NATIONAL HEALTHCARE CORP
Form 10-Q
November 03, 2016

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

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016
OR
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to ____________

Commission file number 001–13489

(Exact name of registrant as specified in its Charter)

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

100 E. Vine Street
Murfreesboro, TN

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

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

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

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

Yes [x] No [ ]

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

Large Accelerated filer [ ]

Accelerated filer [x]

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

Smaller reporting company [ ]

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

15,149,339 shares of common stock of the registrant were outstanding as of November 1, 2016.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Statements of Income

(in thousands, except share and per share amounts)

(unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2016	2015	2016	2015
Revenues:				
Net patient revenues	$ 218,647	$ 215,351	$ 653,240	$ 641,845
Other revenues	12,634	10,035	35,397	30,850
Net operating revenues	231,281	225,386	688,637	672,695
Cost and Expenses:				
Salaries, wages and benefits	140,403	135,136	405,491	392,766
Other operating	58,956	56,616	177,571	173,830
Facility rent	10,314	10,006	30,960	29,972
Depreciation and amortization	9,998	9,273	28,847	27,442
Interest	1,020	594	2,913	1,782
Total costs and expenses	220,691	211,625	645,782	625,792
Income Before Non–Operating Income	10,590	13,761	42,855	46,903
Non–Operating Income	5,091	4,550	14,789	12,902
Income Before Income Taxes	15,681	18,311	57,644	59,805
Income Tax Provision	(4,571)	(5,744)	(20,969)	(21,638)
Net Income	11,110	12,567	36,675	38,167
Dividends to Preferred Stockholders	-	(2,152)	-	(6,487)
Net Income Available to Common Stockholders	$ 11,110	$ 10,415	$ 36,675	$ 31,680

Earnings Per Common Share:				
Basic	$ 0.73	$ 0.75	$ 2.42	$ 2.30
Diluted	$ 0.73	$ 0.72	$ 2.41	$ 2.21
Weighted Average Common Shares Outstanding:				
Basic	15,198,696	13,801,245	15,128,728	13,778,705
Diluted	15,222,648	14,422,660	15,216,838	14,365,251
Dividends Declared Per Common Share	$ 0.45	$ 0.40	$ 1.30	$ 1.14

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

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Statements of Comprehensive Income

(unaudited – in thousands)

	Three Months Ended September 30		Nine Months Ended September 30	
	2016	2015	2016	2015
Net Income	$ 11,110	$ 12,567	$ 36,675	$ 38,167
Other Comprehensive Income (Loss):				
Unrealized gains (losses) on investments in marketable securities	5,458	(6,724)	36,085	(21,809)
Reclassification adjustment for realized gains on sale of securities	(264)	(28)	(804)	(449)
Income tax (expense) benefit related to items of other comprehensive income	(2,028)	2,657	(13,582)	8,670
Other comprehensive income (loss), net of tax	3,166	(4,095)	21,699	(13,588)
Comprehensive Income	$ 14,276	$ 8,472	$ 58,374	$ 24,579

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

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Balance Sheets

(in thousands)

	September 30, 2016 *unaudited*	December 31, 2015
Assets		
Current Assets:		
Cash and cash equivalents	$ 19,212	$ 38,208
Restricted cash and cash equivalents	14,996	8,793
Marketable securities	147,017	116,168
Restricted marketable securities	12,571	18,276
Accounts receivable, less allowance for doubtful accounts of $8,059 and $5,583, respectively	76,654	84,095
Inventories	7,446	7,568
Prepaid expenses and other assets	2,875	2,171
Notes receivable, current portion	2,253	460
Federal income tax receivable	4,206	3,203
Total current assets	287,230	278,942
Property and Equipment:		
Property and equipment, at cost	921,496	875,287
Accumulated depreciation and amortization	(363,831)	(339,241)
Net property and equipment	557,665	536,046
Other Assets:		
Restricted cash and cash equivalents	2,162	2,313
Restricted marketable securities	166,315	151,590
Deposits and other assets	8,170	8,451
Goodwill	17,600	17,600
Notes receivable, less current portion	12,639	12,704
Investments in limited liability companies	36,574	37,683
Total other assets	243,460	230,341
Total assets	$ 1,088,355	$ 1,045,329

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

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Balance Sheets (continued)

(in thousands, except share and per share amounts)

	September 30, 2016 *unaudited*	December 31, 2015
Liabilities and Stockholders' Equity		
Current Liabilities:		
Trade accounts payable	$ 17,359	$ 20,128
Capital lease obligations, current portion	3,429	3,279
Accrued payroll	50,579	65,338
Amounts due to third party payors	19,007	16,654
Accrued risk reserves, current portion	27,567	27,069
Other current liabilities	18,044	12,192
Dividends payable	6,817	5,996
Total current liabilities	142,802	150,656
Long–term debt	120,000	120,000
Capital lease obligations, less current portion	27,638	30,228
Accrued risk reserves, less current portion	70,042	71,439
Refundable entrance fees	9,669	9,865
Obligation to provide future services	3,440	3,440
Deferred income taxes	23,587	9,096
Other noncurrent liabilities	16,210	16,294
Deferred revenue	4,152	3,315
Stockholders' Equity:		
Common stock, $.01 par value; 30,000,000 shares authorized; 15,149,239 and 15,000,616 shares, respectively, issued and outstanding	152	150
Capital in excess of par value	210,710	209,469
Retained earnings	384,890	368,013
Accumulated other comprehensive income	75,063	53,364
Total stockholders' equity	670,815	630,996
Total liabilities and stockholders' equity	$ 1,088,355	$ 1,045,329

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

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Statements of Cash Flows

(unaudited – in thousands)

	Nine Months Ended September 30	
	2016	2015
Cash Flows From Operating Activities:		
Net income	$ 36,675	$ 38,167
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	28,847	27,442
Provision for doubtful accounts receivable	5,774	5,474
Equity in earnings of unconsolidated investments	(4,926)	(3,924)
Distributions from unconsolidated investments	7,163	6,488
Gains on sale of restricted marketable securities	(804)	(449)
Deferred income taxes	909	(4,795)
Stock–based compensation	502	1,557
Changes in operating assets and liabilities, net of the effect of acquisitions:		
Restricted cash and cash equivalents	(15,507)	(8,897)
Accounts receivable	1,667	(8,485)
Income tax receivable	(1,003)	4,114
Inventories	122	(439)
Prepaid expenses and other assets	(704)	(228)
Trade accounts payable	(2,769)	230
Accrued payroll	(14,759)	(575)
Amounts due to third party payors	2,353	3,480
Other current liabilities and accrued risk reserves	4,981	2,674
Other noncurrent liabilities	(84)	726
Deferred revenue	837	770
Net cash provided by operating activities	49,274	63,330
Cash Flows From Investing Activities:		
Additions to property and equipment	(50,466)	(38,953)
Investments in unconsolidated limited liability companies	(1,282)	(373)
Investments in notes receivable	(2,419)	(5,477)
Collections of notes receivable	845	333
Change in restricted cash and cash equivalents	9,455	7,423
Purchase of restricted marketable securities	(34,747)	(49,993)
Sale of restricted marketable securities	30,963	39,601
Net cash used in investing activities	(47,651)	(47,439)
Cash Flows From Financing Activities:		
Tax (expense) benefit from stock–based compensation	(1,134)	585
Principal payments under capital lease obligations	(2,440)	(2,299)
Dividends paid to preferred stockholders	-	(6,502)
Dividends paid to common stockholders	(18,977)	(15,367)
Issuance of common shares	10,070	8,231

Repurchase of common shares		(8,195)		-
Entrance fee deposits		(196)		(11)
Change in deposits		253		486
Net cash used in financing activities		(20,619)		(14,877)
Net (Decrease) Increase in Cash and Cash Equivalents		(18,996)		1,014
Cash and Cash Equivalents, Beginning of Period		38,208		69,767
Cash and Cash Equivalents, End of Period	$	19,212	$	70,781

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

NATIONAL HEALTHCARE CORPORATION

Interim Condensed Consolidated Statements of Stockholders' Equity

(in thousands, except share and per share amounts)

(unaudited)

