facility's revenue in excess of specified base periods or other thresholds. Such revenue is deferred until the related thresholds are achieved.

The Company monitors the liquidity and creditworthiness of its tenants and borrowers on an ongoing basis. The evaluation considers industry and economic conditions, property performance, security deposits and guarantees, and other matters. The Company establishes provisions and maintains an allowance for estimated losses resulting from the possible inability of its tenants and borrowers to make payments sufficient to recover recognized assets. For straight-line rent amounts, the Company's assessment is based on income recoverable over the term of the lease. At June 30, 2006 and December 31, 2005, the Company had an allowance of \$25 million and \$22 million, respectively, included in other assets, as a result of the Company's determination that collectibility is not reasonably assured for certain straight-line rent amounts.

Loans Receivable

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

Real Estate

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

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

The Company records acquired above-and-below market leases at their fair value using a discount rate which reflects the risks associated with the leases acquired, equal to the difference between (i) the contractual amounts to be paid pursuant to each in-place lease and (ii) management's estimate of fair market lease rates for each corresponding in-place lease, measured over a period equal to the remaining term of the lease for above-market leases and the initial term plus the term for any below-market fixed rate renewal options for below-market leases. Other intangible assets acquired include amounts for in-place lease values that are based on the Company's evaluation of the specific characteristics of each tenant's lease. Factors to be considered include estimates of carrying costs during hypothetical expected lease-up periods, market conditions, and costs to execute similar leases. In estimating carrying costs, the Company includes real estate taxes, insurance and other operating expenses, and estimates of lost rentals at market rates during the expected lease-up periods, depending on local market conditions. In estimating costs to execute similar leases, the Company considers leasing commissions, legal and other related costs.

Real estate assets and related intangibles are periodically reviewed for potential impairment by comparing the carrying amount to the expected undiscounted future cash flows to be generated from the assets. If the sum of the expected future net undiscounted cash flows is less than the carrying amount of the property, the Company will recognize an impairment loss by adjusting the asset's carrying amount to its estimated fair value. Fair value for properties to be held and used is based on the present value of the future cash flows expected to be generated from the asset. Properties held for sale are recorded at the lower of their carrying amount or fair value less costs to dispose.

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

The Company computes depreciation on properties using the straight-line method over the assets' estimated useful lives. Depreciation is discontinued when a property is identified as held for sale. Buildings and improvements are depreciated over useful lives ranging up to 45 years. Above-and-below market rent intangibles are amortized primarily to revenue over the remaining noncancellable lease terms and bargain renewal periods. Other in-place lease intangibles are amortized to expense over the remaining lease terms and bargain renewal periods. At June 30, 2006 and December 31, 2005, lease intangible assets, net were \$60.8 million and \$38.8 million, respectively. At June 30, 2006 and December 31, 2005, lease intangible liabilities, net were \$13.6 million and \$5.3 million, respectively, and are included in deferred revenue.

Income Taxes

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

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

Discontinued Operations

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

The Company periodically sells assets based on market conditions and the exercise of purchase options by tenants. The operating results of properties meeting the criteria established in SFAS No. 144 are reported as discontinued operations in the Company's consolidated statements of income. Discontinued operations for the three and six months ended June 30, 2006, include eight and 14 properties with revenues of \$1.4 million and \$3.4 million, respectively. The Company had 28 and 32 properties classified as discontinued operations for the three and six months ended June 30, 2005, with revenues of \$2.8 and \$6.7 million, respectively. During the six months ended June 30, 2006 and 2005, eight properties were sold in each period, with net gains on real estate dispositions of \$10.9 million and \$8.9 million, respectively. At June 30, 2006 and December 31, 2005, the number of assets held for sale were six and 14 with carrying amounts of \$45.7 million and \$60.5 million, respectively, and are included in real estate held for sale, net on our consolidated balance sheets.

Stock-Based Compensation

On January 1, 2002, the Company adopted the fair value method of accounting for stock-based compensation in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transaction and Disclosure* (SFAS No. 148). The fair value provisions of SFAS No. 123 were adopted prospectively with the fair value of all new stock option grants recognized as compensation expense beginning January 1, 2002. Since only new grants are accounted for under the fair value method, stock-based compensation expense is less than that which would have been recognized if the fair value method had been applied to all awards. Compensation expense for awards with graded vesting is generally recognized ratably over the period from the date of grant to the date when the award is no longer contingent on the employee providing additional services.

