OMEGA HEALTHCARE INVESTORS INC
Form S-3/A
February 23, 2004

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As filed with the Securities and Exchange Commission on February 23, 2004

Registration No. 333-112731

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

AMENDMENT NO. 1 TO FORM S-3

REGISTRATION STATEMENT
Under
THE SECURITIES ACT OF 1933

OMEGA HEALTHCARE INVESTORS, INC.

(Exact name of registrant as specified in its charter)

MARYLAND	**38-3041398**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

9690 DEERECO ROAD, SUITE 100
TIMONIUM, MARYLAND 21093
(410) 427-1700
(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

C. TAYLOR PICKETT
CHIEF EXECUTIVE OFFICER
OMEGA HEALTHCARE INVESTORS, INC.
9690 DEERECO ROAD, SUITE 100
TIMONIUM, MARYLAND 21093
(410) 427-1700
(Name, address, including zip code, and telephone number, including area code, of agent for service)

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Approximate date of commencement of proposed sale to the public: From time to time or at one time after the effective date of this registration statement as determined by the selling stockholder.

If the only securities being registered on this form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. o

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. ý

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. o

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. o

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until this registration statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

Explanatory Note

This Registration Statement (the "Selling Stockholder Registration Statement") contains both a Base Prospectus and a Prospectus Supplement (the "Prospectus Supplement") relating to a proposed offering of 18,118,246 shares of common stock of Omega Healthcare Investors, Inc. (the "Company") by a stockholder of the Company. The Prospectus Supplement contemplates that an Underwriters' over-allotment option covering 2,717,736 shares of the Company's common stock will be granted by the Company. The shares of common stock covered by the over-allotment option have been registered under the Securities Act of 1933, as amended, pursuant to the Company's Registration Statement on Form S-3 (Reg. No. 333-69675) (the "Company Shelf Registration Statement").

In connection with the offering contemplated by the Prospectus Supplement, the Company and the Underwriters intend to deliver to investors the Prospectus Supplement accompanied by both the Base Prospectus contained herein relating to the shares to be sold by the Selling Stockholder and the Base Prospectus forming part of the Company Shelf Registration Statement relating to the shares of common stock that may be sold by the Company pursuant to the Underwriters' over-allotment option.

The information in this preliminary prospectus supplement is not complete and may be changed. This preliminary prospectus supplement and the accompanying prospectuses are not an offer to sell these securities and we are not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

PRELIMINARY PROSPECTUS SUPPLEMENT	Subject to Completion	February 23, 2004

(To Prospectus dated February 5, 2004 and Prospectus dated February , 2004)

18,118,246 Shares

Common Stock

Explorer Holdings, L.P., or Explorer, the selling stockholder, is offering 18,118,246 shares of our common stock. We will not receive any proceeds from the sale of our shares by the selling stockholder. Our common stock is traded on the New York Stock Exchange under the symbol "OHI". On February 20, 2004, the last reported sale price of our common stock on the New York Stock Exchange was $10.38 per share.

Investing in our common stock involves significant risks. Before buying any shares, you should carefully read both the accompanying prospectuses and this prospectus supplement in their entirety, including the discussion of material risks of investing in our common stock in "Risk factors" beginning on page S-6.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement or the accompanying prospectuses are truthful or complete. Any representation to the contrary is a criminal offense.

	Per Share	Total
Public offering price	$	$
Underwriting discounts and commissions	$	$
Proceeds, before expenses, to the selling stockholder	$	$

We have agreed to sell to the underwriters up to 2,717,736 shares of our common stock at the public offering price, less underwriting discounts and commissions payable by us, to cover over-allotments, if any, within 30 days from the date of this prospectus supplement.

The underwriters are offering the shares of common stock as described in "Underwriting". Delivery of the shares of common stock will be made on or about , 2004.