	Preferred Stock		Common Stock		Capital in Excess of Par Value	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Shares	Amount	Shares	Amount				
Balance at January 1, 2015	10,836,659	$ 170,494	14,110,859	$ 140	$ 154,965	$ 343,941	$ 64,608	$ 734,148
Net income	–	–	–	–	–	38,167	–	38,167
Other comprehensive loss	–	–	–	–	–	–	(13,588)	(13,588)
Stock–based compensation	–	–	–	–	1,557	–	–	1,557
Tax benefit from exercise of stock options	–	–	–	–	585	–	–	585
Shares sold – options exercised	–	–	176,184	3	8,228	–	–	8,231
Shares issued in conversion of preferred stock to common stock	(74,967)	(1,189)	18,142	–	1,189	–	–	–
Dividends declared to preferred stockholders ($0.60 per share)	–	–	–	–	–	(6,487)	–	(6,487)
Dividends declared to common stockholders ($1.14 per share)	–	–	–	–	–	(16,256)	–	(16,256)
Balance at September 30, 2015	10,761,692	$ 169,305	14,305,185	$ 143	$ 166,524	$ 359,365	$ 51,020	$ 746,357

Balance at January 1, 2016	–	$ –	15,000,616	$ 150	$ 209,469	$ 368,013	$ 53,364	$ 630,996
Net income	–	–	–	–	–	36,675	–	36,675
Other comprehensive income	–	–	–	–	–	–	21,699	21,699
Stock–based compensation	–	–	–	–	502	–	–	502
Tax expense from exercise of stock options	–	–	–	–	(1,134)	–	–	(1,134)
Shares sold – options exercised	–	–	278,623	3	10,067	–	–	10,070
Repurchase of common stock	–	–	(130,000)	(1)	(8,194)	–	–	(8,195)
Dividends declared to common stockholders ($1.30 per share)	–	–	–	–	–	(19,798)	–	(19,798)
Balance at September 30, 2016	–	$ –	15,149,239	$ 152	$ 210,710	$ 384,890	$ 75,063	$ 670,815

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

NATIONAL HEALTHCARE CORPORATION

Notes to Interim Condensed Consolidated Financial Statements

September 30, 2016

(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, 2016, we operate or manage, through certain affiliates, 74 long-term care centers with a total of 9,398 licensed beds, 21 assisted living facilities, five independent living facilities, and 36 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.

Note 2 – Summary of Significant Accounting Policies

The listing below is not intended to be a comprehensive list of all of our significant accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by generally accepted accounting principles, with limited need for management's judgment in their application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result. See our audited December 31, 2015 consolidated financial statements and notes thereto which contain accounting policies and other disclosures required by generally accepted accounting principles. Our audited December 31, 2015 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. We assume that users of these interim financial statements have read or have access to the audited December 31, 2015 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 November 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2015-17, "Income Taxes" which requires that deferred tax liabilities and assets be classified as noncurrent in a classified balance sheet. Prior to the issuance of the standard, deferred tax liabilities and assets were required to be separately classified into a current amount and a noncurrent amount in the balance sheet. The new accounting guidance represents a change in accounting principle and the standard is required to be adopted in annual

periods beginning after December 15, 2016. Early adoption is permitted and the Company elected to early adopt this guidance as of December 31, 2015.

In April 2015, the FASB issued ASU 2015-03, "Imputation of Interest (Sub-Topic 835.30): Simplifying the Presentation of Debt Issuance Costs". ASU 2015-03 requires debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. In August 2015, the FASB issued ASU 2015-15 clarifying the application of this guidance to line of credit arrangements. The amendments in the ASUs are effective retrospectively for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. This guidance did not have a material impact on our consolidated financial statements.

In February 2015, the FASB issued ASU No. 2015-02 “Amendments to the Consolidation Analysis”. This update is in response to stakeholders that have expressed concerns that current generally accepted accounting principles (“GAAP”) might require a reporting entity to consolidate another legal entity in situations in which the reporting entity’s contractual rights do not give it the ability to act primarily on its own behalf, the reporting entity does not hold a majority of the legal entity’s voting rights, or the reporting entity is not exposed to a majority of the legal entity’s economic benefits or obligations. Thus, the update modifies the evaluation of whether limited partnerships and similar legal entities are variable interest entities (“VIEs”) or voting interest entities. It eliminates the presumption that a general partner should consolidate a limited partnership, for limited partnerships and similar legal entities that qualify as voting interest entities; a limited partner with a controlling financial interest should consolidate a limited partnership. A controlling financial interest may be achieved through holding a limited partner interest that provides substantive kick-out rights. Finally, it requires consideration of the effects of fee arrangements and related parties on the primary beneficiary determination. The amendments in this update are effective for annual reporting periods beginning after December 15, 2015, including interim periods within that reporting period. This guidance did not have a material impact on our consolidated financial statements.

Recent Accounting Guidance Not Yet Adopted

In March 2016, the FASB issued ASU 2016-09, “Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.” ASU 2016-09 simplifies the accounting for share-based payment award transactions including: income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. ASU 2016-09 is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted. We are currently evaluating the requirements of ASU 2016-09 and have not yet determined its impact on our consolidated financial statements.

In February 2016, the FASB issued ASU 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. Additionally, we are currently evaluating the impact this standard will have on our policies and procedures and internal control framework.

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. ASU No. 2016-01 is effective for interim and annual periods beginning after December 15, 2017, with early adoption permitted. Adopting ASU No. 2016-01 may result in a cumulative effect adjustment to the Company’s retained earnings as of the beginning of the year of adoption. We are currently evaluating the potential effects of adopting the provisions of ASU No. 2016-01.

In May 2014, the FASB issued ASU No. 2014-09 “Revenue from Contracts with Customers”. 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 FASB is amending the Accounting Standards Codification and creating a new Topic 606, “Revenue from Contracts

with Customers". 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 be entitled in exchange for those goods or services. For a public entity, the amendments in this update are effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. The Company is currently evaluating the impact of this guidance on our consolidated financial statements and control framework.

Revenue Recognition – Third Party Payors

Approximately 65% of our net patient revenues are derived from Medicare, Medicaid, and other government programs. Amounts earned under these programs are subject to review by the Medicare and Medicaid intermediaries or their agents. In our opinion, adequate provision has been made for any adjustments that may result from these reviews. Any differences between our original estimates of reimbursements and subsequent revisions are reflected in operations in the period in which the revisions are made often due to final determination or the period of payment no longer being subject to audit or review. We have recorded liabilities of approximately $19,007,000 and $16,654,000 as of September 30, 2016 and December 31, 2015, respectively, for various Medicare and Medicaid current and prior year cost reports and claims reviews.

Revenue Recognition – Private Pay

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

Revenue Recognition – Subordination of Fees and Uncertain Collections

We provide management services to certain senior care facilities and to others we provide accounting and financial services. We generally charge 6% to 7% of net operating revenues for our management services and a predetermined fixed rate per bed for the accounting and financial services. Our policy is to recognize revenues associated with both management services and accounting and financial services on an accrual basis as the services are provided. However, under the terms of our management contracts, payments for our management services are subject to subordination to other expenditures of the long–term care center being managed. Furthermore, for certain of the third parties with whom we have contracted to provide services and which we have determined that collection is not reasonably assured; our policy is to recognize income only in the period in which the amounts are realized. We may receive payment for the unpaid and unrecognized management fees in whole or in part in the future only if cash flows from the operating and investing activities of the centers or proceeds from the sale of the centers are sufficient to pay

the fees. There can be no assurance that such future cash flows will occur. The realization of such previously unrecognized revenue could cause our reported net income to vary significantly from period to period.

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

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, which were $22,624,000 and $23,356,000 for the nine months ended September 30, 2016 and 2015, 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 2016, we and/or our managed centers are defendants in 35 such claims inclusive of years 2005 through September 30, 2016. 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 center ("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 lessor 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. In each case, we amortize the non-refundable part of these fees 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 classified as non-current liabilities and non-refundable entrance fees are classified as deferred revenue in the Company's consolidated balance sheets. The balances of refundable entrance fees as of September 30, 2016 and December 31, 2015 were $9,669,000 and $9,865,000, 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

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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, 2016 and December 31, 2015, we have recorded a future service obligation in the amount of $3,440,000.

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.

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 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.

