

NATIONAL HEALTHCARE CORP
Form 10-Q
November 08, 2018

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

FORM 10-Q

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

For the quarterly
period
ended September
30, 2018

OR

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

For the transition
period from

_____ to

Commission file

number
001-13489

(Exact name of registrant as specified in its Charter)

Delaware 52-2057472
(State or other jurisdiction of (I.R.S. Employer incorporation or organization Identification No.)

100 E. Vine Street
Murfreesboro, TN

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

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

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

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

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large Accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Emerging growth company []

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. []

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

15,233,254 shares of common stock of the registrant were outstanding as of November 7, 2018.

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Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****NATIONAL HEALTHCARE CORPORATION****Interim Condensed Consolidated Statements of Operations***(in thousands, except share and per share amounts)**(unaudited)*

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|--------------------------|-------------------|--------------------------|
| | September 30 | | September 30 | |
| | 2018 | 2017 | 2018 | 2017 |
| | | <i>(as adjusted)</i> | | <i>(as adjusted)</i> |
| Revenues: | | | | |
| Net patient revenues | \$234,827 | \$229,259 | \$697,173 | \$683,598 |
| Other revenues | 11,499 | 11,937 | 34,256 | 34,831 |
| Net operating revenues | 246,326 | 241,196 | 731,429 | 718,429 |
| Cost and expenses: | | | | |
| Salaries, wages and benefits | 149,188 | 145,900 | 434,749 | 426,639 |
| Other operating | 64,507 | 63,250 | 192,268 | 188,522 |
| Facility rent | 10,190 | 10,106 | 30,691 | 30,273 |
| Depreciation and amortization | 10,437 | 10,833 | 31,176 | 31,609 |
| Interest | 1,170 | 1,322 | 3,663 | 3,599 |
| Total costs and expenses | 235,492 | 231,411 | 692,547 | 680,642 |
| Income from operations | 10,834 | 9,785 | 38,882 | 37,787 |
| Other income: | | | | |
| Non-operating income | 8,467 | 6,090 | 11,056 | 16,047 |
| Unrealized gains on marketable equity securities | 3,486 | — | 417 | — |
| Income before income taxes | 22,787 | 15,875 | 50,355 | 53,834 |
| Income tax provision | (1,700) | (4,691) | (9,792) | (19,448) |
| Net income | 21,087 | 11,184 | 40,563 | 34,386 |
| Net loss attributable to noncontrolling interest | 55 | 168 | 249 | 349 |
| | \$21,142 | \$11,352 | \$40,812 | \$34,735 |

Net income attributable to National HealthCare Corporation

Earnings per share attributable to National HealthCare Corporation stockholders:

| | | | | |
|---------|---------|--------|--------|--------|
| Basic | \$ 1.39 | \$0.75 | \$2.68 | \$2.29 |
| Diluted | \$ 1.39 | \$0.75 | \$2.68 | \$2.28 |

Weighted average common shares outstanding:

| | | | | |
|---------|------------|------------|------------|------------|
| Basic | 15,225,654 | 15,195,394 | 15,221,217 | 15,186,315 |
| Diluted | 15,242,086 | 15,220,567 | 15,230,692 | 15,217,797 |

| | | | | |
|-------------------------------------|--------|--------|--------|--------|
| Dividends declared per common share | \$0.50 | \$0.48 | \$1.48 | \$1.41 |
|-------------------------------------|--------|--------|--------|--------|

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

Table of Contents**NATIONAL HEALTHCARE CORPORATION****Interim Condensed Consolidated Statements of Comprehensive Income***(unaudited – in thousands)*

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------|----------------------|----------------------|----------------------|
| | September 30 2018 | September 30 2017 | September 30 2018 | September 30 2017 |
| Net income | \$21,087 | \$11,184 | \$40,563 | \$34,386 |
| Other comprehensive gain (loss): | | | | |
| Unrealized gains (losses) on investments in restricted marketable debt securities | (180) | 397 | (3,772) | 2,629 |
| Unrealized gains (losses) on investments in marketable equity securities | – | (4,373) | – | 5,751 |
| Reclassification adjustment for realized (gains) losses on sale of securities | 7 | (17) | (18) | (255) |
| Income tax benefit (expense) related to items of other comprehensive income | 36 | 1,572 | 795 | (3,074) |
| Other comprehensive gain (loss), net of tax | (137) | (2,421) | (2,995) | 5,051 |
| Net loss attributable to noncontrolling interest | 55 | 168 | 249 | 349 |
| Comprehensive income attributable to National HealthCare Corporation | \$21,005 | \$8,931 | \$37,817 | \$39,786 |

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

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

| | September 30, | December 31, |
|---|------------------|-----------------|
| | 2018 | 2017 |
| | <i>unaudited</i> | |
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$55,599 | \$59,118 |
| Restricted cash and cash equivalents, current portion | 10,209 | 6,397 |
| Marketable equity securities | 139,502 | 139,085 |
| Restricted marketable debt securities, current portion | 17,606 | 21,012 |
| Accounts receivable, net | 87,263 | 86,767 |
| Inventories | 7,590 | 7,153 |
| Prepaid expenses and other assets | 3,163 | 2,864 |
| Notes receivable, current portion | 1,338 | 1,450 |
| Federal income tax receivable | 2,203 | 5,465 |
| Total current assets | 324,473 | 329,311 |
| Property and Equipment: | | |
| Property and equipment, at cost | 977,373 | 958,748 |
| Accumulated depreciation and amortization | (436,437) | (409,429) |
| Net property and equipment | 540,936 | 549,319 |
| Other Assets: | | |
| Restricted cash and cash equivalents, less current portion | 1,925 | 1,906 |
| Restricted marketable debt securities, less current portion | 150,428 | 145,383 |
| Deposits and other assets | 5,807 | 4,867 |
| Goodwill | 20,995 | 17,600 |
| Notes receivable, less current portion | 10,031 | 11,801 |
| Investments in limited liability companies | 30,073 | 36,339 |
| Total other assets | 219,259 | 217,896 |
| Total assets | \$1,084,668 | \$1,096,526 |

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

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

| | September 30, | December 31, |
|---|------------------|-----------------|
| | 2018 | 2017 |
| | <i>unaudited</i> | |
| Liabilities and Stockholders' Equity | | |
| Current Liabilities: | | |
| Trade accounts payable | \$ 19,611 | \$ 15,978 |
| Capital lease obligations, current portion | 3,865 | 3,696 |
| Accrued payroll | 58,487 | 67,102 |
| Amounts due to third party payors | 17,596 | 17,389 |
| Accrued risk reserves, current portion | 27,815 | 27,409 |
| Other current liabilities | 16,561 | 16,194 |
| Dividends payable | 7,613 | 7,297 |
| Total current liabilities | 151,548 | 155,065 |
| Long-term debt | 75,000 | 100,000 |
| Capital lease obligations, less current portion | 20,132 | 23,052 |
| Accrued risk reserves, less current portion | 67,972 | 65,866 |
| Refundable entrance fees | 8,668 | 8,827 |
| Obligation to provide future services | 2,887 | 2,887 |
| Deferred income taxes | 18,648 | 18,376 |
| Other noncurrent liabilities | 14,703 | 15,795 |
| Deferred revenue | 3,892 | 3,226 |
| Total liabilities | 363,450 | 393,094 |
| Equity: | | |
| Common stock, \$.01 par value; 45,000,000 shares authorized; 15,225,654 and 15,212,133 shares, respectively, issued and outstanding | 152 | 152 |
| Capital in excess of par value | 217,657 | 215,659 |
| Retained earnings | 505,906 | 419,423 |
| Accumulated other comprehensive income (loss) | (3,692) | 67,504 |
| Total National HealthCare Corporation stockholders' equity | 720,023 | 702,738 |
| Noncontrolling interest | 1,195 | 694 |
| Total equity | 721,218 | 703,432 |
| Total liabilities and equity | \$ 1,084,668 | \$ 1,096,526 |

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

Table of Contents**NATIONAL HEALTHCARE CORPORATION****Interim Condensed Consolidated Statements of Cash Flows***(unaudited – in thousands)*

| | Nine Months Ended | |
|---|-------------------|--------------------------|
| | September 30 | |
| | 2018 | 2017 |
| | | <i>(as adjusted)</i> |
| Cash Flows From Operating Activities: | | |
| Net income | \$40,563 | \$ 34,386 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 31,176 | 31,609 |
| Equity in (earnings) losses of unconsolidated investments | 1,860 | (5,908) |
| Distributions from unconsolidated investments | 3,830 | 7,748 |
| Unrealized gains on marketable equity securities | (417) | – |
| Gains on sale of restricted marketable debt securities | (18) | (255) |
| Gain on acquisition of equity method investment | (2,050) | – |
| Deferred income taxes | 1,067 | 881 |
| Stock-based compensation | 1,538 | 1,263 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 613 | 2,273 |
| Income tax receivable | 3,262 | (1,248) |
| Inventories | (437) | 395 |
| Prepaid expenses and other assets | (1,336) | (942) |
| Trade accounts payable | 3,319 | (3,857) |
| Accrued payroll | (8,615) | (10,326) |
| Amounts due to third party payors | 207 | 3,630 |
| Accrued risk reserves | 2,668 | 4,375 |
| Other current liabilities | 262 | 7,086 |
| Other noncurrent liabilities | (1,092) | (760) |
| Deferred revenue | 666 | 645 |
| Net cash provided by operating activities | 77,066 | 70,995 |
| Cash Flows From Investing Activities: | | |
| Additions to property and equipment | (22,708) | (24,328) |
| Acquisition of equity method investment, net of cash acquired | (527) | – |
| Distributions from/(investments in) unconsolidated companies | 376 | (176) |
| Collections of notes receivable | 1,180 | 3,970 |
| Purchase of restricted marketable securities | (9,950) | (24,874) |
| Sale of restricted marketable securities | 4,539 | 46,598 |

| | | |
|--|-----------------|-----------------|
| Net cash (used in) provided by investing activities | (27,090) | 1,190 |
| Cash Flows From Financing Activities: | | |
| Principal payments on debt | (25,000) | – |
| Principal payments under capital lease obligations | (2,751) | (2,591) |
| Dividends paid to common stockholders | (22,214) | (20,943) |
| Issuance of common shares | 1,327 | 1,627 |
| Repurchase of common shares | (867) | – |
| Equity attributable to noncontrolling interest | – | 970 |
| Entrance fee refunds | (159) | (1,097) |
| Net cash used in financing activities | (49,664) | (22,034) |
| Net Increase in Cash, Cash Equivalents, Restricted Cash, and Restricted Cash Equivalents | 312 | 50,151 |
| Cash, Cash Equivalents, Restricted Cash, and Restricted Cash Equivalents, Beginning of Period | 67,421 | 31,589 |
| Cash, Cash Equivalents, Restricted Cash, and Restricted Cash Equivalents, End of Period | \$67,733 | \$81,740 |
| Balance Sheet Classifications: | | |
| Cash and cash equivalents | \$55,599 | \$69,790 |
| Restricted cash and cash equivalents | 12,134 | 11,950 |
| Total Cash, Cash Equivalents, Restricted Cash, and Restricted Cash Equivalents | \$67,733 | \$81,740 |

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

Table of Contents**NATIONAL HEALTHCARE CORPORATION****Interim Condensed Consolidated Statements of Stockholders' Equity***(in thousands, except share and per share amounts)**(unaudited)*

| | Common Stock | | Capital in Excess of Par | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Non- controlling Interest | Total Stockholders' Equity |
|--|--------------|--------|--------------------------------|----------------------|---|---------------------------------|----------------------------------|
| | Shares | Amount | Value | Earnings | (Loss) | Interest | Equity |
| Balance at January 1, 2017 | 15,162,938 | \$ 152 | \$211,457 | \$391,934 | \$ 66,068 | \$ – | \$ 669,611 |
| Net income attributable to National HealthCare Corporation | – | – | – | 34,735 | – | – | 34,735 |
| Net loss attributable to noncontrolling interest | – | – | – | – | – | (349) | (349) |
| Equity contributed by noncontrolling interest | – | – | – | – | – | 970 | 970 |
| Other comprehensive income | – | – | – | – | 5,051 | – | 5,051 |
| Stock-based compensation | – | – | 1,263 | – | – | – | 1,263 |
| Shares sold – options exercised | 33,917 | – | 1,627 | – | – | – | 1,627 |
| Dividends declared to common stockholders (\$1.41 per share) | – | – | – | (21,419) | – | – | (21,419) |
| Balance at September 30, 2017 | 15,196,855 | \$ 152 | \$214,347 | \$405,250 | \$ 71,119 | \$ 621 | \$ 691,489 |
| Balance at January 1, 2018 | 15,212,133 | \$ 152 | \$215,659 | \$419,423 | \$ 67,504 | \$ 694 | \$ 703,432 |
| Reclassification due to new accounting standards | – | – | – | 68,201 | (68,201) | – | – |
| Net income attributable to National HealthCare Corporation | – | – | – | 40,812 | – | – | 40,812 |
| Net loss attributable to noncontrolling interest | – | – | – | – | – | (249) | (249) |
| Equity contributed by noncontrolling interest | – | – | – | – | – | 750 | 750 |
| Other comprehensive loss | – | – | – | – | (2,995) | – | (2,995) |
| Stock-based compensation | – | – | 1,538 | – | – | – | 1,538 |
| Shares sold – options exercised | 28,027 | – | 1,327 | – | – | – | 1,327 |
| Repurchase of common shares | (14,506) | – | (867) | – | – | – | (867) |
| | – | – | – | (22,530) | – | – | (22,530) |

Dividends declared to common
stockholders (\$1.48 per share)

Balance at September 30, 2018 15,225,654 \$ 152 \$ 217,657 \$ 505,906 \$ (3,692) \$ 1,195 \$ 721,218

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

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NATIONAL HEALTHCARE CORPORATION

Notes to Interim Condensed Consolidated Financial Statements

September 30, 2018

(unaudited)

Note 1 – Description of Business

National HealthCare Corporation (“NHC” or the “Company”) is a leading provider of senior health care services. As of September 30, 2018, we operate or manage, through certain affiliates, 76 skilled nursing facilities with a total of 9,604 licensed beds, 24 assisted living facilities, five independent living facilities, one geriatric psychiatric hospital, and 35 homecare programs. We operate specialized care units within certain of our healthcare centers such as Alzheimer's disease care units and sub-acute nursing units. We also have a noncontrolling ownership interest in a hospice care business that services NHC owned skilled nursing facilities and others. In addition, we provide insurance services, management and accounting services, and we lease properties to operators of skilled nursing facilities. We operate in 10 states and are located primarily in the southeastern United States.