SFAS No. 123R, *Share-Based Payments* (SFAS No. 123R), which is a revision of SFAS No. 123, was issued in December 2004. Generally, the approach in SFAS No. 123R is similar to that in SFAS No. 123. However, SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, be recognized in the income

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statement based on their fair values. Pro forma disclosure is no longer an alternative. On January 1, 2006, the Company adopted SFAS No. 123R using the modified prospective application transition method which provides for only current and future period stock-based awards to be measured and recognized at fair value. The adoption of SFAS No. 123R did not have a significant impact on the Company's financial position or results of operations since the fair value provisions of SFAS No. 123 were adopted prospectively on January 1, 2002.

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

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income, as reported	\$ 43,047	\$ 86,505
Add: Stock-based compensation expense included in reported net income	1,870	3,198
Deduct: Stock-based employee compensation expense determined under the fair value based method	(1,950)	(3,358)
Pro forma net income	\$ 42,967	\$ 86,345
Earnings per share:		
Basic as reported	\$ 0.28	\$ 0.57
Basic pro forma	\$ 0.28	\$ 0.57
Diluted as reported	\$ 0.28	\$ 0.56
Diluted pro forma	\$ 0.28	\$ 0.56

Cash and Cash Equivalents

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

Restricted Cash

Restricted cash primarily consists of amounts held by mortgage lenders to provide for future real estate tax expenditures and tenant improvements and security deposits.

Derivatives

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

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

Marketable Securities

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The Company classifies its existing marketable equity securities as available-for-sale in accordance with the provisions of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, (SFAS No. 115). These

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securities are carried at market value, with unrealized gains and losses reported in stockholders' equity as a component of accumulated other comprehensive income (loss). Gains or losses on securities sold are based on the specific identification method. There were no sales of securities for the six months ended June 30, 2006 and 2005.

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

Segment Reporting

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

New Accounting Pronouncements

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

In April 2006 the FASB issued FASB Staff Position FIN 46R-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46R* (FSP FIN 46R-6). FSP FIN 46R-6 addresses how variability should be considered when applying FIN 46R. Variability affects the determination of whether an entity is a VIE, which interests are variable interests, and which party, if any, is the primary beneficiary of the VIE that is required to be consolidated. FSP FIN 46R-6 clarifies that the design of the entity also should be considered when identifying which interests are variable interests.

FSP FIN 46R-6 must be applied prospectively to all entities in which the Company first becomes involved, beginning September 1, 2006. Early application is permitted. The Company does not expect that the adoption of FSP FIN 46R-6 will have a material effect on the Company's financial position or results of operations.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). This interpretation, among other things, creates a two step approach for evaluating uncertain tax positions. Recognition (step one) occurs when an enterprise concludes that a tax position, based solely on its technical merits, is more-likely-than-not to be sustained upon examination. Measurement (step two) determines the amount of benefit that more-likely-than-not will be realized upon settlement. Derecognition of a tax position that was previously recognized would occur when a company subsequently determines that a tax position no longer meets the more-likely-than-not threshold of being sustained. FIN 48 specifically prohibits the use of a valuation allowance as a substitute for derecognition of tax positions, and it has expanded disclosure requirements. FIN 48 is effective for fiscal years beginning after December 15, 2006, in which the impact of adoption should be accounted for as a cumulative-effect adjustment to the beginning balance of retained earnings. The Company is evaluating FIN 48 and has not yet determined the impact the adoption will have on the Company's financial position or results of operations.

Reclassifications

Certain reclassifications have been made for comparative financial statement presentation.

(3) Merger with CNL Retirement Properties, Inc. and Acquisition of CNL Retirement Corp.

On May 1, 2006, HCP entered into a definitive merger agreement with CNL Retirement Properties, Inc. (CRP) under which a wholly owned subsidiary of HCP will merger with CRP. Upon the consummation of the merger with CRP, stockholders holding shares of CRP common stock will be entitled to receive consideration consisting of \$11.1293 in cash and 0.0865 of a share of HCP common stock. CRP had 264.2 million shares of common stock outstanding at March 31, 2006. Consummation of the merger with CRP is subject to several conditions, including the registration of the HCP shares to be issued as consideration and the approval of the merger by the CRP stockholders. On August 4, 2006, the Company s registration statement on Form S-4 (No. 333-135569) was declared effective by the Securities and Exchange Commission. The special meeting of stockholders of CRP to consider and approve the merger of CRP with a subsidiary of the Company is scheduled for September 26, 2006. If the stockholders of CRP approve the merger, the Company expects to close the acquisitions of CRP and CRC in October 2006. In connection with the merger with CRP, HCP has also entered into a definitive merger agreement with respect to CNL Retirement Corp. (CRC), the external advisor to CRP, pursuant to which all outstanding shares of CRC capital stock will be converted into the right to receive in the aggregate 4,378,923 shares of HCP common stock. The proposed merger with CRP and with the proposed merger with CRC are each conditioned upon the consummation of the other.