Note 3 – Other Revenues

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

Other revenues include the following:

	Three Months Ended September 30		Nine Months Ended September 30	
(in thousands)	2016	2015	2016	2015
Rental Income	$ 5,434	$ 4,807	$ 16,439	$ 14,385
Management and accounting services fees	5,061	3,384	12,316	10,420
Insurance services	1,729	1,674	5,468	5,281
Other	410	170	1,174	764
	$ 12,634	$ 10,035	$ 35,397	$ 30,850

Management Fees from National

We manage five skilled nursing facilities owned by National. For the three months and nine months ended September 30, 2016, we recognized management fees and interest on management fees of $939,000 and $2,834,000

from these centers, respectively. For the three months and nine months ended September 30, 2015, we recognized management fees and interest on management fees of $885,000 and $2,709,000, respectively, from these centers.

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

Insurance Services

For workers' compensation insurance services, the premium revenues reflected in the interim condensed consolidated statements of income for the three and nine months ended September 30, 2016 were $1,064,000 and $3,447,000, respectively. For the three months and nine months ended September 30, 2015, the workers' compensation premium revenues reflected in the interim condensed consolidated statements of income were $977,000 and $3,190,000. Associated losses and expenses are reflected in the interim condensed consolidated statements of income as "Salaries, wages and benefits."

For professional liability insurance services, the premium revenues reflected in the interim condensed consolidated statements of income for the three months and nine months ended September 30, 2016 were $665,000 and $2,021,000, respectively. For the three months and nine months ended September 30, 2015, the professional liability insurance premium revenues reflected in the interim condensed consolidated statements of income were $697,000 and $2,091,000. Associated losses and expenses including those for self–insurance are included in the interim condensed consolidated statements of income as "Other operating costs and expenses".

Note 4 – Non–Operating Income

Non–operating income is outlined in the table below. Non–operating income includes equity in earnings of unconsolidated investments, dividends and other realized gains and losses on marketable securities, and interest income. Our most significant equity method investment is a 75.1% non–controlling ownership interest in Caris

HealthCare L.P. ("Caris"), a business that specializes in hospice care services.

	Three Months Ended September 30		Nine Months Ended September 30	
(in thousands)	2016	2015	2016	2015
Equity in earnings of unconsolidated investments	$ 1,806	$ 1,538	$ 4,926	$ 3,924
Dividends and other net realized gains and losses on sales of securities	1,892	1,588	5,654	5,093
Interest income	1,393	1,424	4,209	3,885
	$ 5,091	$ 4,550	$ 14,789	$ 12,902

Note 5 – 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, 2016	December 31, 2015
	(in thousands)	
Buildings and personal property	$ 39,032	$ 39,032
Accumulated amortization	(10,139)	(7,196)
	$ 28,893	$ 31,836

Operating Leases

At September 30, 2016, NHC 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 $9,480,000 and $9,178,000 for the three months ended September 30, 2016 and 2015, respectively. Total facility rent expense to NHI was $28,440,000 and $27,533,000 for the nine months ended September 30, 2016 and 2015, respectively.

Minimum Lease Payments

The approximate future minimum lease payments required under all leases that have remaining non-cancelable lease terms at September 30, 2016 are as follows:

	Operating Leases	Capital Leases
	(in thousands)	
2017	$ 34,200	$ 5,200

2018	34,200	5,200
2019	34,200	5,200
2020	34,200	5,200
2021	34,200	5,200
Thereafter	185,300	12,567
Total minimum lease payments	$ 356,300	$ 38,567
Less: Amounts representing interest		(7,500)
Present value of minimum lease payments		31,067
Less: Current portion		(3,429)
Long-term capital lease obligations		$ 27,638

Note 6 – Earnings per Share

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

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

(in thousands, except for share and per share amounts)	Three Months Ended September 30		Nine Months Ended September 30	
	2016	2015	2016	2015
Basic:				
Weighted average common shares outstanding	15,198,696	13,801,245	15,128,728	13,778,705
Net income	$ 11,110	$ 12,567	$ 36,675	$ 38,167
Dividends to preferred stockholders	–	(2,152)	–	(6,487)
Net income available to common stockholders	$ 11,110	$ 10,415	$ 36,675	$ 31,680
Earnings per common share, basic	$ 0.73	$ 0.75	$ 2.42	$ 2.30
Diluted:				
Weighted average common shares outstanding	15,198,696	13,801,245	15,128,728	13,778,705
Dilutive effect of stock options	23,952	150,395	23,588	154,113
Dilutive effect of restricted stock	–	–	–	1,577
Dilutive effect of contingent issuable stock	–	471,020	64,522	430,856
Assumed average common shares outstanding	15,222,648	14,422,660	15,216,838	14,365,251
Net income available to common stockholders	$ 11,110	$ 10,415	$ 36,675	$ 31,680
Earnings per common share, diluted	$ 0.73	$ 0.72	$ 2.41	$ 2.21

In the above table, options to purchase 11,592 shares of our common stock have been excluded for the quarter ended and nine months ended September 30, 2015 due to their anti–dilutive impact.

Note 7 – Investments in Marketable Securities

Our investments in marketable securities are classified as available for sale securities. Realized gains and losses from securities sales are recognized in results of operations upon disposition of the securities using the specific identification method on a trade date basis. Refer to Note 8 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:

	September 30, 2016		December 31, 2015	
	Amortized	Fair	Amortized	Fair
(in thousands)	Cost	Value	Cost	Value
Investments available for sale:				
Marketable equity securities	$ 30,176	$ 147,017	$ 30,176	$ 116,168
Restricted investments available for sale:				
Corporate debt securities	65,938	67,826	71,960	71,143
Commercial mortgage–backed securities	53,531	53,913	61,645	60,910
U.S. Treasury securities	26,816	27,188	21,123	21,033
State and municipal securities	29,478	29,959	16,446	16,780
	$ 205,939	$ 325,903	$ 201,350	$ 286,034

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

	September 30, 2016			December 31, 2015		
			Fair			Fair
	Shares	Cost	Value	Shares	Cost	Value
NHI Common Stock	1,630,642	$ 24,734	$ 127,973	1,630,642	$ 24,734	$ 99,257

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

	September 30, 2016		December 31, 2015	
(in thousands)	Cost	Fair Value	Cost	Fair Value
Maturities:				
Within 1 year	$ 18,530	$ 18,581	$ 23,291	$ 23,273
1 to 5 years	81,710	82,810	74,747	74,671
6 to 10 years	73,505	75,474	71,442	70,223
Over 10 years	2,018	2,021	1,694	1,699
	$ 175,763	$ 178,886	$ 171,174	$ 169,866

Gross unrealized gains related to available for sale securities are $120,218,000 and $86,921,000 as of September 30, 2016 and December 31, 2015, respectively. Gross unrealized losses related to available for sale securities are $254,000 and $2,237,000 as of September 30, 2016 and December 31, 2015, 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, 2016 or for the year ended December 31, 2015.

Proceeds from the sale of securities during the nine months ended September 30, 2016 and 2015 were $30,963,000 and $39,601,000, respectively. Investment gains of $804,000 and $449,000 were realized on these sales during the nine months ended September 30, 2016 and 2015, respectively.

Note 8 – Fair Value Measurements

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

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

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

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

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

Valuation of Marketable Securities

The Company determines fair value for marketable securities with Level 1 inputs through quoted market prices. The Company determines fair value for marketable securities with Level 2 inputs through broker or dealer quotations or alternative pricing sources with reasonable levels of price transparency. Our Level 2 marketable securities have been initially valued at the transaction price and subsequently valued, at the end of each month, typically utilizing third party pricing services or other market observable data. The pricing services utilize industry standard valuation models, including both income and market based approaches and observable market inputs to

determine value. These observable market inputs include reportable trades, benchmark yields, credit spreads, broker/dealer quotes, bids, offers, and other industry and economic events.

We validated the prices provided by our broker by reviewing their pricing methods, obtaining market values from other pricing sources, analyzing pricing data in certain instances and confirming that the relevant markets are active. After completing our validation procedures, we did not adjust or override any fair value measurements provided by our broker as of September 30, 2016. We did not have any transfers of assets between Level 1 and Level 2 of the fair value measurement hierarchy during the nine months ended September 30, 2016.