Note 2 – Summary of Significant Accounting Policies

The listing below is not intended to be a comprehensive list of all our significant accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles, with limited need for management's judgment in their application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result. See our audited December 31, 2017 consolidated financial statements and notes thereto which contain accounting policies and other disclosures required by generally accepted accounting principles. Our audited December 31, 2017 consolidated financial statements are available at our web site: www.nhccare.com.

Basis of Presentation

The unaudited interim condensed consolidated financial statements to which these notes are attached include all normal, recurring adjustments which are necessary to fairly present the financial position, results of operations and cash flows of NHC. All significant intercompany transactions and balances have been eliminated in consolidation. The consolidated financial statements include the accounts of all entities controlled by NHC. The Company presents noncontrolling interest within the equity section of its consolidated balance sheets. The Company presents the amount of consolidated net income that is attributable to NHC and the noncontrolling interest in its consolidated statements of operations.

We assume that users of these interim condensed consolidated financial statements have read or have access to the audited December 31, 2017 consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations and that the adequacy of additional disclosure needed for a fair presentation, except in regard to material contingencies, may be determined in that context. Accordingly, footnotes and other disclosures which would substantially duplicate the disclosure contained in our most recent annual report to stockholders have been omitted. This interim financial information is not necessarily indicative of the results that may be expected for a full year for a variety of reasons.

Estimates and Assumptions

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

Recently Adopted Accounting Guidance

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standard Update ("ASU") No. 2014-09 "Revenue from Contracts with Customers," also known as the "New Revenue Standard." This update is the result of a collaborative effort by the FASB and the International Accounting Standards Board to simplify revenue recognition guidance, remove inconsistencies in the application of revenue recognition, and to improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to receive for those goods or services. The New Revenue Standard is applied through the following five-step process:

1. Identify the contract(s) with a customer.
2. Identify the performance obligation in the contract.

3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

For a public entity, this update is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period by applying either the full retrospective method or the cumulative catch-up transition method.

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On January 1, 2018, the Company adopted the provisions of ASU No. 2014-09 using the full retrospective method, which requires us to restate each prior reporting period presented. The most significant impact to NHC relates to the recording of revenue for patients that have individual copayment responsibilities and are eligible for both Medicare and Medicaid benefits (also known as dual eligible patients). As such with these patients, net patient revenues will only include the amounts expected to be collected from the patients in accordance with ASU No. 2014-09. Under the prior accounting guidance, we recorded the price stated in the contract as net patient revenue, and the amounts not collected from our patients were recorded as bad debts in other operating expenses. The adoption of ASU No. 2014-09 has no impact on the Company's accounts receivable as it was historically recorded net of allowance for doubtful accounts and contractual adjustments. The following tables present the effect on the interim condensed consolidated statements of operations for the three months and nine months ended September 30, 2017 for the accounting change that was retrospectively adopted on January 1, 2018:

Consolidated Statements of Operations

(in thousands)

| | Three Months Ended September 30, 2017 | | |
|--------------------------|--|-----------------------------------|----------------|
| | As Previously Reported | Effect of Accounting Change | As Adjusted |
| Net patient revenues | \$230,048 | \$ (789) | \$229,259 |
| Net operating revenues | 241,985 | (789) | 241,196 |
| Other operating expenses | 64,039 | (789) | 63,250 |
| Total costs and expenses | 232,200 | (789) | 231,411 |
| Net income | \$11,184 | \$ – | \$11,184 |

| | Nine Months Ended September 30, 2017 | | |
|--------------------------|---|-----------------------------------|----------------|
| | As Previously Reported | Effect of Accounting Change | As Adjusted |
| Net patient revenues | \$685,854 | \$ (2,256) | \$683,598 |
| Net operating revenues | 720,685 | (2,256) | 718,429 |
| Other operating expenses | 190,778 | (2,256) | 188,522 |
| Total costs and expenses | 682,898 | (2,256) | 680,642 |
| Net income | \$34,386 | \$ – | \$34,386 |

In January 2016, the FASB issued ASU No. 2016-01, “Financial Instruments – Recognition and Measurement of Financial Assets and Financial Liabilities (Topic 825).” ASU No. 2016-01 revises the classification and measurement of investments in certain equity investments and the presentation of certain fair value changes for certain financial liabilities measured at fair value. ASU No. 2016-01 requires the change in fair value of many equity investments to be recognized in net income. On January 1, 2018, the Company adopted the provisions of ASU No. 2016-01 using the modified retrospective method as required by the standard. The adoption of ASU No. 2016-01 resulted in a \$68,073,000 reclassification of net unrealized gains from accumulated other comprehensive income (“AOCI”) to the opening balance of retained earnings. For the three months and nine months ended September 30, 2018, the Company recognized a gain of \$3,486,000 and \$417,000, respectively, in our interim condensed consolidated statement of operations related to the change in fair value of our marketable equity securities. The adoption of ASU No. 2016-01 increases the volatility of other income due to the market fluctuation of our marketable equity securities.

In August 2016, the FASB issued ASU No. 2016-15, “Clarification on Classification of Certain Cash Receipts and Cash Payments on the Statements of Cash Flows.” ASU No. 2016-15 was issued to create consistency in the classification of eight specific cash flow items and provides an accounting policy election for classifying distributions received from equity method investments. Such equity method investment distributions are now classified using a 1) cumulative earnings approach, or 2) nature of distribution approach. On January 1, 2018, the Company adopted the provisions of ASU No. 2016-15 and this standard did not have a material impact on our consolidated financial statements.

In May 2017, the FASB issued ASU No. 2017-09, “Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting.” ASU No. 2017-09 amends the scope of modification accounting for share-based payment arrangements. The ASU provides guidance on the types of changes to the terms or conditions of share-based payment awards to which an entity would be required to apply modification accounting under Accounting Standards Codification (“ASC”) 718. On January 1, 2018, the Company adopted the provisions of ASU No. 2017-09 and this standard did not have a material impact on our consolidated financial statements.

In February 2018, the FASB issued ASU No. 2018-02, “Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.” ASU No. 2018-02 permits a company to reclassify disproportionate tax effects in accumulated other comprehensive income caused by the Tax Cuts and Jobs Act of 2017 to retained earnings. The FASB refers to these amounts as “stranded tax effects.” On January 1, 2018, the Company early adopted the provisions of ASU No. 2018-02. The adoption of this standard resulted in an adjustment of accumulated other comprehensive income, with a corresponding adjustment to the opening balance of retained earnings in the amount of \$128,000, related to the stranded tax effects of the unrealized losses in our restricted marketable debt securities.

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Recent Accounting Guidance Not Yet Adopted

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." The objective of this update is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. This ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those annual periods and is to be applied utilizing a modified retrospective approach. We anticipate this standard will have a material impact on our consolidated financial statements and will result in an increase to total assets and total liabilities. Additionally, we are currently evaluating the impact this standard will have on our policies and procedures and internal control framework.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments." ASU No. 2016-13 replaces the current incurred loss impairment methodology for credit losses with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. This ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those annual periods, with early adoption permitted for fiscal years beginning after December 15, 2018. We are currently evaluation the impact this standard will have on our policies and procedures and internal control framework.

Segment Reporting

In accordance with the provisions of ASC 280, "Segment Reporting", the Company is required to report financial and descriptive information about its reportable operating segments. The Company has two reportable operating segments: (1) inpatient services, which includes the operation of skilled nursing facilities and assisted and independent living facilities, and (2) homecare services. The Company also reports an "all other" category that includes revenues from rental income, management and accounting services fees, insurance services, and costs of the corporate office. See Note 6 for further disclosure of the Company's operating segments.

Other Operating Expenses

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

General and Administrative Costs

With the Company being a healthcare provider, the majority of our expenses are "cost of revenue" items. Costs that could be classified as "general and administrative" by the Company would include its corporate office costs, excluding stock-based compensation, which were \$7,805,000 and \$21,056,000 for the three months and nine months ended September 30, 2018, respectively. General and administrative costs were \$7,180,000 and \$22,442,000 for the three months and nine months ended September 30, 2017, respectively.

Property and Equipment

Property and equipment are recorded at cost. Depreciation is provided by the straight-line method over the expected useful lives of the assets estimated as follows: buildings and improvements, 20-40 years and equipment and furniture, 3-15 years. Leasehold improvements are amortized over periods that do not exceed the non-cancelable respective lease terms using the straight-line method.

Capital leases are recorded at the lower of fair market value or the present value of future minimum lease payments. Capital leases are amortized in accordance with the provision codified within Accounting Standards Codification ("ASC") Subtopic 840-30, *Leases – Capital Leases*. Amortization of capital lease assets is included in depreciation and amortization expense.

Accrued Risk Reserves

We are self-insured for risks related to health insurance and have wholly-owned limited purpose insurance companies that insure risks related to workers' compensation and general and professional liability insurance claims. The accrued risk reserves include a liability for reported claims and estimates for incurred but unreported claims. Our policy is to engage an external, independent actuary to assist in estimating our exposure for claims obligations (for both asserted and unasserted claims). We reassess our accrued risk reserves on a quarterly basis.

Professional liability remains an area of particular concern to us. The long-term care industry has seen an increase in personal injury/wrongful death claims based on alleged negligence by skilled nursing facilities and their employees in providing care to residents. As of September 30, 2018, we and/or our managed centers are defendants in 65 such claims. It remains possible that those pending matters plus potential unasserted claims could exceed our reserves, which could have a material adverse effect on our consolidated financial position, results of operations and cash flows. It is also possible that future events could cause us to make significant adjustments or revisions to these reserve estimates and cause our reported net income to vary significantly from period to period.

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

Continuing Care Contracts and Refundable Entrance Fee

We have one Continuing Care Retirement Community ("CCRC") within our operations. Residents at this retirement center may enter into continuing care contracts with us. The contracts provide that 10% of the resident entry fee becomes non-refundable upon occupancy, and the remaining refundable portion of the entry fee is calculated using the lesser of the price at which the apartment is re-assigned or 90% of the original entry fee, plus 40% of any appreciation if the apartment exceeds the original resident's entry fee.

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Non-refundable fees are included as a component of the transaction price and are amortized into revenue over the actuarially determined remaining life of the resident, which is the expected period of occupancy by the resident. We pay the refundable portion of our entry fees to residents when they relocate from our community and the apartment is re-occupied. Refundable entrance fees are not included as part of the transaction price and are classified as non-current liabilities in the Company's consolidated balance sheets. The balances of refundable entrance fees as of September 30, 2018 and December 31, 2017 were \$8,668,000 and \$8,827,000, respectively.

Obligation to Provide Future Services

We annually estimate the present value of the cost of future services and the use of facilities to be provided to the current CCRC residents and compare that amount with the balance of non-refundable deferred revenue from entrance fees received. If the present value of the cost of future services exceeds the related anticipated revenues, a liability is recorded (obligation to provide future services) with a corresponding charge to income. As of September 30, 2018, and December 31, 2017, we have recorded a future service obligation in the amount of \$2,887,000.

Other Noncurrent Liabilities

Other noncurrent liabilities include reserves primarily related to various uncertain income tax positions.

Deferred Revenue

Deferred revenue includes the deferred gain on the sale of assets to National Health Corporation ("National"), the non-refundable portion (10%) of CCRC entrance fees being amortized over the remaining life expectancies of the residents, and premiums received within our workers' compensation and professional liability companies that are not yet earned.

Noncontrolling Interest

The noncontrolling interest in a subsidiary is presented within total equity in the Company's interim condensed consolidated balance sheets. The Company presents the noncontrolling interest and the amount of consolidated net income attributable to NHC in its interim condensed consolidated statements of operations. The Company's earnings per share is calculated based on net income attributable to NHC's stockholders. The carrying amount of the

noncontrolling interest is adjusted based on an allocation of subsidiary earnings based on ownership interest.

Variable Interest Entities

We have equity interests in unconsolidated limited liability companies that operate various post-acute and senior healthcare businesses. We analyze our investments in these limited liability companies to determine if the company is considered a variable interest entity (“VIE”) and would require consolidation. To the extent that we own interests in a VIE and we (i) are the sole entity that has the power to direct the activities of the VIE and (ii) have the obligation or rights to absorb the VIE's losses or receive its benefits, then we would be determined to be the primary beneficiary and would consolidate the VIE. To the extent we own interests in a VIE, then at each reporting period, we re-assess our conclusions as to which, if any, party within the VIE is considered the primary beneficiary.

The Company's maximum exposure to losses in its investments in unconsolidated VIEs cannot be quantified and may or may not be limited to its investment in the unconsolidated VIE. The investments in unconsolidated VIEs are classified as “investments in limited liability companies” in the consolidated balance sheets.

Prior Period Classifications

Certain amounts in prior periods have been reclassified to conform with current period presentation.

Note 3 – Net Patient Revenues

Net patient revenues are derived from services rendered to patients for skilled and intermediate nursing, rehabilitation therapy, assisted living and independent living, and home health care services. Net patient revenue is reported at the amount that reflects the consideration to which the Company expects to be entitled in exchange for providing patient services. These amounts are due from patients, governmental programs, and other third-party payors, and include variable consideration for retroactive revenue adjustments due to settlement of audits, reviews, and investigations.