Joint Book-Running Managers

UBS Investment Bank | Deutsche Bank Securities

Banc of America Securities LLC

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In this prospectus supplement, the terms "Omega", "we", "company", "us", and "our" refer to Omega Healthcare Investors, Inc. and its majority-owned subsidiaries unless otherwise expressly stated or the context otherwise requires.

Unless otherwise stated in this prospectus supplement, we have assumed throughout this prospectus supplement that the underwriters' over-allotment option is not exercised.

You should rely only on the information contained or incorporated by reference in this prospectus supplement and the accompanying prospectuses. We and the selling stockholder have not, and the underwriters have not, authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We and the selling stockholder are not, and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus supplement and the accompanying prospectuses, as well as information we previously filed with the SEC and incorporated by reference, is accurate only as of their respective dates. Our business, financial condition, results of operations and prospects may have changed since those dates.

Prospectus supplement summary

This summary may not contain all of the information that is important to you. You should carefully read this entire prospectus supplement and the accompanying prospectuses, including the "Risk factors" section. You should also read the documents referred to in "Incorporation of certain information by reference".

This prospectus supplement describes the terms of this offering. This prospectus supplement is accompanied by two prospectuses: one prospectus relates to the common stock being offered by the selling stockholder, which is numbered SS-1 through SS-37; and the other relates to the common stock that will be sold by us in the event the underwriters exercise their over-allotment option, which is numbered C-1 through

C-35. This prospectus supplement may add, update or change information in the accompanying prospectuses and the documents incorporated by reference herein. It is important for you to read and consider all information contained in this prospectus supplement, the accompanying prospectuses and the information incorporated by reference in making your investment decision.

OUR COMPANY

We were incorporated in the State of Maryland on March 31, 1992. We are a self-administered real estate investment trust, or REIT, investing in income-producing healthcare facilities, principally long-term care facilities located in the United States. We provide lease or mortgage financing to qualified operators of skilled nursing facilities and, to a lesser extent, assisted living and acute care facilities. We have historically financed investments through borrowings under our revolving credit facilities, private placements or public offerings of debt or equity securities, the assumption of secured indebtedness, or a combination of these methods.

Our portfolio of investments consists of 211 healthcare facilities, primarily skilled nursing facilities, located in 28 states and operated by 39 third-party operators. This portfolio is made up of:

- 152 long-term healthcare facilities and two rehabilitation hospitals owned and leased to third parties;
- fixed rate mortgages on 51 long-term healthcare facilities; and
- six long-term healthcare facilities that were recovered from customers and are currently closed.

As of December 31, 2003, our gross investments in healthcare facilities, net of impairments, totaled $812.3 million. In addition, we also held miscellaneous investments of approximately $29.8 million, consisting primarily of secured loans to third-party operators of our facilities.

In making investments in properties, we generally have focused on established, creditworthy, middle-market healthcare operators that meet our standards for quality and experience of management. We have sought to diversify our investments in terms of geographic locations, operators and facility types.

In evaluating potential investments, we consider such factors as:

- the quality and experience of management and the creditworthiness of the operator of the facility;
- the facility's historical, current and forecasted cash flow and its ability to meet operational needs, capital expenditures and lease or debt service obligations, providing a competitive return on investment to us;
- the construction quality, condition and design of the facility;
- the geographic area and type of facility;

- the tax, growth, regulatory and reimbursement environment of the jurisdiction in which the facility is located;
- the occupancy and demand for similar healthcare facilities in the same or nearby communities; and
- the payor mix of private, Medicare and Medicaid patients.

We prefer to invest in equity ownership of properties. Due to regulatory, tax or other considerations, we sometimes pursue alternative investment structures, including convertible participating and participating mortgages, that can achieve returns comparable to equity investments.

Our principal executive offices are located at 9690 Deereco Road, Suite 100, Timonium, Maryland 21093, and our telephone number is (410) 427-1700. Additional information regarding our company is set forth in the documents on file with the Securities and Exchange Commission and incorporated by reference in this prospectus supplement. See "Where you can find more information" and "Incorporation of certain information by reference".