Other

The carrying amounts of cash and cash equivalents, restricted cash and cash equivalents, accounts receivable, and accounts payable approximate fair value due to their short–term nature. The estimated fair value of notes receivable approximates the carrying value based principally on their underlying interest rates and terms, maturities, collateral and credit status of the receivables. Our long–term debt approximates fair value due to variable interest rates, but fair value is also determined using Level 2 inputs through alternative pricing sources. At September 30, 2016, there were no material differences between the carrying amounts and fair values of NHC's financial instruments.

The following table summarizes fair value measurements by level at September 30, 2016 and December 31, 2015 for assets and liabilities measured at fair value on a recurring basis *(in thousands)*:

		Fair Value Measurements Using		
September 30, 2016	Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash and cash equivalents	$ 19,212	$ 19,212	$ –	$ –
Restricted cash and cash equivalents	17,158	17,158	–	–
Marketable equity securities	147,017	147,017	–	–
Corporate debt securities	67,826	34,538	33,288	–
Mortgage–backed securities	53,913	–	53,913	–
U.S. Treasury securities	27,188	27,188	–	–
State and municipal securities	29,959	–	29,959	–
Total financial assets	$ 362,273	$ 245,113	$ 117,160	$ –

		Fair Value Measurements Using		
December 31, 2015	Fair Value	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash and cash equivalents	$ 38,208	$ 38,208	$ –	$ –
Restricted cash and cash equivalents	11,106	11,106	–	–
Marketable equity securities	116,168	116,168	–	–
Corporate debt securities	71,143	32,683	38,460	–
Mortgage-backed securities	60,910	–	60,910	–
U.S. Treasury securities	21,033	21,033	–	–
State and municipal securities	16,780	–	16,780	–
Total financial assets	$ 335,348	$ 219,198	$ 116,150	$ –

Note 9 – Long–Term Debt

Long–term debt consists of the following:

	Weighted Average Interest Rate	Maturities	September 30, 2016	December 31, 2015
	Variable		*(dollars in thousands)*	
Revolving Credit Facility, interest payable monthly	1.9%	2020	$ 110,000	$ 110,000
Unsecured term note payable to National, interest payable quarterly, principal payable at maturity	3.0%	2018	10,000	10,000
			120,000	120,000
Less current portion			–	–
			$ 120,000	$ 120,000

$175,000,000 Credit Facility

On October 7, 2015, we entered into a $175 million Credit Agreement with Bank of America that replaces our former $75 million credit facility. The maturity date of the new credit facility is October 7, 2020. Loans bear interest at either (i) LIBOR plus 1.40% or (ii) the base rate plus 0.40%. The base rate is defined as the highest of (a) the Federal Funds Rate plus ½ of 1%, (b) the Bank of America prime rate, and (c) LIBOR plus 1.00%. The credit facility is available for general corporate purposes, including working capital and acquisitions. NHC is permitted, upon required notice to the lender, to prepay the loans outstanding under the credit facility at any time, without penalty.

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

Note 10 - Stock Repurchase Program

In May 2015, the Board of Directors authorized two new stock repurchase programs, one that allowed for the repurchase of up to $25 million of its common stock and one that allowed for the repurchase of up to $25 million of its preferred stock. As of November 2015, all of the Company's preferred stock was redeemed. Therefore, no future repurchases of the preferred stock will be performed. On August 5, 2016, the Company repurchased 130,000 shares of its common stock for a total cost of $8,195,000. The shares were funded from cash on hand and were cancelled and returned to the status of authorized but unissued. This repurchase plan expired on August 31, 2016.

In August 2016, the Board of Directors authorized a new common stock purchase program. The program will allow for repurchases of up to $25 million of its common stock. The new stock repurchase plan began on September 1, 2016 and will expire on August 31, 2017. No repurchases of common stock have been executed under this current program.

Note 11 – Stock–Based Compensation

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

The 2005 and 2010 Stock–Based Compensation Plans

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

In May 2005, our stockholders approved the 2005 Stock Option, Employee Stock Purchase, Physician Stock Purchase and Stock Appreciation Rights Plan ("the 2005 Plan") pursuant to which 1,200,000 shares of our common stock were available to grant as stock–based payments to key employees, directors, and non–employee consultants. The shares granted during the nine months ended September 30, 2016 consisted of 45,000 shares to the Directors of the Company. At September 30, 2016, 131,276 shares were available for future grants under the 2005 Plan.

In May 2010, our stockholders approved the 2010 Omnibus Equity Incentive Plan ("the 2010 Plan") pursuant to which 1,200,000 shares of our common stock were available to grant as stock–based payments to key employees, directors, and non–employee consultants. In May 2015, our stockholders voted to amend the 2010 Plan to increase the number of shares of our common stock authorized under the Plan from the original 1,200,000 shares to 2,575,000 shares. The shares granted during the nine months ended September 30, 2016 consisted of 11,774 shares through the Employee Stock Purchase Plan. At September 30, 2016, 1,750,760 shares were available for future grants under the amended 2010 Plan.

Compensation expense is recognized only for the awards that ultimately vest. Stock–based compensation totaled $9,000 and $425,000 for the three months ended September 30, 2016 and 2015, respectively. Stock–based compensation totaled $502,000 and $1,557,000 for the nine months ended September 30, 2016 and 2015, respectively. Stock–based compensation is included in "Salaries, wages and benefits" in the interim condensed consolidated statements of income.

Stock Options

The following table summarizes the significant assumptions used to value the options granted for the nine months ended September 30, 2016 and for the year ended December 31, 2015.

	2016	2015
Risk–free interest rate	0.9%	0.7%
Expected volatility	15.8%	16.5%
Expected life, in years	2.2 years	2.2 years
Expected dividend yield	3.1%	2.7%

The following table summarizes our outstanding stock options for the nine months ended September 30, 2016 and for the year ended December 31, 2015.

	Number of Shares		Weighted Average Exercise Price		Aggregate Intrinsic Value
Options outstanding at January 1, 2015	954,678	$	46.92	$	–
Options granted	56,210		61.47		–
Options exercised	(389,498)		47.06		–
Options outstanding at December 31, 2015	621,390		48.15		–
Options granted	56,774		62.53		–
Options exercised	(480,275)		46.81		–
Options forfeited	(656)		46.69		–
Options outstanding at September 30, 2016	197,233	$	55.55	$	2,062,000
Options exercisable at September 30, 2016	185,459	$	55.15	$	2,010,000

Options Outstanding September 30, 2016	Exercise Prices		Weighted Average Exercise Price	Weighted Average Remaining Contractual Life in Years
97,500	$44.80 - $52.93	$	48.95	1.7
99,733	$61.25 - $62.78		61.98	3.7
197,233		$	55.55	2.7

Note 12 – Income Taxes

The income tax provision for the three months ended September 30, 2016 is $4,571,000 (an effective income tax rate of 29.1%). The income tax provision and effective tax rate for the three months ended September 30, 2016 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of $1,306,000 or 8.3% of income before taxes for the quarter. The income tax provision for the three months ended September 30, 2015 was $5,744,000 (an effective income tax rate of 31.4%). The income tax provision and effective tax rate for the three months ended September 30, 2015 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of $1,715,000 or 9.4% of income before taxes for the quarter.

The income tax provision for the nine months ended September 30, 2016 is $20,969,000 (an effective income tax rate of 36.4%). The income tax provision and effective tax rate for the nine months ended September 30, 2016 were favorably impacted by the statute of limitation expirations resulting in a benefit to the provision of $1,306,000 or 2.3% of income before taxes in 2016. The income tax provision for the nine months ended September 30, 2015 was $21,638,000 (an effective income tax rate of 36.2%). The income tax provision and effective tax rate for the nine months ended September 30, 2015 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of $1,715,000 or 2.9% of income before taxes in 2015.

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 2012 (with certain state exceptions). Currently, the 2012 U.S. federal return is under examination.

Note 13 – 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 $97,609,000 and $98,508,000 at September 30, 2016 and December 31, 2015, 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, 2016, we and/or our managed centers are currently defendants in 35 such claims.

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

Insurance coverage for all years includes both primary policies and excess policies. Beginning in 2003, both primary and excess coverage is provided through our wholly–owned insurance company. The primary coverage is in the amount of $1.0 million per incident, $3.0 million per location with an annual primary policy aggregate limit that is adjusted on an annual basis. The excess coverage is $7.5 million annual excess in the aggregate applicable to years 2005–2007, $9.0 million annual excess in the aggregate for years 2008–2010, $4.0 million excess per occurrence for 2011–2013 and $9.0 million excess per occurrence for 2014-2016.