The Company disaggregates revenue from contracts with customers by service type and by payor.

Table of Contents*Revenue by Service Type*

The Company's net patient services can generally be classified into the following two categories: (1) inpatient services, which includes the operation of skilled nursing facilities and assisted and independent living facilities, and (2) homecare services.

| | Three Months Ended | | Nine Months Ended | |
|---------------------------|--------------------|-----------|-------------------|-----------|
| | September 30 | | September 30 | |
| <i>(in thousands)</i> | 2018 | 2017 | 2018 | 2017 |
| Net patient revenues: | | | | |
| Inpatient services | \$220,099 | \$213,814 | \$652,066 | \$636,311 |
| Homecare | 14,728 | 15,445 | 45,107 | 47,287 |
| Total net patient revenue | \$234,827 | \$229,259 | \$697,173 | \$683,598 |

The Company recognizes revenue as its performance obligations are completed. The performance obligations are satisfied over time as the patient simultaneously receives and consumes the benefits of the healthcare services provided. For inpatient services, revenue is recognized on a daily basis as each day represents a separate contract and performance obligation. For homecare, revenue is recognized when services are provided based on the number of days of service rendered in the episode or on a per-visit basis. Typically, patients and third-party payors are billed monthly after services are performed or the patient is discharged and payments are due based on contract terms.

As our performance obligations relate to contracts with a duration of one year or less, the Company has elected to apply the optional exemption provided in FASB ASC 606-10-50-14(a) and, therefore, is not required to disclose the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially unsatisfied at the end of the reporting period. The Company has minimal unsatisfied performance obligations at the end of the reporting period as our patients are typically under no obligation to remain admitted in our facilities or under our care.

As the period between the time of service and time of payment is typically one year or less, the Company elected as a practical expedient under ASC 606-10-32-18 to not adjust for the effects of a significant financing component.

Revenue by Payor

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Certain groups of patients receive funds to pay the cost of their care from a common source. The following table sets forth sources of net patient revenues for the periods indicated:

| Source | Three Months Ended | | Nine Months Ended | |
|-----------------------|--------------------|-------|-------------------|-------|
| | September 30 | | September 30 | |
| | 2018 | 2017 | 2018 | 2017 |
| Medicare | 34 % | 34 % | 35 % | 35 % |
| Managed Care | 12 % | 13 % | 12 % | 13 % |
| Medicaid | 27 % | 27 % | 26 % | 26 % |
| Private Pay and Other | 27 % | 26 % | 27 % | 26 % |
| Total | 100 % | 100 % | 100 % | 100 % |

The Company determines the transaction price based on established billing rates reduced by contractual adjustments provided to third party payors. Contractual adjustments are based on contractual agreements and historical experience. The Company considers the patient's ability and intent to pay the amount of consideration upon admission. Subsequent changes resulting from a patient's ability to pay are recorded as bad debt expense, which is included as a component of other operating expenses in the interim condensed consolidated statements of operations. The provision for doubtful accounts was \$1,098,000 and \$3,121,000 for the three months and nine months ended September 30, 2018, respectively. The provision for doubtful accounts was \$982,000 and \$3,215,000 for the three months and nine months ended September 30, 2017, respectively.

Medicare covers skilled nursing services for beneficiaries who require nursing care and/or rehabilitation services following a hospitalization of at least three consecutive days. For each eligible day a Medicare beneficiary is in a skilled nursing facility, Medicare pays the facility a daily payment, subject to adjustment for certain factors such as a wage index in the geographic area. The payment covers all services provided by the skilled nursing facility for the beneficiary that day, including room and board, nursing, therapy and drugs, as well as an estimate of capital-related costs to deliver those services.

For homecare services, Medicare pays based on the acuity level of the patient and based on episodes of care. An episode of care is defined as a length of care up to 60 days with multiple continuous episodes allowed. The services covered by the episode payment include all disciplines of care, in addition to medical supplies, within the scope of the home health benefit. We are allowed to make a request for anticipated payment at the start of care equal to 60% of the expected payment for the initial episode. The remaining balance due is paid following the submission of the final claim at the end of the episode. Deferred revenue is recorded for payments received for which the related services have not yet been provided

Medicaid is operated by individual states with the financial participation of the federal government. The states in which we operate currently use prospective cost-based reimbursement systems. Under cost-based reimbursement

systems, the skilled nursing facility is reimbursed for the reasonable direct and indirect allowable costs it incurred in a base year in providing routine resident care services as defined by the program.

Private pay, managed care, and other payment sources include commercial insurance, individual patient funds, managed care plans and the Veterans Administration. Private paying patients, private insurance carriers and the Veterans Administration generally pay based on the healthcare facilities charges or specifically negotiated contracts. For private pay patients in skilled nursing, assisted living and independent living facilities, the Company bills for room and board charges, with the remittance being due on receipt of the statement and generally by the 10th day of the month the services are performed.

Certain managed care payors for homecare services pay on a per-visit basis. This non-episodic based revenue is recorded on an accrual basis based upon the date of services at amounts equal to its established or estimated per-visit rates.

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Third Party Payors

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Noncompliance with such laws and regulations can be subject to regulatory actions including fines, penalties, and exclusion from the Medicare and Medicaid programs. We believe that we are in compliance with all applicable laws and regulations.

Medicare and Medicaid program revenues, as well as certain Managed Care program revenues, are subject to audit and retroactive adjustment by government representatives or their agents. The Medicare PPS methodology requires that patients be assigned to Resource Utilization Groups ("RUGs") based on the acuity level of the patient to determine the amount paid to us for patient services. The assignment of patients to the various RUG categories is subject to post-payment review by Medicare intermediaries or their agents. Settlements with third-party payors for retroactive adjustments due to audits, reviews or investigations are considered variable consideration and are included in the determination of the estimated transaction price for providing patient care. These settlements are estimated based on the terms of the payment agreement with the payor, correspondence from the payor and the Company's historical settlement activity, including an assessment to ensure that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the retroactive adjustment is subsequently resolved. Estimated settlements are adjusted in future periods as adjustments become known, or as years are settled or are no longer subject to such audits, reviews, and investigations. We believe currently that any differences between the net revenues recorded and final determination will not materially affect the consolidated financial statements. We have made provisions of approximately \$17,596,000 and \$17,389,000 as of September 30, 2018 and December 31, 2017, respectively, for various Medicare, Medicaid, and Managed Care claims reviews and current and prior year cost reports.

Note 4 – Other Revenues

Revenues from rental income include health care real estate properties owned by us and leased to third party operators. Revenues from management and accounting services fees are generated by providing management and accounting services to third-party post-acute healthcare facilities. Revenues from insurance services include premiums for workers' compensation and professional liability insurance policies that our wholly-owned insurance subsidiaries have written for third-party post-acute health care facilities to which we provide management or accounting services. "Other" revenues include miscellaneous health care related earnings.

Other revenues include the following:

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------|----------|----------------------|----------|
| | September 30 | | September 30 | |
| <i>(in thousands)</i> | 2018 | 2017 | 2018 | 2017 |
| Rental income | \$5,548 | \$5,500 | \$16,633 | \$16,501 |
| Management and accounting services fees | 3,818 | 4,130 | 11,265 | 11,741 |
| Insurance services | 1,716 | 2,077 | 5,362 | 5,721 |
| Other | 417 | 230 | 996 | 868 |
| Total other revenues | \$11,499 | \$11,937 | \$34,256 | \$34,831 |

Management Fees from National

We manage five skilled nursing facilities owned by National. For the three months and nine months ended September 30, 2018, we recognized management fees and interest on management fees of \$1,087,000 and \$3,140,000 from these centers, respectively. For the three months and nine months ended September 30, 2017, we recognized management fees and interest on management fees of \$977,000 and \$2,902,000 for these centers.

Insurance Services

For workers' compensation insurance services, the premium revenues reflected in the interim condensed consolidated statements of operations for the three months and nine months ended September 30, 2018 were \$1,043,000 and \$3,342,000, respectively. For the three months and nine months ended September 30, 2017, the workers' compensation premium revenues reflected in the interim condensed consolidated statements of operations were \$1,399,000 and \$4,087,000. Associated losses and expenses are reflected in the interim condensed consolidated statements of operations as "Salaries, wages and benefits."

For professional liability insurance services, the premium revenues reflected in the interim condensed consolidated statements of operations for the three months and nine months ended September 30, 2018 were \$673,000 and \$2,020,000, respectively. For professional liability insurance services, the premium revenues reflected in the interim condensed consolidated statements of operations for the three months and nine months ended September 30, 2017 were \$678,000 and \$1,634,000, respectively. Associated losses and expenses including those for self-insurance are included in the interim condensed consolidated statements of operations as "Other operating costs and expenses".

Table of Contents**Note 5 – Non-Operating Income**

Non-operating income includes equity in earnings of unconsolidated investments, dividends and other realized gains and losses on marketable securities, interest income, and gain on acquisition of additional interest of a geriatric psychiatry partnership.

Our most significant equity method investment is a 75.1% non-controlling ownership interest in Caris HealthCare L.P. (“Caris”), a business that specializes in hospice care services. For the nine months ended September 30, 2018, Caris recorded expenses of \$8,364,000 for the settlement of their Qui Tam legal matter, all of which were incurred during the first two quarters of the year. Please see Note 15 – *Contingencies and Commitments* for further detail describing the Caris’ legal investigation and settlement.

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------|----------------------|----------------------|----------------------|
| | September 30 2018 | September 30 2017 | September 30 2018 | September 30 2017 |
| <i>(in thousands)</i> | | | | |
| Equity in earnings/(losses) of unconsolidated investments | \$2,724 | \$2,528 | \$(1,860) | \$5,908 |
| Dividends and net realized gains on sales of securities | 1,777 | 1,696 | 5,374 | 5,319 |
| Interest income | 1,916 | 1,866 | 5,492 | 4,820 |
| Gain on acquisition of equity method investment | 2,050 | – | 2,050 | – |
| Total non-operating income | \$8,467 | \$6,090 | \$11,056 | \$16,047 |

Gain on acquisition of equity method investment

On July 20, 2018, the Company expanded its operations through an acquisition of additional ownership resulting in a controlling financial interest of a 14-bed geriatric psychiatric hospital in Osage Beach, Missouri. We previously held a noncontrolling interest and accounted for the hospital as an equity method investment. The operating results of the business have been included in the accompanying interim condensed consolidated financial statements since the controlling interest acquisition date.

Upon acquiring a controlling financial interest in the investee, the Company fair valued its previously held equity interest as of the acquisition date. This remeasurement of our equity interest at fair value resulted in a gain of \$2,050,000 during the third quarter of 2018. The gain was recorded in "Non-operating income" in the interim

condensed consolidated statement of operations. Additionally, the excess of the fair value over the amounts assigned to the assets and liabilities of the investee resulted in goodwill in the amount of \$3,395,000.

Note 6 – Business Segments

The Company has two reportable operating segments: (1) inpatient services, which includes the operation of skilled nursing facilities, assisted and independent living facilities, and our geriatric psychiatric hospital; (2) homecare services. These reportable operating segments are consistent with information used by the Company’s Chief Executive Officer, as chief operating decision maker (“CODM”), to assess performance and allocate resources.

The Company also reports an “all other” category that includes revenues from rental income, management and accounting services fees, insurance services, and costs of the corporate office. For additional information on these reportable segments see Note 2 - *Summary of Significant Accounting Policies*.

The Company’s CODM evaluates performance and allocates capital resources to each segment based on an operating model that is designed to improve the quality of patient care and profitability of the Company while enhancing long-term shareholder value. The CODM does not review assets by segment in his resource allocation and therefore, assets by segment are not disclosed below.

The following table sets forth the Company’s unaudited interim condensed consolidated statements of operations by business segment (*in thousands*):

| | Three Months Ended September 30, 2018 | | | |
|-------------------------------|---------------------------------------|-----------|-----------|-----------|
| | Inpatient | Homecare | All Other | Total |
| | Services | | | |
| Revenues: | | | | |
| Net patient revenues | \$220,099 | \$ 14,728 | \$– | \$234,827 |
| Other revenues | 136 | – | 11,363 | 11,499 |
| Net operating revenues | 220,235 | 14,728 | 11,363 | 246,326 |
| Costs and expenses: | | | | |
| Salaries, wages and benefits | 131,418 | 8,367 | 9,403 | 149,188 |
| Other operating | 57,371 | 4,797 | 2,339 | 64,507 |
| Rent | 8,255 | 488 | 1,447 | 10,190 |
| Depreciation and amortization | 9,570 | 55 | 812 | 10,437 |
| Interest | 369 | – | 801 | 1,170 |
| Total costs and expenses | 206,983 | 13,707 | 14,802 | 235,492 |

| | | | | |
|--|-----------|----------|----------|-----------|
| Income (loss) from operations | 13,252 | 1,021 | (3,439) | 10,834 |
| Non-operating income | – | – | 8,467 | 8,467 |
| Unrealized gains on marketable equity securities | – | – | 3,486 | 3,486 |
| Income before income taxes | \$ 13,252 | \$ 1,021 | \$ 8,514 | \$ 22,787 |