HCP intends to finance the merger cash consideration and costs, including approximately \$2.94 billion cash portion of the consideration payable to CRP stockholders, under new revolving, term and bridge facilities to be entered into by HCP before the closing of the merger providing for aggregate borrowings of up to \$4.4 billion. HCP has received executed commitments for the \$4.4 billion of such related financings. All of HCP s domestic subsidiaries will guarantee any outstanding obligations under the facilities. The bridge commitment provides for a 364 day facility and the term commitment and revolving commitment for two and three year terms, respectively, with interest rates varying depending on HCP s credit ratings. The facilities will contain covenants similar to those contained in HCP s existing credit agreement, including leverage ratios, a secured debt ratio, an unsecured debt ratio, a fixed charge coverage ratio and a minimum net worth test. In addition, the bridge and term loan facilities impose certain mandatory prepayments with the proceeds from asset sales, capital market transactions, and contributions to joint ventures..

(4) Operator Concentration

Tenet Healthcare Corporation (Tenet) (NYSE: THC) and American Retirement Corporation (ARC) (NYSE: ARC) accounted for 9.3% and 7.6%, respectively, of the Company s revenue during the six months ended June 30, 2006, and accounted for 11.6% and 9.3% respectively, of the Company s revenue during the six months ended June 30, 2005. The carrying amount of the Company s real estate assets leased to Tenet and ARC at June 30, 2006, was \$337.8 million and \$368.0 million, respectively.

On July 25, 2006, ARC was acquired by Brookdale Senior Living Inc. (Brookdale) (NYSE: BKD). As of March 31, 2006, Brookdale operates over 400 senior living facilities in 32 states.

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

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

(5) Acquisitions and Dispositions

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

Acquisitions (1)	Consideration		DownREIT Units (2)	Assets Acquired	
	Cash Paid	Debt Assumed		Real Estate	Net Intangibles
Medical office buildings	\$ 141,301	\$ 11,928	\$ 5,523	\$ 145,685	\$ 13,067
Senior housing facilities	79,421	61,393		138,191	2,623
Other healthcare facilities	30,303			27,539	2,764
	\$ 251,025	\$ 73,321	\$ 5,523	\$ 311,415	\$ 18,454

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

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

(1) Includes transaction costs, if any.

(2) Non-managing member LLC units.

During the six months ended June 30, 2006, the Company acquired properties aggregating \$329.9 million, including the following significant acquisitions:

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

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

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

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

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

During the six months ended June 30, 2006, the Company sold eight properties for \$28 million and recognized gains of approximately \$11 million.

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

(6) Investments in and Advances to Unconsolidated Joint Ventures

HCP Medical Office Portfolio, LLC

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

The Company uses the equity method of accounting for its investment in HCP MOP because it exercises significant influence through voting rights and its position as managing member. However, the Company does not consolidate HCP MOP since it does not control, through voting

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rights or other means, the joint venture as GE has substantive participating decision-making rights and has the majority of the economic interest. The accounting policies of HCP MOP are the same as those described in the summary of significant accounting policies (see Note 2).

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Summarized unaudited condensed financial information of HCP MOP is as follows:

Balance Sheets	June 30, 2006	December 31, 2005
	(In thousands)	
Real estate, at cost	\$ 397,742	\$ 402,845
Less accumulated depreciation and amortization	27,141	22,087
Net real estate	370,601	380,758
Real estate held for sale, net		67,551
Other assets, net	50,344	36,790
Total assets	\$ 420,945	\$ 485,099
Mortgage debt and notes payable	\$ 263,049	\$ 272,681
Mortgage debt on assets held for sale		46,605
Other liabilities	18,872	30,851
GE s capital	93,146	90,424
HCP s capital	45,878	44,538