Beginning in 2008 and continuing through September 30, 2016, additional insurance is purchased through third party providers that serve to supplement the coverage provided through our wholly–owned captive insurance company.

Civil Investigative Demand

On December 19, 2013, the Company was served with a civil investigative demand (“CID”) from the U.S. Department of Justice and the Office of the U.S. Attorney for the Eastern District of Tennessee (“DOJ Investigation”) requesting the production of documents and interrogatory responses regarding the billing for and medical necessity of certain rehabilitative therapy services. Based upon our review, the CID appears to relate to services provided at our facilities based in Knoxville, Tennessee.

On October 7, 2014, the Company received a subpoena from the Office of Inspector General of the United Department of Health and Human Services ("OIG Subpoena") related to the current DOJ Investigation. The OIG Subpoena requests certain financial and organizational documents from the Company and certain of its subsidiaries and SNFs and medical records from certain of the Company's Tennessee-based SNFs.

The Company is cooperating fully with these requests. We are unable to evaluate the outcome of this investigation at this time. It is possible that this investigation could lead to a claim that could have a material adverse effect on our consolidated financial position, results of operations and cash flows.

Caris HealthCare, L.P. Investigation

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 alleges that Caris billed the government for ineligible hospice patients between June 2013 and December 2013 and in relation to forty-five patients who were the subject of a Caris internal audit in June 2013. It seeks treble damages and civil penalties under the Federal False Claims Act and asserts claims for payment under mistake of fact, unjust enrichment, and conversion. The relator has filed a notice of voluntary dismissal without prejudice of the non-intervened claims asserted in her *qui tam* complaint.

Caris denies the allegations in the United States' complaint and intends to defend itself vigorously. Given the early stage of this action, we are unable to assess the probable outcome or potential liability, if any, arising from this action. It is possible that this claim could have a material adverse effect on our consolidated financial position, results of operations and cash flows.

South Carolina Medicaid Audits

The South Carolina Office of State Auditor ("State Auditor") conducted Medicaid cost report audits for eleven of the Company's South Carolina skilled nursing facilities. The State Auditor has issued audit findings for the fiscal years ending September 30, 2013 and September 30, 2014.

During 2015, the Company paid the South Carolina Department of Health and Human Services $6.8 million due to the State Auditor findings. The Company has filed administrative appeals with the South Carolina Department of Health and Human Services to recoup these funds and this process is continuing within the legal system. At September 30, 2016, there are no amounts recorded in our interim condensed consolidated balance sheets pertaining to the potential recoupment of these funds.

Financing Commitments

Effective January 1, 2016 and in conjunction with the signed rental agreement for eleven of our healthcare properties, we entered into a short-term line of credit arrangement with a third party operator. The maximum commitment under the line of credit is $10,000,000 and the maturity date is December 30, 2016, or earlier with 30 days written notice. At September 30, 2016, the third party operator had an outstanding balance on the line of credit of $2,168,000. This amount is classified in the current portion of notes receivable in the interim condensed consolidated balance sheets.

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, 2016, National did not have an outstanding balance on the line of credit.

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, 74 long-term care centers with a total of 9,398 licensed beds, 21 assisted living facilities, five independent living facilities, and 36 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

Earnings

To monitor our earnings, we have developed budgets and management reports to monitor labor, census, and the composition of revenues.

Occupancy

Occupancy, or census, in our skilled nursing facilities is a primary area of management focus. For the nine months ended September 30, 2016, the total census at our owned and leased skilled nursing facilities averaged 89.5%, compared to an average of 90.0% for the same period a year ago.

The number of skilled nursing facilities in the United States has been declining for several years. Despite this decline in inventory, occupancy levels for skilled nursing facilities have also seen a steady decline during this period. We believe the steady decline of occupancy has been caused by the following factors: (1) a combination of Federal and State initiatives have led to government programs aggressively shifting more patients to home and community-based services; (2) an increased availability of continuing care retirement communities, assisted living and memory care facilities and other senior living options; and (3) a shorter average length of stay for skilled nursing patients. To monitor our census, we have developed budgets and created programs to assess facility availabilities within certain regions. We also continue to develop and enhance our relationships with the various payor sources and local referral sources in the communities in which we operate.

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/AL	New Facility	92 beds/60 Units	Gallatin, TN	April, 2015
Memory Care	Partnership	60 beds	St. Peters, MO	November, 2015
SNF	Bed Addition	44 beds	Charleston, SC	May, 2016
SNF/AL	New Facility	90 beds / 80 Units	Nashville, TN	June, 2016
SNF	Bed Addition	8 beds	Kingsport, TN	September 2016
AL	New Facility	78 Units	Bluffton, SC	Under construction
AL	New Facility	80 Units	Garden City, SC	Under construction
SNF	New Facility	112 beds	Columbia, TN	Under construction

For the three projects under construction at September 30, 2016, all are expected to begin operations late in the fourth quarter of 2016 or the beginning of the first quarter of 2017.

During 2016, we plan to apply for Certificates of Need for additional beds in certain of our markets. We also will evaluate the feasibility of expansion into new markets by building private pay health care centers or assisted living communities.

Accrued Risk Reserves

Our accrued professional liability and workers’ compensation reserves totaled $97,609,000 at September 30, 2016 and are a primary area of management focus. We have set aside restricted cash and cash equivalents and 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.

Application of Critical Accounting Policies

There were no significant changes during the nine month period ended September 30, 2016 to the items we disclosed as our critical accounting policies and estimates in our discussion and analysis of financial condition and results of operations in our December 31, 2015 Annual Report on Form 10–K filed with the SEC.

Government Program Financial Changes

Federal Health Care Reform

In March 2010, President Obama signed into law the Patient Protection and Affordable Care Act ("PPACA" or, commonly, “ACA”) and the Health Care and Education Reconciliation Act of 2010 ("HCERA"), which represents significant changes to the current U.S. health care system (collectively the "Acts"). The primary goals of the Acts are to: (1) expand coverage to Americans without health insurance, (2) reform the delivery system to improve quality and drive efficiency, (3) and to lower the overall costs of providing health care. The timeline of the enacted provisions span over several years – some of the provisions were effective immediately in 2010 and others will be phased in through 2020.

A significant goal of federal health care reform is to transform the delivery of health care by holding providers accountable for the cost and quality of care provided. Medicare and many commercial third party payors are implementing Accountable Care Organization ("ACO") models in which groups of providers share in the benefit and risk of providing care to an assigned group of individuals. Other reimbursement methodology reforms in which we are participating include value-based purchasing, in which a portion of provider reimbursement is redistributed

based on relative performance on designated economic, clinical quality, and patient satisfaction metrics. Also, CMS is implementing demonstration programs to bundle acute care and post-acute care reimbursement to hold providers accountable for costs across a broader continuum of care. These reimbursement methodologies and similar programs are likely to continue and expand, both in public and commercial health plans. In 2015, CMS announced its goal by 2016 to have 30% of Medicare payments through alternative payment models such as ACOs or bundled payments and up to 50% by the end of 2018. Providers who respond successfully to these trends and are able to deliver quality care at lower costs are likely to benefit financially.

Medicare – Skilled Nursing Facilities

In July 2016, CMS released its final rule outlining the fiscal year 2017 Medicare payments and policy changes for skilled nursing facilities. The 2017 final rule provided for an approximate 2.4% rate update, which began October 1, 2016. This estimated increase consists of a 2.7% market basket increase reduced by 0.3% for a multifactor productivity adjustment required by the ACA. CMS estimates the update will increase overall payments to skilled nursing facilities in fiscal year 2017 by $920 million compared to fiscal year 2016 levels. The policy changes in the 2017 final rule continue to shift skilled nursing facility Medicare payments from volume to value. The final rule makes changes to the SNF Quality Reporting Program and Value-Based Purchasing Program with some of these changes effective for the fiscal year beginning October 1, 2017.