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| <i>(As adjusted)</i> | Three Months Ended September 30, 2017 | | | |
|-------------------------------|---------------------------------------|-----------|--------------|------------|
| | Inpatient Services | Homecare | All Other | Total |
| Revenues: | | | | |
| Net patient revenues | \$213,814 | \$ 15,445 | \$– | \$ 229,259 |
| Other revenues | 181 | – | 11,756 | 11,937 |
| Net operating revenues | 213,995 | 15,445 | 11,756 | 241,196 |
| Costs and expenses: | | | | |
| Salaries, wages and benefits | 128,403 | 8,318 | 9,179 | 145,900 |
| Other operating | 56,062 | 5,291 | 1,897 | 63,250 |
| Rent | 8,128 | 502 | 1,476 | 10,106 |
| Depreciation and amortization | 9,756 | 41 | 1,036 | 10,833 |
| Interest | 423 | – | 899 | 1,322 |
| Total costs and expenses | 202,772 | 14,152 | 14,487 | 231,411 |
| Income (loss) from operations | 11,223 | 1,293 | (2,731) | 9,785 |
| Non-operating income | – | – | 6,090 | 6,090 |
| Income before income taxes | \$ 11,223 | \$ 1,293 | \$ 3,359 | \$ 15,875 |

| | Nine Months Ended September 30, 2018 | | | |
|--|--------------------------------------|-----------|--------------|------------|
| | Inpatient Services | Homecare | All Other | Total |
| Revenues: | | | | |
| Net patient revenues | \$652,066 | \$ 45,107 | \$– | \$ 697,173 |
| Other revenues | 588 | – | 33,668 | 34,256 |
| Net operating revenues | 652,654 | 45,107 | 33,668 | 731,429 |
| Costs and expenses: | | | | |
| Salaries, wages and benefits | 382,913 | 25,009 | 26,827 | 434,749 |
| Other operating | 171,275 | 14,816 | 6,177 | 192,268 |
| Rent | 24,780 | 1,460 | 4,451 | 30,691 |
| Depreciation and amortization | 28,602 | 137 | 2,437 | 31,176 |
| Interest | 1,149 | - | 2,514 | 3,663 |
| Total costs and expenses | 608,719 | 41,422 | 42,406 | 692,547 |
| Income (loss) from operations | 43,935 | 3,685 | (8,738) | 38,882 |
| Non-operating income | – | – | 11,056 | 11,056 |
| Unrealized gains on marketable equity securities | – | – | 417 | 417 |

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Income before income taxes \$43,935 \$ 3,685 \$2,735 \$50,355

| <i>(As adjusted)</i> | Nine Months Ended September 30, 2017 | | | |
|-------------------------------|--------------------------------------|-----------|--------------|-----------|
| | Inpatient Services | Homecare | All Other | Total |
| Revenues: | | | | |
| Net patient revenues | \$636,311 | \$ 47,287 | \$- | \$683,598 |
| Other revenues | 631 | - | 34,200 | 34,831 |
| Net operating revenues | 636,942 | 47,287 | 34,200 | 718,429 |
| Costs and expenses: | | | | |
| Salaries, wages and benefits | 373,641 | 24,760 | 28,238 | 426,639 |
| Other operating | 167,454 | 15,484 | 5,584 | 188,522 |
| Rent | 24,552 | 1,490 | 4,231 | 30,273 |
| Depreciation and amortization | 28,362 | 120 | 3,127 | 31,609 |
| Interest | 1,309 | - | 2,290 | 3,599 |
| Total costs and expenses | 595,318 | 41,854 | 43,470 | 680,642 |
| Income (loss) from operations | 41,624 | 5,433 | (9,270) | 37,787 |
| Non-operating income | - | - | 16,047 | 16,047 |
| Income before income taxes | \$41,624 | \$ 5,433 | \$6,777 | \$53,834 |

Table of Contents**Note 7 – Long-Term Leases***Capital Leases*

Fixed assets recorded under the capital leases, which are included in property and equipment in the interim condensed consolidated balance sheets, are as follows:

| | September 30, | December 31, |
|---------------------------------|-----------------------|-----------------|
| | 2018 | 2017 |
| | <i>(in thousands)</i> | |
| Buildings and personal property | \$39,032 | \$39,032 |
| Accumulated amortization | (17,989) | (15,045) |
| | \$21,043 | \$23,987 |

Operating Leases

The Company leases from National Health Investors, Inc. (“NHI”) the real property of 35 skilled nursing facilities, seven assisted living facilities and three independent living facilities under two separate lease agreements. Base rent expense under both lease agreements totals \$34,200,000 annually with rent thereafter escalating by 4% of the increase in facility revenue over the base year. Total facility rent expense to NHI was \$9,478,000 and \$9,314,000 for the three months ended September 30, 2018 and 2017, respectively. Total facility rent expense to NHI was \$28,434,000 and \$27,942,000 for the nine months ended September 30, 2018 and 2017, respectively.

Minimum Lease Payments

The approximate future minimum lease payments required under all leases that have remaining non-cancelable lease terms at September 30, 2018 are as follows:

| | |
|-----------|---------|
| Operating | Capital |
| Leases | Leases |

| | <i>(in thousands)</i> | |
|---|-----------------------|----------|
| 2019 | \$34,200 | \$5,200 |
| 2020 | 34,200 | 5,200 |
| 2021 | 34,200 | 5,200 |
| 2022 | 34,200 | 5,200 |
| 2023 | 34,200 | 5,200 |
| Thereafter | 116,900 | 2,167 |
| Total minimum lease payments | \$287,900 | \$28,167 |
| Less: Amounts representing interest | | (4,170) |
| Present value of minimum lease payments | | 23,997 |
| Less: Current portion | | (3,865) |
| Long-term capital lease obligations | | \$20,132 |

Note 8 – Earnings per Share

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

The following table summarizes the earnings and the weighted average number of common shares used in the calculation of basic and diluted earnings per share *(in thousands, except for share and per share amounts)*:

| | Three Months Ended September 30 | | Nine Months Ended September 30 | |
|--|------------------------------------|------------|-----------------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| Basic: | | | | |
| Weighted average common shares outstanding | 15,225,654 | 15,195,394 | 15,221,217 | 15,186,315 |
| Net income attributable to National HealthCare Corporation | \$21,142 | \$11,352 | \$40,812 | \$34,735 |
| Earnings per common share, basic | \$1.39 | \$0.75 | \$2.68 | \$2.29 |
| Diluted: | | | | |
| Weighted average common shares outstanding | 15,225,654 | 15,195,394 | 15,221,217 | 15,186,315 |
| Dilutive effect of stock options | 16,432 | 25,173 | 9,475 | 31,482 |
| Weighted average common shares outstanding | 15,242,086 | 15,220,567 | 15,230,692 | 15,217,797 |
| Net income attributable to National HealthCare Corporation | \$21,142 | \$11,352 | \$40,812 | \$34,735 |
| Earnings per common share, diluted | \$1.39 | \$0.75 | \$2.68 | \$2.28 |

In the above table, options to purchase 1,048,275 and 1,122,585 shares of our common stock have been excluded for the quarter ended and nine-months ended September 30, 2018 and 2017, respectively, due to their anti-dilutive impact.

Table of Contents**Note 9 – Investments in Marketable Securities**

Our investments in marketable equity securities are carried at fair value with the changes in unrealized gains and losses recognized in our results of operations at each measurement date. Our investments in marketable debt securities are classified as available for sale securities and carried at fair value with the unrealized gains and losses recognized through accumulated other comprehensive income at each measurement date. Realized gains and losses from securities sales are recognized in results of operations upon disposition of the securities using the specific identification method on a trade date basis. Refer to Note 10 - *Fair Value Measurements* for a description of the Company's methodology for determining the fair value of marketable securities.

Marketable securities and restricted marketable securities consist of the following (*in thousands*):

| | September 30, 2018 | | December 31, 2017 | |
|--|--------------------|-----------|-------------------|-----------|
| | Amortized Fair | | Amortized Fair | |
| | Cost | Value | Cost | Value |
| Investments available for sale: | | | | |
| Marketable equity securities | \$30,176 | \$139,502 | \$30,176 | \$139,085 |
| Restricted investments available for sale: | | | | |
| Corporate debt securities | 67,905 | 66,190 | 65,107 | 65,461 |
| Commercial mortgage-backed securities | 57,626 | 56,293 | 54,030 | 53,544 |
| U.S. Treasury securities | 23,497 | 22,540 | 21,685 | 21,172 |
| State and municipal securities | 23,679 | 23,011 | 26,455 | 26,218 |
| | \$202,883 | \$307,536 | \$197,453 | \$305,480 |

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

| | September 30, 2018 | | | December 31, 2017 | | |
|------------------|--------------------|----------|------------|-------------------|----------|------------|
| | Shares | Cost | Fair Value | Shares | Cost | Fair Value |
| NHI Common Stock | 1,630,642 | \$24,734 | \$123,260 | 1,630,642 | \$24,734 | \$122,918 |

The amortized cost and estimated fair value of the marketable debt securities classified as available for sale, by contractual maturity, are as follows (*in thousands*):

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| | September 30, 2018 | | December 31, 2017 | |
|---------------|--------------------|------------|-------------------|------------|
| | Cost | Fair Value | Cost | Fair Value |
| Maturities: | | | | |
| Within 1 year | \$19,273 | \$19,220 | \$18,492 | \$18,499 |
| 1 to 5 years | 88,952 | 87,276 | 70,331 | 70,157 |
| 6 to 10 years | 63,282 | 60,340 | 77,657 | 76,943 |
| Over 10 years | 1,200 | 1,198 | 797 | 796 |
| | \$172,707 | \$168,034 | \$167,277 | \$166,395 |

Gross unrealized gains related to marketable equity securities are \$109,331,000 and \$108,933,000 as of September 30, 2018 and December 31, 2017, respectively. Gross unrealized losses related to marketable equity securities are \$5,000 and \$24,000 as of September 30, 2018 and December 31, 2017, respectively. For the three months and nine months ended September 30, 2018, the Company recognized a net unrealized gain of \$3,486,000 and \$417,000, respectively, for the change in market value of the marketable equity securities in the interim condensed consolidated statements of operations.

Gross unrealized gains related to available for sale marketable debt securities are \$73,000 and \$823,000 as of September 30, 2018 and December 31, 2017, respectively. Gross unrealized losses related to available for sale marketable debt securities are \$4,746,000 and \$1,705,000 as of September 30, 2018 and December 31, 2017, respectively.

For the marketable securities in gross unrealized loss positions, (a) it is more likely than not that the Company will not be required to sell the investment securities before recovery of the unrealized losses, and (b) the Company expects that the contractual principal and interest will be received on the investment securities. As a result, the Company recognized no other-than-temporary impairment during the nine months ended September 30, 2018 or for the year ended December 31, 2017.

Proceeds from the sale of available for sale marketable debt securities during the nine months ended September 30, 2018 and 2017 were \$4,539,000 and \$46,598,000, respectively. Investment gains of \$18,000 and \$255,000 were realized on these sales during the nine months ended September 30, 2018 and 2017, respectively. No sales were reported for the marketable equity securities for the nine months ended September 30, 2018 and 2017, respectively.

Table of Contents**Note 10 – Fair Value Measurements**

The accounting standard for fair value measurements provides a framework for measuring fair value and requires expanded disclosures regarding fair value measurements. Fair value is defined as the price that would be received for an asset or the exit price that would be paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants on the measurement date. This accounting standard establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs, where available. The following summarizes the three levels of inputs that may be used to measure fair value:

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

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

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

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

The following table summarizes fair value measurements by level at September 30, 2018 and December 31, 2017 for assets and liabilities measured at fair value on a recurring basis (*in thousands*):

| September 30, 2018 | Fair Value Measurements Using | | | |
|--------------------|-------------------------------|---|---|---|
| | Fair Value | Quoted Prices in Active Markets For Identical | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| | | | | |

| Assets | | | | | |
|--------------------------------------|-----------|-----------|------------|----|---|
| (Level 1) | | | | | |
| Cash and cash equivalents | \$55,599 | \$55,599 | \$ – | \$ | – |
| Restricted cash and cash equivalents | 12,134 | 12,134 | – | | – |
| Marketable equity securities | 139,502 | 139,502 | – | | – |
| Corporate debt securities | 66,190 | 43,901 | 22,289 | | – |
| Mortgage-backed securities | 56,293 | – | 56,293 | | – |
| U.S. Treasury securities | 22,540 | 22,540 | – | | – |
| State and municipal securities | 23,011 | – | 23,011 | | – |
| Total financial assets | \$375,269 | \$273,676 | \$ 101,593 | \$ | – |

| Fair Value Measurements Using | | | | | |
|--------------------------------------|------------|----------------------|----------------------|----------------------|----------------------|
| Quoted | | | | | |
| Prices in | | | | | |
| Significant | | | | | |
| Significant | | | | | |
| Active | | | | | |
| Markets | | | | | |
| Other | | | | | |
| Unobservable | | | | | |
| Inputs | | | | | |
| (Level 3) | | | | | |
| Observable | | | | | |
| Inputs | | | | | |
| (Level 2) | | | | | |
| Assets | | | | | |
| (Level 1) | | | | | |
| December 31, 2017 | Fair Value | For Identical Assets | For Identical Assets | For Identical Assets | For Identical Assets |
| Cash and cash equivalents | \$59,118 | \$59,118 | \$ – | \$ | – |
| Restricted cash and cash equivalents | 8,303 | 8,303 | – | | – |
| Marketable equity securities | 139,085 | 139,085 | – | | – |
| Corporate debt securities | 65,461 | 43,073 | 22,388 | | – |
| Mortgage-backed securities | 53,544 | – | 53,544 | | – |
| U.S. Treasury securities | 21,172 | 21,172 | – | | – |
| State and municipal securities | 26,218 | – | 26,218 | | – |
| Total financial assets | \$372,901 | \$270,751 | \$ 102,150 | \$ | – |

Note 11 – Long-Term Debt

Long-term debt consists of the following:

| Weighted | September | December |
|---------------|-----------|----------|
| Average | 30, | 31, |
| Maturities | 2018 | 2017 |
| Interest Rate | | |

| | <i>Variable</i> | | <i>(dollars in thousands)</i> | |
|---|-----------------|------|-------------------------------|-----------|
| Credit Facility, interest payable monthly | 3.6% | 2020 | \$75,000 | \$90,000 |
| Unsecured term note payable to National, interest payable quarterly, principal payable at maturity | 4.5% | 2028 | – | 10,000 |
| | | | 75,000 | 100,000 |
| Less current portion | | | – | – |
| | | | \$75,000 | \$100,000 |

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\$150,000,000 Credit Facility

During the second quarter of 2018, the Company lowered the available borrowing capacity of the credit facility from \$175 million to \$150 million. The credit facility has a five-year maturity date (October 2020). Loans bear interest at either (i) LIBOR plus 1.40% or (ii) the base rate plus 0.40%.