RECENT DEVELOPMENTS

Dividends

In 2001, our board of directors suspended dividends on our common stock and all series of preferred stock in an effort to generate cash to address then impending debt maturities. In the third quarter of 2003, we paid all accrued but unpaid dividends on all series of preferred stock and reinstated dividends on all series of preferred stock. In September 2003, our board of directors reinstated our common stock dividend that was paid in November 2003 in the amount of $0.15 per common share. On January 21, 2004, our board of directors increased the quarterly dividend on our common stock to $0.17 per common share, representing a 13% increase over the previous quarterly dividend on common stock. We cannot assure you, however, that we will be able to continue to pay dividends in the future.

Portfolio developments

Effective January 1, 2004, we re-leased five skilled nursing facilities to an existing operator under a new master lease, which has a 5-year term and an initial annual lease rate of $0.75 million. Four former Sun Healthcare Group, Inc., or Sun, skilled nursing facilities, three located in Illinois and one located in Indiana and representing an aggregate of 449 beds, were part of the transaction. The fifth skilled nursing facility in the transaction, located in Illinois and representing 128 beds, was the last remaining owned and operated facility in our portfolio.

On January 26, 2004, we announced that we signed a non-binding term sheet representing an agreement in principle with Sun regarding 51 properties we own that are leased to various affiliates of Sun. Under the arrangement contemplated by the non-binding term sheet, Sun would continue to operate and occupy 23 long-term care facilities, five behavioral properties and two hospital properties. One property in the State of Washington, formerly operated by a Sun affiliate, has already been closed and the lease relating to that property will be terminated. With respect to the remaining 20 facilities, 15 have already been transitioned to new operators and five are in the process of being transferred to new operators.

The non-binding term sheet contemplates execution and delivery of a new master lease with the following general terms:

> *Term:* Through December 31, 2013.

> *Base Rent:* Commencing February 1, 2004, monthly base rent would be $1,560,529, subject to annual increases not to exceed 2.5% per year.

> *Deferred Base Rent:* $7,761,000 would be deferred and shall bear interest at a floating rate with a floor of 6% per year. Interest would accrue but would not be payable to us through

January 3, 2008. Interest thereafter accruing would be paid monthly. We are releasing all other claims for base rent which otherwise would be due under the current leases.

> *Conversion of Deferred Base Rent*: Omega would have the right at any time to convert the deferred base rent into 800,000 shares of Sun's common stock, subject to certain non-dilution provisions and the right of Sun to pay cash in an amount equal to the value of that stock in lieu of issuing stock to Omega. If the value of the common stock exceeds 140% of the deferred base rent, Sun can require Omega to convert the deferred base rent into Sun's common stock. Omega would have the right to require Sun to prepare and file with the SEC a registration statement to facilitate resales of the Sun stock.

The terms described above are subject to the negotiation and execution of definitive documents satisfactory to us and Sun.

Series D preferred stock offering and repurchase of Series C preferred stock from Explorer

On February 5, 2004, we entered into a Repurchase and Conversion Agreement with our largest stockholder, Explorer Holdings, L.P., or Explorer, pursuant to which Explorer granted us an option to repurchase up to 700,000 shares of our Series C preferred stock at $145.92 per share (or $9.12 per share of common stock on an as-converted basis), provided we purchased a minimum of $100 million on or prior to February 27, 2004. Explorer also agreed to convert all of its remaining shares of Series C preferred stock into shares of our common stock upon exercise of the repurchase option.

On February 10, 2004, we sold in a registered direct placement 4,739,500 shares of our 8.375% Series D cumulative redeemable preferred stock at $25 per share to a number of institutional investors and other purchasers for net proceeds, after fees and expenses, of approximately $114.9 million. Following the closing of the Series D preferred stock offering, we used approximately $102.1 million of the net proceeds to repurchase 700,000 shares of Series C preferred stock from Explorer pursuant to the repurchase option. In connection with the transaction, Explorer converted its remaining 348,420 shares of Series C preferred stock into 5,574,720 shares of common stock. We anticipate using the balance of the net proceeds of the offering to redeem approximately 600,000 shares of our 9.25% Series A cumulative preferred stock.