In July 2015, CMS released its final rule outlining the fiscal year 2016 Medicare payments for skilled nursing facilities, which began October 1, 2015. The 2016 final rule provided for an approximate 1.2% rate update. This estimated increase consisted of a 2.3% market basket increase, reduced by a 0.6% forecast error adjustment and further reduced 0.5% for a multifactor productivity adjustment required by the ACA. CMS estimated the update would increase overall payments to skilled nursing facilities in fiscal year 2016 by $430 million compared to fiscal year 2015 levels.

In August 2014, CMS released its skilled nursing facility PPS update for the fiscal year 2015, which began October 1, 2014. The final rule provided for a 2.0% rate update, which reflected a 2.5% market basket increase less a 0.5% multifactor productivity adjustment as required by the ACA. CMS estimated the update would increase overall payments to skilled nursing facilities in fiscal year 2015 by $750 million compared to fiscal year 2014 levels. The 2015 final rule also included wage index updates, revisions to the change of therapy (COT) other Medicare required assessment (OMRA) policy, and comments pertaining to CMS' observations on therapy utilization trends.

For the first nine months of 2016, our average Medicare per diem rate for skilled nursing facilities increased 2.7% compared to the same period in 2015.

Medicaid – Skilled Nursing Facilities

Effective July 1, 2015 and for the fiscal year 2016, the state of Tennessee implemented specific individual nursing facility rate increases. The resulting increase in revenue beginning July 1, 2015 was approximately $4,000,000 annually, or $1,000,000 per quarter.

Effective July 1, 2016 and for the fiscal year 2017, the state of Tennessee implemented specific individual nursing facility rate increases. The resulting increase in revenue beginning July 1, 2016 was approximately $1,700,000 annually, or $425,000 per quarter.

Effective October 1, 2015 and for the fiscal year 2016, South Carolina implemented specific individual nursing facility rate changes. The resulting rate changes for the 2016 fiscal year have an immaterial impact on revenues.

Effective October 1, 2016 and for the fiscal year 2017, South Carolina implemented specific individual nursing facility rate changes. We estimate the resulting increase in revenue for the 2017 fiscal year will be approximately $1,000,000 annually, or $250,000 per quarter.

In April 2016 and retroactively applied back to October 1, 2015, the state of Missouri implemented specific individual nursing facility rate increases. We estimate the resulting increase in revenue will be approximately $400,000 annually, or $100,000 per quarter.

Effective July 1, 2016, the state of Missouri approved a Medicaid rate increase of $2.83 per patient day to Missouri skilled nursing providers. We estimate the resulting increase in revenue will be approximately $800,000 annually, or $200,000 per quarter.

For the first nine months of 2016, our average Medicaid per diem increased 1.9% compared to the same period in 2015. 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

In October 2015 and effective January 1, 2016, CMS released its final rule for 2016 home health prospective payment system rates. CMS estimates that the net impact of the PPS rule will result in a 1.5% decrease ($260 million) in Medicare payments for agencies in 2016. The payment decrease reflects the impact of a 1.9% inflation update offset by a .97% decrease to account for upcoding of claims, a 2.4% decrease required by the third year of the four-year phase-in of the rebasing adjustments, and a decrease resulting from a change in the conversion factor for non-routine medical supplies. The final rule also established a value-based purchasing model that began January 1, 2016 for Medicare-certified agencies in nine states, including Tennessee and Florida.

Results of Operations

Three Months Ended September 30, 2016 Compared to Three Months Ended September 30, 2015

Results for the quarter ended September 30, 2016 include a 2.6% increase in net operating revenues and a 14.4% decrease in income before income taxes compared to the same period in 2015. There have been five newly constructed healthcare facilities placed in service during 2015 and 2016 (two skilled nursing facilities, two assisted living facilities, and one memory care facility). The operating losses before income taxes for these entities were approximately $3,012,000 for the three months ended September 30, 2016, which includes $1,833,000 of losses when compared to the same period a year ago. Therefore, excluding the operating losses from these five newly constructed facilities, income before income taxes would have decreased 4.1% compared to the same period in 2015.

With the removal of the preferred dividend due to the Company's preferred stock redemption in November 2015, net income available to common shareholders for the quarter ended September 30, 2016 was $11,110,000, which increased 6.7% compared to the third quarter of 2015. Excluding the operating losses from the five newly constructed healthcare facilities placed in service in 2015 and 2016, net income available to common shareholders for the quarter ended September 30, 2016 would have been $12,947,000.

The total census at owned and leased skilled nursing facilities for the quarter averaged 89.3% compared to an average of 89.7% for the same quarter a year ago. Medicare per diem rates increased 2.6% and Managed Care per diem rates decreased 0.7% compared to the quarter a year ago. Medicaid and private pay per diem rates increased 2.1% and 4.0%, respectively, compared to the quarter a year ago. Overall, the composite skilled nursing facility per diem at our owned and leased skilled nursing facilities increased 1.7% compared to the quarter a year ago.

Net patient revenues increased $3,296,000, or 1.5%, compared to the same period last year. The majority of the increase is due to the newly constructed healthcare facilities that have been placed in service during 2015 and 2016 ($2,970,000) compared to the same period a year ago.

Other revenues increased $2,599,000, or 25.9%, compared to the same quarter last year, as further detailed in Note 3 to our interim condensed consolidated financial statements. The majority of the increase in other revenues was derived from the increase in management fee revenue and rental income. The increase in management fee revenue primarily consisted of interior design services that were performed for several of our managed healthcare facilities ($1,618,000). This interior design revenue is sporadic and is performed on an as-needed basis to the

managed facilities. As of March 1, 2016, we no longer provide management services to The Quarters of Des Peres skilled nursing facility in Des Peres, Missouri. We expect our management fee revenue to decrease by approximately $600,000 annually, or $150,000 per quarter.

Effective January 1, 2016, we entered into a new triple net lease agreement for eleven of the healthcare properties we own that are operated by a third party entity. The new lease agreement is for a ten year period and is expected to increase rental income by approximately $2,300,000 annually, or $575,000 per quarter, over the previous lease agreement.

Total costs and expenses for the third quarter of 2016 compared to the third quarter of 2015 increased $9,066,000, or 4.3%, to $220,691,000 from $211,625,000. Salaries, wages and benefits, the largest operating costs of our company, increased $5,267,000, or 3.9%, to $140,403,000 from $135,135,000. Other operating expenses increased $2,340,000, or 4.1%, to $58,956,000 for the 2016 period compared to $56,616,000 for the 2015 period. Facility rent expense increased $308,000 to $10,314,000. Depreciation and amortization increased $725,000 to $9,998,000. Interest expense increased $426,000 to $1,020,000.

Salaries, wages and benefits as a percentage of net operating revenue was 60.7% compared to 60.0% for the three months ended September 30, 2016 and 2015, respectively. The increase in salaries, wages and benefits is primarily due to the newly constructed healthcare facilities that have been placed in service during 2015 and 2016 ($2,079,000) and also due to an increase in health insurance expense. We are self-insured for health insurance coverage and recorded an increase in health insurance expense of $1,460,000 due to unfavorable claims activity in the current quarter compared to the same quarter a year ago.

Other operating expenses as a percentage of net operating revenue was 25.5% compared to 25.1% for the three months ended September 30, 2016 and 2015, respectively. The increase in other operating expenses for the current quarter was due to the operations of the newly constructed healthcare facilities compared to the quarter a year ago.

The increase in interest expense is primarily from the line of credit borrowings ($540,000) that took place when the Company's Preferred Stock was redeemed during the fourth quarter of 2015. At September 30, 2016, we have $110 million outstanding on our credit facility.

Non–operating income increased by $541,000 compared to the same period last year, as further detailed in Note 4 to our interim condensed consolidated financial statements. The increase in non-operating income is primarily from our equity method investment in our geriatric psychiatric hospital in Osage Beach, Missouri. This investment increased non-operating income $291,000 in comparison to the quarter a year ago.

The income tax provision for the three months ended September 30, 2016 is $4,571,000 (an effective income tax rate of 29.1%). The income tax provision and effective tax rate for the three months ended September 30, 2016 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of $1,306,000 or 8.3% of income before taxes for the quarter. The income tax provision for the three months ended September 30, 2015 was $5,744,000 (an effective income tax rate of 31.4%). The income tax provision and effective tax rate for the three months ended September 30, 2015 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of $1,715,000 or 9.4% of income before taxes for the quarter.