Note 12 - Stock Repurchase Program

In August 2018, the Board of Directors authorized a common stock purchase program. The program will allow for repurchases of up to \$25 million of its common stock. No repurchases have been made under this plan. Under the previous plan which expired on August 31, 2018, the Company repurchased 14,506 shares of its common stock for a total cost of \$867,000. The shares were funded from cash on hand and were cancelled and returned to the status of authorized but unissued.

Note 13 – Stock-Based Compensation

NHC recognizes stock-based compensation expense for all stock options granted over the requisite service period using the fair value at the date of grant using the Black-Scholes pricing model. Stock-based compensation totaled \$361,000 and \$430,000 for the three months ended September 30, 2018 and 2017, respectively. Stock-based compensation totaled \$1,538,000 and \$1,263,000 for the nine months ended September 30, 2018 and 2017, respectively. Stock-based compensation is included in “Salaries, wages and benefits” in the interim condensed consolidated statements of operations.

At September 30, 2018, the Company had \$5,728,000 of unrecognized compensation cost related to unvested stock-based compensation awards. This unrecognized compensation cost will be amortized over an approximate three-year period.

Stock Options

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The following table summarizes the significant assumptions used to value the options granted for the nine months ended September 30, 2018 and for the year ended December 31, 2017.

| | September 30, 2018 | December 31, 2017 |
|-------------------------|-----------------------|----------------------|
| Risk-free interest rate | 2.5% | 2.1% |
| Expected volatility | 16.1% | 16.6% |
| Expected life, in years | 3.0 | 4.8 |
| Expected dividend yield | 3.3% | 3.1% |

The following table summarizes our outstanding stock options for the nine months ended September 30, 2018 and for the year ended December 31, 2017.

| | Number of Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value |
|---|---------------------|--|---------------------------------|
| Options outstanding at January 1, 2017 | 177,959 | \$ 55.48 | \$- |
| Options granted | 1,125,443 | 72.96 | - |
| Options exercised | (48,995) | 51.25 | - |
| Options cancelled | (15,000) | 72.94 | - |
| Options outstanding at December 31, 2017 | 1,239,407 | 71.19 | - |
| Options granted | 110,821 | 61.40 | - |
| Options exercised | (33,526) | 51.25 | - |
| Options cancelled | (50,000) | 72.94 | - |
| Options outstanding at September 30, 2018 | 1,266,702 | \$ 70.79 | \$5,800,000 |
| Options vested at September 30, 2018 | 210,881 | \$ 63.35 | \$2,535,000 |

| Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life in Years |
|--------------------------------------|--|---|
| Outstanding September 30, 2018 | | |
| 218,427 | \$52.93- | \$62.78 |
| 1,048,275 | \$72.94 | \$ 60.48 |
| 1,266,702 | | 72.94 |
| | | \$ 70.79 |
| | | 2.7 |
| | | 3.4 |
| | | 3.3 |

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Note 14 – Income Taxes

The income tax provision for the three months ended September 30, 2018 is \$1,700,000 (an effective income tax rate of 7.5%). The income tax provision for the three months ended September 30, 2017 was \$4,691,000 (an effective income tax rate of 29.5%). The income tax provision and effective tax rate for the three months ended September 30, 2018 was favorably impacted by the following: (1) a tax benefit of \$547,000 related to the gain on acquisition of equity method investment; (2) a tax benefit of \$2,222,000 related to statute of limitation expirations; and (3) a tax benefit of \$1,434,000 related to a provision to return adjustment on the Company's 2017 federal and state income tax returns, resulting in a net decrease in the provision.

The income tax provision for the nine months ended September 30, 2018 is \$9,792,000 (an effective income tax rate of 19.5%). The income tax provision and effective tax rate for the nine months ended September 30, 2018 were unfavorably impacted by nondeductible expenses of \$945,000 (primarily the non-deductible portion of the settlement of the Caris HealthCare, L.P. Qui Tam legal matter) or 1.9% of income before taxes for the nine months. The income tax provision for the nine months ended September 30, 2018 was favorably impacted by the following: (1) a tax benefit of \$547,000 related to the gain on acquisition of equity method investment; (2) a tax benefit of \$2,222,000 related to statute of limitation expirations; and (3) a tax benefit of \$1,434,000 related to a provision to return adjustment on the Company's 2017 federal and state income tax returns. The income tax provision for the nine months ended September 30, 2017 was \$19,448,000 (an effective income tax rate of 36.1%). The income tax provision and effective tax rate for the nine months ended September 30, 2017 were favorably impacted by statute of limitations expirations resulting in a benefit to the provision of \$1,753,000 or 3.3% of income before taxes in 2017.

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 ("2017 Tax Act") was signed into law making significant changes to the Internal Revenue Code. The SEC issued Staff Accounting Bulletin No. 118 ("SAB 118"), which provides guidance on accounting for the tax effects of the 2017 Tax Act. As of December 31, 2017, we made a reasonable estimate that the revaluation of our net deferred tax liability using the new federal corporate tax rates resulted in a provisional net tax benefit of \$8,488,000, which reduced our net deferred tax liability balance. This amount continues to be a provisional adjustment as of September 30, 2018. We will recognize any changes to provisional amounts as we continue to analyze the existing statute or as additional guidance becomes available. We expect to complete our analysis of the provisional amounts by the end of 2018.

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

The Company is no longer subject to U.S. federal and state examinations by tax authorities for years before 2015 (with certain state exceptions).

Note 15 – Contingencies and Commitments

Accrued Risk Reserves

We are self-insured for risks related to health insurance and have wholly-owned limited purpose insurance companies that insure risks related to workers' compensation and general and professional liability insurance claims both for our owned or leased entities and certain of the entities to which we provide management or accounting services. The liability we have recognized for reported claims and estimates for incurred but unreported claims totals \$95,787,000 and \$93,275,000 at September 30, 2018 and December 31, 2017, respectively. The liability is included in accrued risk reserves in the interim condensed consolidated balance sheets and is subject to adjustment for actual claims incurred. It is possible that these claims plus unasserted claims could exceed our insurance coverages and our reserves, which could have a material adverse effect on our consolidated financial position, results of operations and cash flows.

As a result of the terms of our insurance policies and our use of wholly-owned limited purpose insurance companies, we have retained significant insurance risk with respect to workers' compensation and general and professional liability. We consider the professional services of independent actuaries to assist us in estimating our exposures for claims obligations (for both asserted and unasserted claims) related to deductibles and exposures in excess of coverage limits, and we maintain reserves for these obligations. Such estimates are based on many variables including historical and statistical information and other factors.

Workers' Compensation

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

General and Professional Liability Lawsuits and Insurance

The senior care industry has experienced increases in both the number of personal injury/wrongful death claims and in the severity of awards based upon alleged negligence by nursing facilities and their employees in providing care to residents. As of September 30, 2018, we and/or our managed centers are currently defendants in 65 such claims.

Insurance coverage for both periods includes both primary policies and excess policies. The primary coverage is in the amount of \$1.0 million per incident, \$3.0 million per location with an annual primary policy aggregate limit that is adjusted on an annual basis. For 2017 and 2018, the excess coverage is \$9.0 million per occurrence. Additional insurance is purchased through third party providers that serve to supplement the coverage provided through our wholly-owned captive insurance company.

Financing Commitments

In conjunction with our management contract with National, we have entered into a line of credit arrangement whereby we may have amounts due from National from time to time. The maximum loan commitment under the line of credit is \$2,000,000. At September 30, 2018, National did not have an outstanding balance on the line of credit.

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Caris HealthCare, L.P. Investigation and Related Litigation

On December 9, 2014, Caris Healthcare, L.P., a business that specializes in hospice care services in Company-owned health care centers and in other settings, received notice from the U.S. Attorney's Office for the Eastern District of Tennessee and the Attorney Generals' Offices for the State of Tennessee and State of Virginia that those government entities were conducting an investigation regarding patient eligibility for hospice services provided by Caris precipitated by a *qui tam* lawsuit. We have a 75.1% non-controlling ownership interest in Caris.

A *qui tam* lawsuit was filed on May 22, 2014, in the U.S. District Court for the Eastern District of Tennessee by a former Caris employee, Barbara Hinkle, and is captioned *United States of America, State of Tennessee, and State of Virginia ex rel. Barbara Hinkle v. Caris Healthcare, L.P.*, No. 3:14-cv-212 (E.D. Tenn.).

On June 16, 2016, the State of Tennessee and the State of Virginia declined to intervene in the *qui tam* lawsuit. On June 20, 2016, the Court ordered that the complaint be unsealed. On October 11, 2016, the United States filed a Complaint in Intervention against Caris Healthcare, L.P. and Caris Healthcare, LLC, a wholly owned subsidiary of Caris Healthcare, L.P. The United States' complaint alleged that Caris billed the government for ineligible hospice patients between June 2013 and December 2013 and retained overpayments regarding ineligible hospice patients from April 2010 through June 2013.

On March 9, 2018, Caris and the United States jointly moved for a partial 90-day stay of the case to allow the parties to finalize a settlement in principle of the action. That settlement was finalized on June 25, 2018, in which Caris agreed to pay \$8.5 million plus interest for a full release associated with the alleged submission of false claims and alleged retention of overpayments from Medicare for hospice services provided between April 1, 2010, and December 31, 2013. On June 28, 2018, the District Court entered an Order in connection with the parties' Joint Stipulation of Dismissal, which dismissed the action with prejudice as to the Hinkle and Hinkle's bankruptcy trustee, with prejudice to the United States with respect to the conduct released by the settlement, and without prejudice to the United States with respect to all remaining claims. The District Court's Order concludes this litigation.

Nutritional Support Services, L.P., Qui Tam Litigation

On June 19, 2018, a First Amended Complaint was filed naming Nutritional Support Services, L.P. ("NSS"), a wholly-owned subsidiary of the Company, as a defendant in the action captioned *U.S. ex rel. McClain v. Nutritional Support Services, L.P.*, No. 6:17-cv-2608-AMQ (D.S.C.), which was filed in the United States District Court for the District of South Carolina. The action alleges that NSS violated the False Claims Act by reporting a National Drug Code ("NDC") number that did not correspond to the NDC for dispensed prescriptions. On April 16, 2018, the United States filed a Notice of Election to Decline Intervention with respect to the allegations asserted in this action. NSS

intends to vigorously defend itself with respect to this action.

Governmental Regulations

Laws and regulations governing the Medicare, Medicaid and other federal healthcare programs are complex and subject to interpretation. Management believes that it is in compliance with all applicable laws and regulations in all material respects. However, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusions from the Medicare, Medicaid and other federal healthcare programs.

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

Overview

National HealthCare Corporation (“NHC” or the “Company”) is a leading provider of senior health care services. We operate or manage, through certain affiliates, 76 skilled nursing facilities with a total of 9,604 licensed beds, 24 assisted living facilities, five independent living facilities, one geriatric psychiatric hospital, and 35 homecare programs. We operate specialized care units within certain of our healthcare centers such as Alzheimer's disease care units and sub-acute nursing units. We also have a non-controlling ownership interest in a hospice care business that services NHC owned health care centers and others. In addition, we provide insurance services, management and accounting services, and we lease properties to operators of skilled nursing centers. We operate in 10 states and are located primarily in the southeastern United States.

Summary of Goals and Areas of Focus

Occupancy

A primary area of management focus continues to be the rates of occupancy within our skilled nursing facilities. The overall census in owned and leased skilled nursing facilities for the nine months ending September 30, 2018 was 89.7% compared to 90.4% for the same period a year ago. With the average length of stay decreasing for a skilled nursing patient, as well as the increased availability of assisted living facilities and home and community-based services, the challenge of maintaining desirable patient census levels has been amplified. Management has undertaken a number of steps in order to best position our current and future health care facilities. This includes working

internally to examine and improve systems to be most responsive to referral sources and payors. Additionally, NHC is in various stages of partnerships with hospital systems, payors, and other post-acute alliances to better position ourselves so we are an active participant in the delivery of post-acute healthcare services.

Table of Contents*Quality of Patient Care*

The Centers for Medicare and Medicaid Services (“CMS”) introduced the Five-Star Quality Rating System to help consumers, their families and caregivers compare skilled nursing facilities more easily. The Five-Star Quality Rating System gives each skilled nursing operation a rating of between one and five stars in various categories (five stars being the best). The Company has always strived for patient-centered care and quality outcomes as precursors to outstanding financial performance. The table below summarizes our overall performance in these quality ratings:

| | As of | | |
|---|----------------------|---------------------|---------------------|
| | Sept. 30, 2018 | Dec. 31, 2017 | Dec. 31, 2016 |
| Total number of skilled nursing facilities | 76 | 76 | 74 |
| Number of 4 and 5-star rated skilled nursing facilities | 66 | 62 | 54 |
| Percentage of 4 and 5-star rated skilled nursing facilities | 87% | 82% | 73% |

Development and Growth

We are undertaking to expand our senior care operations while protecting our existing operations and markets. The following table lists our recent development activities.

| Type of Operation | Description | Size | Location | Placed in Service |
|----------------------|--------------|----------|------------------|--------------------|
| SNF | New Facility | 112 beds | Columbia, TN | January, 2017 |
| ALF | New Facility | 78 units | Bluffton, SC | March, 2017 |
| ALF | New Facility | 80 units | Garden City, SC | June, 2017 |
| Memory Care | Bed Addition | 23 units | Murfreesboro, TN | July, 2017 |
| SNF | Bed Addition | 30 beds | Springfield, MO | April, 2018 |
| Memory Care | New Facility | 60 beds | Farragut, TN | Under construction |

For the project under construction at September 30, 2018, the 60-bed memory care facility in Farragut, Tennessee is expected to open in the fourth quarter of 2018.