Nine Months Ended September 30, 2016 Compared to Nine Months Ended September 30, 2015

Results for the nine months ended September 30, 2016 include a 2.4% increase in net operating revenues and a 3.6% decrease in income before income taxes compared to the same period in 2015. There have been five newly constructed healthcare facilities placed in service during 2015 and 2016 (two skilled nursing facilities, two assisted living facilities, and one memory care facility). The operating losses before income taxes for these entities were approximately $5,530,000 for the nine months ended September 30, 2016, which includes $2,896,000 of losses when compared to the same period a year ago. Therefore, excluding the operating losses from these five newly constructed facilities, income before income taxes would have increased 1.2% compared to the same period in 2015.

With the removal of the preferred dividend due to the Company's preferred stock redemption in November 2015, net income available to common shareholders for the nine months ended September 30, 2016 was

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$36,675,000, which increased 15.8% compared to the same nine month period of 2015. Excluding the operating losses from the five newly constructed healthcare facilities placed in service in 2015 and 2016, net income available to common shareholders for the nine months ended September 30, 2016 would have been $40,048,000.

The total census at owned and leased skilled nursing facilities for the nine months averaged 89.5% compared to an average of 90.0% for the same period a year ago. Medicare and Managed Care per diem rates at our owned and leased skilled nursing facilities increased 2.7% and 0.1%, respectively, compared to the nine months a year ago. Medicaid and private pay per diem rates at our owned and leased skilled nursing facilities increased 1.9% and 3.3%, respectively, compared to the period a year ago. Overall, the composite skilled nursing per diem at our owned and leased skilled nursing facilities increased 0.9% compared to the nine months a year ago.

Net patient revenues increased $11,395,000, or 1.8%, compared to the same period last year. The majority of the increase is due to the newly constructed healthcare facilities that have been placed in service during 2015 and 2016 ($6,339,000) compared to the same period a year ago. The net patient revenues from our same-facility skilled nursing facilities increased $3,526,000 compared to the nine month period a year ago. The same-facility centers benefitted from the per diem increases mentioned in the above paragraph.

Other revenues increased $4,547,000, or 14.7%, compared to the same period last year, as further detailed in Note 3 to our interim condensed consolidated financial statements. The majority of the increase in other revenues was derived from the increase in management fee revenue and rental income. The increase in management fee revenue primarily consisted of interior design services that were performed for several of our managed healthcare facilities ($1,618,000). This interior design revenue is sporadic and is performed on an as-needed basis to the managed facilities. As of March 1, 2016, we no longer provide management services to The Quarters of Des Peres skilled nursing facility in Des Peres, Missouri. We expect our management fee revenue to decrease by approximately $600,000 annually, or $150,000 per quarter.

Effective January 1, 2016, we entered into a new triple net lease agreement for eleven of the healthcare properties we own that are operated by a third party entity. The new lease agreement is for a ten year period and is expected to increase rental income by approximately $2,300,000 annually, or $575,000 per quarter, over the previous lease agreement.

Total costs and expenses for the 2016 nine months compared to the same period in 2015 increased $19,990,000, or 3.2%, to $645,782,000 from $625,792,000. Salaries, wages and benefits, the largest operating costs of our company, increased $12,725,000, or 3.2%, to $405,491,000 from $392,766,000. Other operating expenses increased $3,741,000, or 2.2%, to $177,571,000 for the 2016 period compared to $173,830,000 for the 2015 period. Facility rent expense increased $988,000 to $30,960,000. Depreciation and amortization increased $1,405,000 to $28,847,000. Interest expense increased $1,131,000 to $2,913,000.

Salaries, wages and benefits as a percentage of net operating revenue was 58.9% compared to 58.4% for the nine months ended September 30, 2016 and 2015, respectively. The increase in salaries, wages and benefits is primarily derived from our same-facility skilled nursing facilities ($7,171,000) compared to the nine month period in 2015. The remaining increase was due to the newly constructed healthcare facilities placed in service during 2015 and 2016 compared to the same period a year ago ($3,982,000). We also incurred inflationary wage increases for our partners.

Other operating expenses as a percentage of net operating revenue was 25.8% for both of the nine month periods presented. The increase in other operating expenses for the current period was due to the newly constructed healthcare facilities placed in service during 2015 and 2016 compared to the same period a year ago.

The increase in interest expense is due from the line of credit borrowings ($1,607,000) that took place when the Company's Preferred Stock was redeemed during the fourth quarter of 2015. At September 30, 2016, we have $110 million outstanding on our credit facility.

Non–operating income increased by $1,887,000 compared to the same nine month period last year, as further detailed in Note 4 to our interim condensed consolidated financial statements. The increase in non-operating income is primarily from our equity method investment in our geriatric psychiatric hospital in Osage Beach, Missouri and the increased investment earnings from our marketable securities portfolios. The geriatric psychiatric hospital investment increased non-operating income $981,000 in comparison to the nine month period last year.

The income tax provision for the nine months ended September 30, 2016 is $20,969,000 (an effective income tax rate of 36.4%). The income tax provision and effective tax rate for the nine months ended September 30, 2016 were favorably impacted by the statute of limitation expirations resulting in a benefit to the provision of $1,306,000 or 2.3% of income before taxes in 2016. The income tax provision for the nine months ended September 30, 2015 was $21,638,000 (an effective income tax rate of 36.2%). The income tax provision and effective tax rate for the nine months ended September 30, 2015 were favorably impacted by statute of limitation expirations resulting in a benefit to the provision of $1,715,000 or 2.9% of income before taxes in 2015.

Liquidity, Capital Resources, and Financial Condition

Our primary sources of cash include revenues from the operations of our healthcare and senior living facilities, insurance services, management and accounting services, and rental 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 September 30		Nine Month Change	
	2016	2015	$	%
Cash and cash equivalents at beginning of period	$ 38,208	$ 69,767	$ (31,559)	(45.3)%
Cash provided by operating activities	49,274	63,330	(14,056)	(22.2)%
Cash used in investing activities	(47,651)	(47,439)	(212)	(0.4)%
Cash used in financing activities	(20,619)	(14,877)	(5,742)	(38.6)%
Cash and cash equivalents at end of period	$ 19,212	$ 70,781	$ (51,569)	(84.2)%

Operating Activities

Net cash provided by operating activities for the nine months ended September 30, 2016 was $49,274,000, as compared to $63,330,000 in the same period last year. Cash provided by operating activities consisted of net income of $36,675,000, adjustments for non–cash items of $36,032,000, and cash distributions in excess of earnings from equity method investments of $2,237,000. There was cash used for working capital in the amount of $24,866,000 and

also gains on the sale of restricted marketable securities ($804,000) that offset against the positive operating cash flow items stated above.

Cash used for working capital primarily consisted of a decrease in accrued payroll and an increase in restricted cash and cash equivalents. The majority of the decrease in accrued payroll is due to the timing and payments of incentive compensation related to the 2015 year. The increase in restricted cash and cash equivalents is due to NHC healthcare entities paying insurance premiums to our wholly-owned insurance companies, which restrict the cash payment.

Investing Activities

Cash used in investing activities totaled $47,651,000 and $47,439,000 for the nine months ended September 30, 2016 and 2015, respectively. Cash used for property and equipment additions was $50,466,000 for the nine months ended September 30, 2016 and $38,953,000 for the same nine-month period in 2015. The Company made investments in unconsolidated partnerships in the amount of $1,282,000 and $373,000 for the nine months ended September 30, 2016 and 2015, respectively. The Company made investments in notes receivable of $2,419,000 and $5,477,000 for the nine months ended September 30, 2016 and 2015, respectively. Purchases and sales of restricted marketable securities (including the use of restricted cash and cash equivalents) resulted in net cash provided of $5,671,000 for the 2016 period compared to $2,969,000 used in the 2015 period. The cash

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provided by restricted cash and cash equivalents is primarily from the transfer of restricted cash to the debt securities investment portfolio to earn a better rate of return.

In 2016, construction costs included in additions to property and equipment include $8,782,000 for the final construction and furnishings of the 90-bed skilled nursing facility and 80-unit assisted living facility in Nashville, Tennessee; $12,180,000 for construction and current development of the 112-bed skilled nursing facility located in Columbia, Tennessee; $13,196,000 for the construction and current development of two assisted living facilities in Bluffton, South Carolina and Garden City, South Carolina; and $1,139,000 for the construction and 44-bed addition to our skilled nursing facility located in Charleston, South Carolina.

The largest note receivable made during the 2016 nine-month period was a line of credit agreement to a third party operator that is leasing and operating eleven of our healthcare facilities. At September 30, 2016, the third party operator had an outstanding balance on the line of credit of $2,168,000. The maximum commitment from NHC under the line of credit is $10,000,000 and the maturity date is December 30, 2016, or earlier with 30 days written notice.

Financing Activities

Net cash used in financing activities totaled $20,619,000 and $14,877,000 for the nine months ended September 30, 2016 and 2015, respectively. Cash used for dividend payments to common stockholders totaled $18,977,000 in the current year period compared to cash used for dividend payments to common and preferred stockholders of $21,869,000 for the same period a year ago. In the current period, $10,070,000 was provided by the issuance of common stock compared to $8,231,000 in the prior year period. In August 2016, the Company used cash to repurchase 130,000 shares of its common stock for a total cost of $8,195,000. There were no stock repurchases for the same period a year ago. The principal payments under the capital lease obligations were $2,440,000 and $2,299,000 for the nine months ended September 30, 2016 and 2015, respectively.

Table of Contractual Obligations

Our contractual obligations as of September 30, 2016 are as follows *(in thousands)*:

	Total	1 year	2–3	4–5	After

			Years	Years	5 Years
Long–term debt – principal	$ 120,000	$ –	$ 10,000	$ 110,000	$ –
Long–term debt – interest	8,838	2,405	4,290	2,143	–
Operating leases	356,300	34,200	68,400	68,400	185,300
Construction obligations	7,028	7,028	–	–	–
Capital lease obligations	38,567	5,200	10,400	10,400	12,567
Total contractual cash obligations	$ 530,733	$ 48,833	$ 93,090	$ 190,943	$ 197,867

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 $19,212,000, marketable securities of $147,017,000 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 $19,212,000, marketable securities of $147,017,000, and our borrowing capacity on the credit facility. At September 30, 2016, the outstanding balance on the credit facility is $110,000,000; therefore, leaving $65,000,000 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.

Commitment and Contingencies

Civil Investigative Demand

On December 19, 2013, the Company was served with a civil investigative demand ("CID") from the U.S. Department of Justice and the Office of the U.S. Attorney for the Eastern District of Tennessee ("DOJ Investigation") requesting the production of documents and interrogatory responses regarding the billing for and medical necessity of certain rehabilitative therapy services. Based upon our review, the CID appears to relate to services provided at our facilities based in Knoxville, Tennessee.

On October 7, 2014, the Company received a subpoena from the Office of Inspector General of the United Department of Health and Human Services ("OIG Subpoena") related to the current DOJ Investigation. The OIG Subpoena requests certain financial and organizational documents from the Company and certain of its subsidiaries and SNFs and medical records from certain of the Company's Tennessee-based SNFs.

The Company is cooperating fully with these requests. We are unable to evaluate the outcome of this investigation at this time. It is possible that this investigation could lead to a claim that could have a material adverse effect on our consolidated financial position, results of operations and cash flows.

Caris HealthCare, L.P. Investigation

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 alleges that Caris billed the government for ineligible hospice patients between June 2013 and December 2013 and in relation to forty-five patients who were the subject of a Caris internal audit in June 2013. It seeks treble damages and civil penalties under the Federal False Claims Act and asserts claims for payment under mistake of fact, unjust enrichment, and conversion. The relator has filed a notice of voluntary dismissal without prejudice of the non-intervened claims asserted in her *qui tam* complaint.

Caris denies the allegations in the United States' complaint and intends to defend itself vigorously. Given the early stage of this action, we are unable to assess the probable outcome or potential liability, if any, arising from this action. It is possible that this claim could have a material adverse effect on our consolidated financial position, results of operations and cash flows.

South Carolina Medicaid Audits

The South Carolina Office of State Auditor ("State Auditor") conducted Medicaid cost report audits for eleven of the Company's South Carolina skilled nursing facilities. The State Auditor has issued audit findings for the fiscal years ending September 30, 2013 and September 30, 2014.

During 2015, the Company paid the South Carolina Department of Health and Human Services $6.8 million due to the State Auditor findings. The Company has filed administrative appeals with the South Carolina Department of Health and Human Services to recoup these funds and this process is continuing within the legal system. At September 30, 2016, there are no amounts recorded in our consolidated balance sheets pertaining to the potential recoupment of these funds.

Financing Commitments

Effective January 1, 2016 and in conjunction with the signed rental agreement for eleven of our healthcare properties, we entered into a short-term line of credit arrangement with a third party operator. The maximum commitment under the line of credit is $10,000,000 and the maturity date is December 30, 2016, or earlier with 30 days written notice. At September 30, 2016, the third party operator had an outstanding balance on the line of credit of $2,168,000. This amount is classified in the current portion of notes receivable in the interim condensed consolidated balance sheets.

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, 2016, National did not have an outstanding balance on the line of credit.

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.

Acquisitions

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

Inflation

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

New Accounting Pronouncements

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

Forward–Looking Statements

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

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

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

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

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

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

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

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

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the ability to attract and retain qualified personnel;

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

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the ability to refinance existing debt on favorable terms;

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the competitive environment in which we operate;

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the ability to maintain and increase census levels; and

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demographic changes.

See the notes to the quarterly financial statements, and “Item 1. Business” in our 2015 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, 2016, we have available for sale debt securities in the amount of $178,886,000. 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, 2016, the Company has $120 million 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 $1,200,000.

Approximately $6.9 million of our notes receivable bear interest at variable rates (generally at the prime rate plus 2%). Because the interest rates of these instruments are variable, a hypothetical 1% change in interest rates would result in a related increase or decrease in interest income of approximately $69,000.

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

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

Credit Risk

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

Equity Price and Concentration Risk

Our available for sale 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, 2016, the fair value of our marketable equity securities is approximately $147,017,000. Of the $147.0 million equity securities portfolio, our investment in National Health Investors, Inc. (“NHI”) comprises approximately $128.0 million, or 87%, of the total fair value. We manage our

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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 $14.7 million. At September 30, 2016, our equity securities had unrealized gains of $116.8 million. Of the $116.8 million of unrealized gains, $103.2 million is related to our investment in NHI.

Item 4. Controls and Procedures.

As of September 30, 2016, 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, 2016. There have been no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

For a discussion of prior, current and pending litigation of material significance to NHC, please see Note 13 of this Form 10–Q.

Item 1A. Risk Factors.

During the nine months ended September 30, 2016, 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, 2015.

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

Not applicable

Item 3. Defaults Upon Senior Securities.

None

Item 5. Other Information.

None

Item 6. Exhibits.

(a)

List of exhibits

EXHIBIT INDEX

Exhibit No.	Description	Page No. or Location
3.1	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)
3.2	Certificate of Amendment to the Certificate of Incorporation of National HealthCare Corporation	Incorporated by reference to Exhibit 3.2 to the Registrant's registration statement on Form 8-A, dated October 31, 2007)
3.3	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
3.4	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.
4.1	Form of Common Stock	Incorporated by reference to Exhibit A attached to Form S-4, (Proxy Statement-Prospectus), amended, Registration No. 333-37185, (December 5, 1997)
4.2		

	Rights Agreement, dated as of August 2, 2007, between National HealthCare Corporation and Computershare Trust Company, N.A.	Incorporated by reference to Exhibit 4.1 to the Registrant's registration statement on Form 8-A, dated August 3, 2007
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer	Filed Herewith
31.2	Rule 13a-14(a)/15d-14(a) Certification of Principal Accounting Officer	Filed Herewith
32	Certification pursuant to 18 U.S.C. Section 1350 by Chief Executive Officer and Principal Accounting Officer	Filed Herewith
*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	

* As provided in Rule 406T of Regulation S-T, this information shall not be deemed "filed" for purposes of Sections 11 and 12 of the Securities Act and Section 18 of the Securities Exchange Act or otherwise subject to liability under those sections.

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 3, 2016

/s/ Robert G. Adams
Robert G. Adams
Chief Executive Officer

Date: November 3, 2016

/s/ Donald K. Daniel
Donald K. Daniel
Senior Vice President and Controller
(Principal Accounting Officer)