Accrued Risk Reserves

Our accrued professional liability and workers' compensation reserves totaled \$95,787,000 at September 30, 2018 and are a primary area of management focus. We have set aside restricted cash and cash equivalents and restricted marketable securities to fund our estimated professional liability and workers' compensation liabilities.

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

Government Program Financial Changes

Medicare – Skilled Nursing Facilities

In July 2018, CMS released its final rule outlining the fiscal year 2019 Medicare payments and policy changes for skilled nursing facilities. The 2019 final rule provided for an approximate 2.4% market basket update that was spelled out in the Bipartisan Budget Act of 2018, resulting in an increase in overall payments to skilled nursing facilities in fiscal year 2019 by \$820 million compared to fiscal year 2018 levels. Also, starting on October 1, 2019, CMS plans to start using a new case-mix model, called the Patient-Driven Payment Model (PDPM), which focuses on a resident's condition and care needs, rather than the amount of care provided, to determine reimbursement levels. The PDPM replaces the existing case-mix classification methodology, the Resource Utilization Groups, Version IV (RUG-IV) model, used to categorize Part A residents into various payment groups based on their level of need. The new PDPM is expected to better account for patient characteristics by relating payment to patients' conditions and clinical needs rather than on volume-based services. The PDPM is also expected to reduce systemic complexity and save skilled nursing facilities approximately \$2.0 billion over 10 years in administrative costs. Under the new rule, CMS is finalizing changes to the Skilled Nursing Facilities Value-based Purchasing Program. Scoring for methodology for low-volume providers will be updated, as will an extraordinary-exemption policy.

In July 2017, CMS released its final rule outlining the fiscal year 2018 Medicare payments and policy changes for skilled nursing facilities. The 2018 final rule provided for an approximate 1.0% rate update, which began October 1, 2017. CMS estimated a 2.7% market basket increase reduced by 0.4% for a multifactor productivity adjustment required by the Affordable Care Act ("ACA"); however, the Medicare Access and CHIP Reauthorization Act of 2015 (MACRA) mandated that all post-acute care providers receive a maximum market basket update of 1% in fiscal year 2018 to offset part of the cost of the legislation. CMS estimates the update will increase overall payments to skilled nursing facilities in fiscal year 2018 by \$370 million compared to fiscal year 2017 levels.

For the first nine months of 2018, our average Medicare per diem rate for skilled nursing facilities increased 0.1% compared to the same period in 2017.

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Medicaid – Skilled Nursing Facilities

Effective July 1, 2018 and for the fiscal year 2019, the state of Tennessee implemented specific individual nursing facility rate increases. We estimate the resulting increase in revenue for the 2019 fiscal year will be approximately \$2,100,000 annually, or \$525,000 per quarter.

Effective October 1, 2018 and for the fiscal year 2019, South Carolina implemented specific individual nursing facility rate changes. The resulting increase in revenue beginning October 1, 2018 will be approximately \$2,200,000 annually, or \$550,000 per quarter.

For the fiscal year 2019, the state of Missouri is in the process of implementing per patient day rate increases. We currently estimate the resulting increase in revenue for the 2019 fiscal year will be approximately \$2,000,000 annually, or \$500,000 per quarter. Although the Missouri state legislation has approved the per diem increase, the state is currently waiting on CMS' approval. We expect these rate increases to be implemented during the fourth quarter of 2018 and paid retroactively to July 1, 2018.

For the first nine months of 2018, our average Medicaid per diem increased 1.9% compared to the same period in 2017. We face challenges with respect to states' Medicaid payments, because many currently do not cover the total costs incurred in providing care to those patients. States will continue to control Medicaid expenditures and also look for adequate funding sources, including provider assessments. There are several pieces of legislation that include provisions designed to reduce Medicaid spending. These provisions include, among others, provisions strengthening the Medicaid asset transfer restrictions for persons seeking to qualify for Medicaid long-term care coverage, which could, due to the timing of the penalty period, increase facilities' exposure to uncompensated care. Other provisions could increase state funding for home and community-based services, potentially having an impact on funding for nursing facilities.

Medicare – Homecare Programs

Effective January 1, 2018, CMS estimated the net impact of the 2018 home health PPS rates would result in a 0.4% decrease (\$80 million) for home health agencies. This decrease reflects the effects of a 1.0% home health payment update percentage; a -0.97% percent adjustment to the national, standardized 60-day episode payment rate to account for nominal case-mix growth; and the sunset of the rural add-on provision for an impact of -0.5%. The rule also finalizes proposals for the Home Health Value-Based Purchasing (HHVBP) Model and the Home Health Quality Reporting Program (HH QRP).

Segment Reporting

The Company has two reportable operating segments: (1) inpatient services, which includes the operation of skilled nursing facilities, assisted and independent living facilities, and our geriatric psychiatric hospital; (2) homecare services. These reportable operating segments are consistent with information used by the Company's Chief Executive Officer, as CODM, to assess performance and allocate resources.

The Company also reports an "all other" category that includes revenues from rental income, management and accounting services fees, insurance services, and costs of the corporate office. For additional information on these reportable segments see Note 2 - *Summary of Significant Accounting Policies*.

The Company's CODM evaluates performance and allocates capital resources to each segment based on an operating model that is designed to enhance the quality of patient care and profitability of the Company while enhancing long-term shareholder value. Our CODM does not review assets by segment in his resource allocation and therefore, assets by segment are not disclosed below.

The following tables set forth the Company's unaudited condensed consolidated statements of operations by business segment (*in thousands*):

| | Three Months Ended September 30, 2018 | | | |
|--|---------------------------------------|-----------|--------------|-----------|
| | Inpatient Services | Homecare | All Other | Total |
| Revenues: | | | | |
| Net patient revenues | \$220,099 | \$ 14,728 | \$— | \$234,827 |
| Other revenues | 136 | — | 11,363 | 11,499 |
| Net operating revenues | 220,235 | 14,728 | 11,363 | 246,326 |
| Costs and expenses: | | | | |
| Salaries, wages and benefits | 131,418 | 8,367 | 9,403 | 149,188 |
| Other operating | 57,371 | 4,797 | 2,339 | 64,507 |
| Rent | 8,255 | 488 | 1,447 | 10,190 |
| Depreciation and amortization | 9,570 | 55 | 812 | 10,437 |
| Interest | 369 | — | 801 | 1,170 |
| Total costs and expenses | 206,983 | 13,707 | 14,802 | 235,492 |
| Income (loss) from operations | 13,252 | 1,021 | (3,439) | 10,834 |
| Non-operating income | — | — | 8,467 | 8,467 |
| Unrealized gains on marketable equity securities | — | — | 3,486 | 3,486 |

| | | | | |
|----------------------------|----------|----------|---------|----------|
| Income before income taxes | \$13,252 | \$ 1,021 | \$8,514 | \$22,787 |
|----------------------------|----------|----------|---------|----------|

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| <i>(As adjusted)</i> | Three Months Ended September 30, 2017 | | | | |
|--|---------------------------------------|-----------|--------------|-----------|-----------|
| | Inpatient | Homecare | All Other | Total | |
| | Services | | | | |
| Revenues: | | | | | |
| Net patient revenues | \$213,814 | \$ 15,445 | \$– | \$229,259 | |
| Other revenues | 181 | – | 11,756 | 11,937 | |
| Net operating revenues | 213,995 | 15,445 | 11,756 | 241,196 | |
| Costs and expenses: | | | | | |
| Salaries, wages and benefits | 128,403 | 8,318 | 9,179 | 145,900 | |
| Other operating | 56,062 | 5,291 | 1,897 | 63,250 | |
| Rent | 8,128 | 502 | 1,476 | 10,106 | |
| Depreciation and amortization | 9,756 | 41 | 1,036 | 10,833 | |
| Interest | 423 | – | 899 | 1,322 | |
| Total costs and expenses | 202,772 | 14,152 | 14,487 | 231,411 | |
| Income (loss) from operations | 11,223 | 1,293 | (2,731) | 9,785 | |
| Non-operating income | – | – | 6,090 | 6,090 | |
| Income before income taxes | \$ 11,223 | \$ 1,293 | \$3,359 | \$ 15,875 | |
| | | | | | |
| | Nine Months Ended September 30, 2018 | | | | |
| | Inpatient | Homecare | All Other | Total | |
| | Services | | | | |
| Revenues: | | | | | |
| Net patient revenues | | \$652,066 | \$ 45,107 | \$– | \$697,173 |
| Other revenues | | 588 | – | 33,668 | 34,256 |
| Net operating revenues | | 652,654 | 45,107 | 33,668 | 731,429 |
| Costs and expenses: | | | | | |
| Salaries, wages and benefits | | 382,913 | 25,009 | 26,827 | 434,749 |
| Other operating | | 171,275 | 14,816 | 6,177 | 192,268 |
| Rent | | 24,780 | 1,460 | 4,451 | 30,691 |
| Depreciation and amortization | | 28,602 | 137 | 2,437 | 31,176 |
| Interest | | 1,149 | – | 2,514 | 3,663 |
| Total costs and expenses | | 608,719 | 41,422 | 42,406 | 692,547 |
| Income (loss) from operations | | 43,935 | 3,685 | (8,738) | 38,882 |
| Non-operating income | | – | – | 11,056 | 11,056 |
| Unrealized gains on marketable equity securities | | – | – | 417 | 417 |
| Income before income taxes | | \$43,935 | \$ 3,685 | \$2,735 | \$ 50,355 |

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Nine Months Ended September 30, 2017

| <i>(As adjusted)</i> | Inpatient Services | Homecare | All Other | Total |
|-------------------------------|-----------------------|-----------|--------------|-----------|
| Revenues: | | | | |
| Net patient revenues | \$636,311 | \$ 47,287 | \$— | \$683,598 |
| Other revenues | 631 | — | 34,200 | 34,831 |
| Net operating revenues | 636,942 | 47,287 | 34,200 | 718,429 |
| Costs and expenses: | | | | |
| Salaries, wages and benefits | 373,641 | 24,760 | 28,238 | 426,639 |
| Other operating | 167,454 | 15,484 | 5,584 | 188,522 |
| Rent | 24,552 | 1,490 | 4,231 | 30,273 |
| Depreciation and amortization | 28,362 | 120 | 3,127 | 31,609 |
| Interest | 1,309 | — | 2,290 | 3,599 |
| Total costs and expenses | 595,318 | 41,854 | 43,470 | 680,642 |
| Income (loss) from operations | 41,624 | 5,433 | (9,270) | 37,787 |
| Non-operating income | — | — | 16,047 | 16,047 |
| Income before income taxes | \$41,624 | \$ 5,433 | \$6,777 | \$53,834 |

Table of ContentsNon-GAAP Financial Presentation

The Company is providing certain non-GAAP financial measures as the Company believes that these figures are helpful in allowing investors to more accurately assess the ongoing nature of the Company's operations and measure the Company's performance more consistently across periods. Therefore, the Company believes this information is meaningful in addition to the information contained in the GAAP presentation of financial information. The presentation of this additional non-GAAP financial information is not intended to be considered in isolation or as a substitute for the financial information prepared and presented in accordance with GAAP.

Specifically, the Company believes the presentation of non-GAAP financial information that excludes the unrealized gains or losses on our marketable equity securities, operating results for the newly constructed healthcare facilities not at full capacity, share-based compensation expense, legal costs and charges related to the settlement of a Qui Tam investigation within our Caris hospice partnership, a gain due to the acquisition of an equity method investment, a gain in the prior year on the sale of assets within an equity method investment, and a tax provision to tax return adjustment after the Company filed our 2017 income tax returns.

The operating results for the three newly constructed healthcare facilities not at full capacity consist of one skilled nursing facility and two assisted living facilities that opened during 2017.

The table below provides reconciliations of GAAP to non-GAAP items (*dollars in thousands, except per share data*):

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------|----------------------|----------------------|----------------------|
| | September 30 2018 | September 30 2017 | September 30 2018 | September 30 2017 |
| Net income attributable to National Healthcare Corporation | \$21,142 | \$11,352 | \$40,812 | \$34,735 |
| Non-GAAP adjustments: | | | | |
| Unrealized gains on marketable equity securities | (3,486) | – | (417) | – |
| Legal costs and charges related to Caris' legal investigation | – | 757 | 8,364 | 1,239 |
| Operating results for newly opened facilities not at full capacity | 492 | 976 | 947 | 2,725 |
| Gain on acquisition of equity method investment | (2,050) | – | (2,050) | – |
| Gain on sale of assets within equity method investment | – | (1,305) | – | (1,305) |
| Stock-based compensation expense | 361 | 430 | 1,538 | 1,263 |
| Tax provision adjustment on 2017 filed income tax returns | (1,434) | – | (1,434) | – |
| Provision of income taxes on non-GAAP adjustments | 685 | (335) | (1,884) | (1,530) |
| Non-GAAP Net income | \$15,710 | \$11,875 | \$45,876 | \$37,127 |

| | | | | |
|--|---------|---------|---------|---------|
| GAAP diluted earnings per share | \$1.39 | \$0.75 | \$2.68 | \$2.28 |
| Non-GAAP adjustments: | | | | |
| Unrealized gains on marketable equity securities | (0.17) | – | (0.02) | – |
| Legal costs and charges related to Caris' legal investigation | – | 0.02 | 0.46 | 0.05 |
| Operating results for newly opened facilities not at full capacity | 0.02 | 0.04 | 0.05 | 0.11 |
| Gain on acquisition of equity method investment | (0.13) | – | (0.13) | – |
| Gain on sale of assets within equity method investment | – | (0.05) | – | (0.05) |
| Stock-based compensation expense | 0.02 | 0.02 | 0.07 | 0.05 |
| Tax provision adjustment on 2017 filed income tax returns | (0.10) | – | (0.10) | – |
| Non-GAAP diluted earnings per share | \$1.03 | \$0.78 | \$3.01 | \$2.44 |

Table of ContentsResults of Operations

The following table and discussion sets forth items from the interim condensed consolidated statements of operations as a percentage of net operating revenues for the three months and nine months ended September 30, 2018 and 2017.

Percentage of Net Operating Revenues

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------|--------|----------------------|--------|
| | September 30 | | September 30 | |
| | 2018 | 2017 | 2018 | 2017 |
| Net operating revenues: | 100.0% | 100.0% | 100 % | 100 % |
| Costs and expenses: | | | | |
| Salaries, wages and benefits | 60.6 | 60.5 | 59.4 | 59.4 |
| Other operating | 26.2 | 26.2 | 26.3 | 26.2 |
| Facility rent | 4.1 | 4.2 | 4.2 | 4.2 |
| Depreciation and amortization | 4.2 | 4.5 | 4.3 | 4.4 |
| Interest | 0.5 | 0.5 | 0.5 | 0.5 |
| Total costs and expenses | 95.6 | 95.9 | 94.7 | 94.7 |
| Income from operations | 4.4 | 4.1 | 5.3 | 5.3 |
| Non-operating income | 3.4 | 2.5 | 1.6 | 2.2 |
| Unrealized gains/losses on marketable equity securities | 1.4 | - | 0.1 | - |
| Income before income taxes | 9.2 | 6.6 | 7.0 | 7.5 |
| Income tax provision | (0.7) | (1.9) | (1.3) | (2.7) |
| Net income | 8.5 | 4.7 | 5.7 | 4.8 |
| Net loss attributable to noncontrolling interest | - | 0.1 | - | - |
| Net income attributable to NHC | 8.5 | 4.8 | 5.7 | 4.8 |

Three Months Ended September 30, 2018 Compared to Three Months Ended September 30, 2017

Results for the quarter ended September 30, 2018 compared to the third quarter in 2017 include a 2.1% increase in net operating revenues and a 10.7% increase in income from operations. For the three months ended September 30, 2018 compared to the same quarter in 2017, income before income taxes increased 43.5% and net income attributable to NHC increased 86.2%. Excluding the unrealized gains in our marketable equity securities during the third quarter of 2018 compared to the same quarter in 2017, income before income taxes increased 21.6% and net income attributable to NHC increased 63.5%.

Net operating revenues

Net patient revenues increased \$5,568,000, or 2.4%, compared to the same period last year. There are three newly constructed healthcare facilities (one skilled nursing facility and two assisted living facilities) placed in service during 2017 that continue to stabilize during 2018. These new healthcare facilities increased net patient revenues \$761,000 compared to the same period a year ago. In July 2018, we acquired a controlling financial interest in a 14-bed geriatric psychiatric hospital located in Osage Beach, Missouri. This geriatric psychiatric hospital increased net patient revenues \$1,077,000 compared to the same period a year ago. The remaining increase in our net patient revenues is primarily due to our existing skilled nursing facility operations.

The total census at owned and leased skilled nursing facilities for the quarter averaged 90.1% compared to an average of 90.4% for the same quarter a year ago. Our Medicare per diem rates increased 0.7% and Managed Care per diem rates decreased 0.6% compared to the same quarter a year ago. Our Medicaid and private pay per diem rates increased 1.7% and 4.3%, respectively, compared to the same quarter a year ago. Overall, the composite skilled nursing facility per diem at our owned and leased skilled nursing facilities increased 1.2% compared to the same quarter a year ago.

Other revenues decreased \$438,000, or 3.7%, compared to the same quarter last year, as further detailed in Note 4 to our interim condensed consolidated financial statements.

Total costs and expenses

Total costs and expenses for the third quarter of 2018 compared to the third quarter of 2017 increased \$4,081,000 or 1.8%, to \$235,492,000 from \$231,411,000.

Salaries, wages and benefits increased \$3,288,000, or 2.3%, to \$149,188,000 from \$145,900,000. Salaries, wages and benefits as a percentage of net operating revenue was 60.6% compared to 60.5% for the three months ended September 30, 2018 and 2017, respectively. The newly constructed healthcare facilities placed in service during 2017 increased salaries, wages and benefits by \$219,000 compared to the same period a year ago. The newly-acquired geriatric psychiatric hospital increased salaries, wages and benefits \$427,000 compared to the same period a year ago. The remaining increase in our salaries, wages and benefits is primarily due to our existing skilled nursing facility operations. We continue to closely monitor and address the wage pressures we feel in most of the markets in which we operate. There is substantial effort and resources being deployed to retain and recruit talented partners.

Other operating expenses increased \$1,257,000, or 2.0%, to \$64,507,000 for the 2018 period compared to \$63,250,000 for the 2017 period. Other operating expenses as a percentage of net operating revenue was 26.2% for

both the three months ended September 30, 2018 and 2017. The newly-acquired geriatric psychiatric hospital increased other operating expenses \$406,000 compared to the same period a year ago.

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Other income

Non-operating income increased by \$2,377,000 compared to the same period last year, as further detailed in Note 5 to our interim condensed consolidated financial statements. The increase in non-operating income is primarily due to the gain of \$2,050,000 recorded on the acquisition of a controlling financial interest in a 14-bed geriatric psychiatric hospital in Osage Beach, Missouri. We previously held a noncontrolling ownership interest and an equity method investment in this hospital. In July 2018 upon acquiring the controlling ownership interest, we had to value the business and our previously held equity position based upon the hospital's fair value.

Effective January 1, 2018, the new accounting pronouncement of ASU No. 2016-01, "Financial Instruments – Recognition and Measurement of Financial Assets and Financial Liabilities (Topic 825)", requires that the change in the fair value of our marketable equity securities be recognized in net income. Therefore, we recorded unrealized gains in the amount of \$3,486,000 for the increase in fair value of our marketable equity securities portfolio during the third quarter of 2018. The marketable equity securities portfolio consists of publicly-traded healthcare REIT's, with NHI comprising approximately 88% of the market value of the portfolio at September 30, 2018.

Income taxes and noncontrolling interest

The income tax provision for the three months ended September 30, 2018 is \$1,700,000 (an effective income tax rate of 7.5%), as further detailed in Note 14 to our interim condensed consolidated financial statements. Excluding nondeductible expenses, we expect our corporate income tax rate for 2018 to be approximately 26%, which is down from approximately 39% in 2017.

The noncontrolling interest in a subsidiary is: (1) the joint venture operations of a skilled nursing facility in Columbia, Tennessee. This facility opened and began operating in January 2017 in which NHC owns 80% of the operating entity and Maury Regional Medical Center owns 20% of the entity; (2) the joint venture operations of a 14-bed geriatric psychiatric hospital in Osage Beach, Missouri in which NHC owns 80% of the operating entity and Reliant Healthcare owns the remaining 20% of the entity.

Nine Months Ended September 30, 2018 Compared to Nine Months Ended September 30, 2017

Results for the nine months ended September 30, 2018 compared to the same nine months of 2017 include a 1.8% increase in net operating revenues and a 2.9% increase in income from operations. For the nine months ended September 30, 2018 compared to the same nine months of 2017, income before income taxes decreased 6.5% and net

income attributable to NHC increased 17.5%. Excluding the unrealized gains in our marketable equity securities and Caris' Qui Tam settlement (including legal fees) for the nine months ended September 30, 2018 compared to the same nine months of 2017, income before income taxes increased 5.9% and net income attributable to NHC increased 33.9%.

Net operating revenues

Net patient revenues increased \$13,575,000, or 2.0%, compared to the same period last year. There are three newly constructed healthcare facilities (one skilled nursing facility and two assisted living facilities) placed in service during 2017 that continue to stabilize during 2018. These new healthcare facilities increased net patient revenues \$4,287,000 compared to the same period a year ago. In July 2018, we acquired a controlling financial interest in a 14-bed geriatric psychiatric hospital located in Osage Beach, Missouri. This geriatric psychiatric hospital increased net patient revenues \$1,077,000 compared to the same nine-month period a year ago. The remaining increase in our net patient revenues is primarily due to our existing skilled nursing facility operations.

The total census at owned and leased skilled nursing facilities for the nine-month period averaged 89.7% compared to an average of 90.4% for the same period a year ago. Our Medicare per diem rates increased 0.1% and Managed Care per diem rates decreased 1.7% compared to the same period a year ago. Medicaid and private pay per diem rates increased 1.9% and 3.0%, respectively, compared to the same period a year ago. Overall, the composite skilled nursing facility per diem at our owned and leased skilled nursing facilities increased 1.1% compared to the same period a year ago.

Other revenues decreased \$575,000, or 1.7%, compared to the same period last year, as further detailed in Note 4 to our interim condensed consolidated financial statements.

Total costs and expenses

Total costs and expenses for the first nine months of 2018 compared to the first nine months of 2017 increased \$11,905,000 or 1.7%, to \$692,547,000 from \$680,642,000.

Salaries, wages and benefits increased \$8,110,000, or 1.9%, to \$434,749,000 from \$426,639,000. Salaries, wages and benefits as a percentage of net operating revenue was 59.4% for both the nine-month periods ended September 30, 2018 and 2017. The newly constructed healthcare facilities placed in service during 2017 increased salaries, wages and benefits by \$907,000 compared to the same period a year ago. The newly-acquired geriatric psychiatric hospital increased salaries, wages and benefits \$427,000 compared to the same period a year ago. The remaining increase in our salaries, wages and benefits is primarily due to our existing skilled nursing facility operations. We continue to closely monitor and address the wage pressures we feel in most of the markets in which we operate. There is

substantial effort and resources being deployed to retain and recruit talented partners.

Other operating expenses increased \$3,746,000, or 2.0%, to \$192,268,000 for the 2018 period compared to \$188,522,000 for the 2017 period. Other operating expenses as a percentage of net operating revenue was 26.3% compared to 26.2% for the nine-month periods ended September 30, 2018 and 2017, respectively. The newly constructed healthcare facilities increased other operating expenses compared to the nine-month period a year ago by \$956,000. The newly-acquired geriatric psychiatric hospital increased other operating expenses \$406,000 compared to the same period a year ago.

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Other income (expense)

Non-operating income decreased by \$4,991,000 compared to the same period last year, as further detailed in Note 5 to our interim condensed consolidated financial statements. The decrease in non-operating income is primarily due from:

Our equity in earnings investment in our Caris hospice operations. During 2018, Caris recorded a charge to earnings of \$8,500,000 for the settlement of a Qui Tam investigation, of which 75.1% is included in the Company's earnings. In total, with the \$8.5 million settlement and legal expenses, Caris' earnings negatively impacted NHC's non-operating income by \$8,364,000 for the nine months ended September 30, 2018. For the nine months ended September 30, 2017, Caris had legal expenses in connection with the Qui Tam investigation that negatively impacted NHC's non-operating income by \$1,239,000.

In July 2018, a gain of \$2,050,000 was recorded on the acquisition of a controlling financial interest in a 14-bed geriatric psychiatric hospital in Osage Beach, Missouri. We previously held a noncontrolling ownership interest and equity method investment in this hospital. Upon acquiring the controlling ownership interest, we had to value the business and our previously held equity position based upon the hospital's fair value.

Effective January 1, 2018, the new accounting pronouncement of ASU No. 2016-01, "Financial Instruments – Recognition and Measurement of Financial Assets and Financial Liabilities (Topic 825)", requires that the change in the fair value of our marketable equity securities be recognized in net income. Therefore, we recorded unrealized gains in the amount of \$417,000 for the increase in fair value of our marketable equity securities portfolio for the nine months ended September 30, 2018. The marketable equity securities portfolio consists of publicly-traded healthcare REIT's, with NHI comprising approximately 88% of the market value of the portfolio at September 30, 2018.

Income taxes and noncontrolling interest

The income tax provision for the nine-month period ended September 30, 2018 is \$9,792,000 (an effective income tax rate of 19.5%), as further detailed in Note 14 to our interim condensed consolidated financial statements. Excluding nondeductible expenses, we expect our corporate income tax rate for 2018 to be approximately 26%, which is down from approximately 39% in 2017.

The noncontrolling interest in a subsidiary is: (1) the joint venture operations of a skilled nursing facility in Columbia, Tennessee. This facility opened and began operating in January 2017 in which NHC owns 80% of the operating entity and Maury Regional Medical Center owns 20% of the entity; (2) the joint venture operations of a 14-bed geriatric

psychiatric hospital in Osage Beach, Missouri in which NHC owns 80% of the operating entity and Reliant Healthcare owns the remaining 20% of the entity.

Liquidity, Capital Resources, and Financial Condition

Our primary sources of cash include revenues from the operations of our healthcare and senior living facilities, management and accounting services, rental income, and investment income. Our primary uses of cash include salaries, wages and other operating costs of our healthcare and senior living facilities, the cost of additions to and acquisitions of real property, facility rent expenses, and dividend distributions. These sources and uses of cash are reflected in our interim condensed consolidated statements of cash flows and are discussed in further detail below.

The following is a summary of our sources and uses of cash flows (*dollars in thousands*):

| | Nine Months Ended | | Nine Month Change | | |
|---|-------------------|----------|-------------------|-----------|---|
| | September 30 | | \$ | % | % |
| | 2018 | 2017 | | | |
| Cash, cash equivalents, restricted cash and restricted cash equivalents, at beginning of period | \$67,421 | \$31,589 | \$35,832 | 113.4 | % |
| Cash provided by operating activities | 77,066 | 70,995 | 6,071 | 8.6 | % |
| Cash provided by (used in) investing activities | (27,090) | 1,190 | (28,280) | (2,376.5) | % |
| Cash used in financing activities | (49,664) | (22,034) | (27,630) | (125.4) | % |
| Cash, cash equivalents, restricted cash and restricted cash equivalents, at end of period | \$67,733 | \$81,740 | \$(14,007) | (17.1) | % |

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Operating Activities

Net cash provided by operating activities for the nine months ended September 30, 2018 was \$77,066,000 as compared to \$70,995,000 in the same period last year. Cash provided by operating activities consisted of net income of \$40,563,000, adjustments for non-cash items of \$31,314,000, cash distributions from unconsolidated investments of \$3,830,000, and operating losses within our unconsolidated investments of \$1,860,000. The losses within our unconsolidated investments was impacted by Caris' Qui Tam settlement, including legal fees, of \$8,364,000. There was cash used for working capital needs in the amount of \$483,000 for the nine months ended September 30, 2018 compared to cash provided by working capital in the amount to \$1,271,000 for the same period a year ago.

Investing Activities

Net cash used in investing activities totaled \$27,090,000 for the nine months ended September 30, 2018 compared to cash provided by investing activities of \$1,190,000 for the nine months ended September 30, 2017. Cash used for property and equipment additions was \$22,708,000 for the nine months ended September 30, 2018 compared to \$24,328,000 for the same period in 2017. In July 2018, the Company acquired a controlling ownership interest in a 14-bed geriatric psychiatric hospital in Osage Beach, Missouri for \$527,000, which is net of the cash acquired from the hospital operations. The Company collected notes receivable of \$1,180,000 and \$3,970,000 for the nine months ended September 30, 2018 and 2017, respectively. Purchases of restricted marketable securities, net of sales, resulted in cash used of \$5,411,000 for the nine months ended September 30, 2018. Sales of restricted marketable securities, net of purchases, resulted in cash provided by investing activities of \$21,724,000 for the nine months ended September 30, 2017.

In 2018, construction and development costs included in additions to property and equipment include \$7,128,000 for the construction of the 60-unit memory care facility located in Farragut, Tennessee and \$2,234,000 for the 30-bed addition to a skilled nursing facility in Springfield, Missouri.

Financing Activities

Net cash used in financing activities totaled \$49,664,000 and \$22,034,000 for the nine months ending September 30, 2018 and 2017, respectively. There was \$25,000,000 of cash used for principal payments on long-term debt compared to \$0 in the prior year period. Cash used for dividend payments to common stockholders totaled \$22,214,000 in the current year period compared to \$20,943,000 for the same period in 2017. In the current period, \$1,327,000 was provided by the issuance of common stock compared to \$1,627,000 in the prior year period. In the current period, repurchases of common stock totaled \$867,000 compared to \$0 in the prior year period.

Table of Contractual Obligations

Our contractual obligations as of September 30, 2018 are as follows (*in thousands*):

| | Total | 1 year | 2–3 Years | 4–5 Years | After 5 Years |
|------------------------------------|-----------|----------|--------------|--------------|------------------|
| Long-term debt – principal | \$75,000 | \$– | \$75,000 | \$– | \$– |
| Long-term debt – interest | 5,516 | 2,731 | 2,785 | – | – |
| Operating leases | 287,900 | 34,200 | 68,400 | 68,400 | 116,900 |
| Construction obligations | 2,876 | 2,876 | – | – | – |
| Capital lease obligations | 28,167 | 5,200 | 10,400 | 10,400 | 2,167 |
| Total contractual cash obligations | \$399,459 | \$45,007 | \$156,585 | \$78,800 | \$119,067 |

We started paying quarterly dividends on our common shares outstanding in 2004. We anticipate the continuation of the dividend payment as approved quarterly by the Board of Directors.

Short-term liquidity

We expect to meet our short-term liquidity requirements primarily from our cash flows from operating activities. In addition to cash flows from operations, our current cash on hand of \$55,599,000, marketable securities of \$139,502,000, and as needed, our borrowing capacity on the credit facility, are expected to be adequate to meet our contractual obligations, operating liquidity, and our growth and development plans in the next twelve months.

Long-term liquidity

We expect to meet our long-term liquidity requirements primarily from our cash flows from operating activities, our current cash on hand of \$55,599,000, marketable securities of \$139,502,000, and our borrowing capacity on the credit facility. At September 30, 2018, the outstanding balance on the credit facility is \$75,000,000; therefore, leaving \$75,000,000 available for future borrowings. The maturity date on the credit facility is October 7, 2020. The credit facility is available for general corporate purposes, including working capital and acquisitions.

Our ability to refinance the credit agreement, to meet our long-term contractual obligations and to finance our operating requirements, and growth and development plans will depend upon our future performance, which will be

affected by business, economic, financial and other factors, including potential changes in state and federal government payment rates for healthcare, customer demand, success of our marketing efforts, pressures from competitors, and the state of the economy, including the state of financial and credit markets.

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Commitment and Contingencies

Caris HealthCare, L.P. Investigation and Related Litigation

On December 9, 2014, Caris Healthcare, L.P., a business that specializes in hospice care services in Company-owned health care centers and in other settings, received notice from the U.S. Attorney's Office for the Eastern District of Tennessee and the Attorney Generals' Offices for the State of Tennessee and State of Virginia that those government entities were conducting an investigation regarding patient eligibility for hospice services provided by Caris precipitated by a *qui tam* lawsuit. We have a 75.1% non-controlling ownership interest in Caris.

A *qui tam* lawsuit was filed on May 22, 2014, in the U.S. District Court for the Eastern District of Tennessee by a former Caris employee, Barbara Hinkle, and is captioned *United States of America, State of Tennessee, and State of Virginia ex rel. Barbara Hinkle v. Caris Healthcare, L.P.*, No. 3:14-cv-212 (E.D. Tenn.).

On June 16, 2016, the State of Tennessee and the State of Virginia declined to intervene in the *qui tam* lawsuit. On June 20, 2016, the Court ordered that the complaint be unsealed. On October 11, 2016, the United States filed a Complaint in Intervention against Caris Healthcare, L.P. and Caris Healthcare, LLC, a wholly owned subsidiary of Caris Healthcare, L.P. The United States' complaint alleged that Caris billed the government for ineligible hospice patients between June 2013 and December 2013 and retained overpayments regarding ineligible hospice patients from April 2010 through June 2013.

On March 9, 2018, Caris and the United States jointly moved for a partial 90-day stay of the case to allow the parties to finalize a settlement in principle of the action. That settlement was finalized on June 25, 2018, in which Caris agreed to pay \$8.5 million plus interest for a full release associated with the alleged submission of false claims and alleged retention of overpayments from Medicare for hospice services provided between April 1, 2010, and December 31, 2013. On June 28, 2018, the District Court entered an Order in connection with the parties' Joint Stipulation of Dismissal, which dismissed the action with prejudice as to the Hinkle and Hinkle's bankruptcy trustee, with prejudice to the United States with respect to the conduct released by the settlement, and without prejudice to the United States with respect to all remaining claims. The District Court's Order concludes this litigation.

Nutritional Support Services, L.P., Qui Tam Litigation

On June 19, 2018, a First Amended Complaint was filed naming Nutritional Support Services, L.P. ("NSS"), a wholly-owned subsidiary of the Company, as a defendant in the action captioned *U.S. ex rel. McClain v. Nutritional*

Support Services, L.P., No. 6:17-cv-2608-AMQ (D.S.C.), which was filed in the United States District Court for the District of South Carolina. The action alleges that NSS violated the False Claims Act by reporting a National Drug Code (“NDC”) number that did not correspond to the NDC for dispensed prescriptions. On April 16, 2018, the United States filed a Notice of Election to Decline Intervention with respect to the allegations asserted in this action. NSS intends to vigorously defend itself with respect to this action.

New Accounting Pronouncements

See Note 2 - *Summary of Significant Accounting Policies* to the interim condensed consolidated financial statements for the impact of new accounting standards.

Forward-Looking Statements

References throughout this document to the Company include National HealthCare Corporation and its wholly-owned subsidiaries. In accordance with the Securities and Exchange Commission’s “Plain English” guidelines, this Quarterly Report on Form 10-Q has been written in the first person. In this document, the words “we”, “our”, “ours” and “us” refer only to National HealthCare Corporation and its wholly-owned subsidiaries and not any other person.

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

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

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

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

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

liabilities and other claims asserted against us, including patient care liabilities, as well as the resolution of current litigation (see Note 15 - *Contingencies and Commitments*);

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

the ability to attract and retain qualified personnel;

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

the ability to refinance existing debt on favorable terms;

the competitive environment in which we operate;

the ability to maintain and increase census levels; and

demographic changes.

See the notes to the quarterly financial statements, and “Item 1. Business” in our 2017 Annual Report on Form 10-K for a discussion of various governmental regulations and other operating factors relating to the healthcare industry and the risk factors inherent in them. This may be found on our web site at www.nhccare.com. You should carefully consider these risks before making any investment in the Company. These risks and uncertainties are not the only ones facing us. There may be additional risks that we do not presently know of or that we currently deem immaterial. If any of the risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our shares of stock could decline, and you may lose all or part of your investment. Given these risks and uncertainties, we can give no assurances that these forward-looking statements will, in fact, transpire and, therefore, caution investors not to place undue reliance on them.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

Interest Rate Risk

The fair values of our fixed-income investments fluctuate in response to changes in market interest rates. Increases and decreases in prevailing interest rates generally translate into decreases and increases, respectively, in the fair values of those instruments. Additionally, the fair values of interest rate sensitive instruments may be affected by the creditworthiness of the issuer, prepayment options, the liquidity of the instrument and other general market conditions. At September 30, 2018, we have available for sale debt securities in the amount of \$168,034,000. The fixed maturity portfolio is comprised of investments with primarily short-term and intermediate-term maturities. The portfolio composition allows flexibility in reacting to fluctuations of interest rates. The fixed maturity portfolio allows our insurance company subsidiaries to achieve an adequate risk-adjusted return while maintaining sufficient liquidity to meet obligations.

As of September 30, 2018, the Company has \$75,000,000 of long-term debt that bears interest at variable interest rates. Based on our outstanding long-term debt, a 1% change in interest rates would change our annual interest cost by approximately \$750,000.

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

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

Credit Risk

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

Equity Price and Concentration Risk

Our marketable equity securities are recorded at their fair market value based on quoted market prices. Thus, there is exposure to equity price risk, which is the potential change in fair value due to a change in quoted market prices. At September 30, 2018, the fair value of our marketable equity securities is approximately \$139,502,000. Of the \$139.5 million equity securities portfolio, our investment in National Health Investors, Inc. (“NHI”) comprises approximately

\$123.3 million, or 88.4%, of the total fair value. We manage our exposure to NHI by closely monitoring the financial condition, performance, and outlook of the company. Hypothetically, a 10% change in quoted market prices would result in a related increase or decrease in the fair value of our equity investments of approximately \$13.9 million. At September 30, 2018, our equity securities had unrealized gains of \$109.3 million. Of the \$109.3 million of unrealized gains, \$98.5 million is related to our investment in NHI.

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Item 4. Controls and Procedures.

As of September 30, 2018, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO") and Principal Accounting Officer ("PAO"), of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and PAO, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2018. There have been no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

For a discussion of prior, current and pending litigation of material significance to NHC, please see Note 15 - *Contingencies and Commitments* of this Form 10-Q.

Item 1A. Risk Factors.

During the nine months ended September 30, 2018, there were no material changes to the risk factors that were disclosed in Item 1A of National HealthCare Corporation's Annual Report on Form 10-K for the year ended December 31, 2017.

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

Not applicable

Item 3. Defaults Upon Senior Securities.

None

Item 4. Mine Safety Disclosures.

Not applicable

Item 5. Other Information.

None

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Item 6. Exhibits.

- (a) List of exhibits

EXHIBIT INDEX

Exhibit No. Description

- | | |
|-----|--|
| 3.1 | <u>Certificate of Incorporation of National HealthCare Corporation (Incorporated by reference to Exhibit 3.1 to the Registrant's registration statement on Form S-4 (File No. 333-37185) dated October 3, 1997.)</u> |
| 3.2 | <u>Certificate of Amendment to the Certificate of Incorporation of National HealthCare Corporation (Incorporated by reference to Exhibit 3.5 to the quarterly report on Form 10-Q filed on August 3, 2017.)</u> |
| 3.3 | <u>Certificate of Designation Series B Junior Participating Preferred Stock (Incorporated by reference to Exhibit 3.1 to the Registrant's registration statement on Form 8-A, dated August 3, 2007.)</u> |
| 3.4 | <u>Restated Bylaws as amended February 14, 2013 (Incorporated by reference to Exhibit 3.5 to the quarterly report on Form 10-Q filed on May 8, 2013.)</u> |

4.1 Form of Common Stock
(Incorporated by reference
to Exhibit 4.1 to the
quarterly report on Form
10-Q filed on August 3,
2017.)

31.1 Rule 13a-14(a)/15d-14(a)
Certification of Chief
Executive Officer

31.2 Rule 13a-14(a)/15d-14(a)
Certification of Principal
Accounting Officer

32 Certification pursuant to
18 U.S.C. Section 1350 by
Chief Executive Officer
and Principal Accounting
Officer

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy
Extension Schema
Document

101.CAL XBRL Taxonomy
Extension Calculation
Linkbase Document

101.DEF XBRL Taxonomy
Extension Definition
Linkbase Document

101.LAB XBRL Taxonomy
Extension Label Linkbase
Document

101.PRE XBRL Taxonomy
Extension Presentation
Linkbase Document

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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.

NATIONAL HEALTHCARE CORPORATION
(Registrant)

Date: November 8, 2018 /s/ Stephen F. Flatt
Stephen F. Flatt
Chief Executive Officer

Date: November 8, 2018 /s/ Brian F. Kidd
Brian F. Kidd
Senior Vice President and Controller
(Principal Accounting Officer)