As a result of the offering of Series D preferred stock, the application of the proceeds received from the offering to fund the exercise of our repurchase option, and the conversion of the remaining Series C preferred stock into shares of our common stock:

- No Series C preferred stock is outstanding, and we plan to re-classify the remaining authorized shares of Series C preferred stock as authorized but unissued preferred stock, without designation as to class;
- 4,739,500 shares of our Series D preferred stock, with an aggregate liquidation preference of $118,487,500, have been issued; and
- Explorer holds, as of the date of this prospectus supplement, 18,118,246 shares of our common stock, representing approximately 41.5% of our outstanding common stock.

On February 5, 2004, we received a request from Explorer pursuant to its registration rights agreement with us requesting that we prepare and file with the SEC a registration statement registering Explorer's shares of our common stock on a shelf basis permitting sales from time to time as determined by Explorer. Accordingly, on February 12, 2004 we filed a registration statement with the SEC, of which the accompanying prospectus dated February , 2004 is a part, registering Explorer's 18,118,246 shares of common stock. Explorer is selling all of these registered shares in this offering.

In connection with our repurchase of a portion of Explorer's Series C preferred stock, our results of operations for the first quarter of 2004 will include a non-recurring reduction in net income attributable to common stockholders of approximately $39 million. This amount reflects the sum of (i) the difference between the deemed redemption price of $145.92 per share of our Series C preferred

stock and the carrying amount of $100 per share of Series C preferred stock multiplied by the number of shares of Series C preferred stock repurchased upon exercise of our option to repurchase shares of Series C preferred stock, and (ii) the cost associated with the original issuance of our Series C preferred stock that was previously classified as additional paid in capital, pro rated for the repurchase. This non-recurring reduction in net income attributable to common stockholders will reduce our earnings per share and our reportable funds from operations for the first quarter of 2004.

Proposed refinancing

On February 23, 2004, we publicly announced our intention to refinance our existing credit facilities and our intention to undertake a private placement of unsecured notes pursuant to Rule 144A of the Securities Act of 1933, as amended. Our primary objective in refinancing our credit facilities is to extend the average maturity of our outstanding indebtedness and obtain more attractive terms. We anticipate using the proceeds of the notes offering, together with the proceeds from a planned approximately $125 million new senior credit facility, to repay borrowings under our existing senior secured credit facility maturing in 2007, to redeem shares of our 9.25% Series A cumulative preferred stock, and for general corporate purposes. The proposed refinancing and notes offering, if completed, would replace our existing $225 million senior secured credit facility and $50 million acquisition credit facility, which would be terminated. We will determine whether to proceed with a refinancing based on market conditions at the time. We cannot assure you that the refinancing of our existing credit facilities or the proposed note offering will be completed, or if completed, the terms will be satisfactory to the company.

Composition of our board of directors following the offering

Under our stockholder agreement with Explorer, Explorer is entitled to designate to our board of directors a number of directors that would generally be proportionate to Explorer's ownership of our voting securities. Explorer is presently entitled to designate four of our ten directors. Three of Explorer's designees (one of whom presently serves as Chairman of our board of directors) have indicated that upon completion of the sale of Explorer's 18.1 million shares of our common stock in this offering, they intend to resign as directors. On February 18, 2004, our board of directors formed a nominating and corporate governance committee comprised of our existing five independent directors. This committee will consider and make appropriate recommendations regarding the size of our board of directors following completion of this offering. This committee will direct the process of identifying appropriate candidates to serve as directors, including a new Chairman of our board of directors.

The offering

Shares being offered by the selling stockholder	18,118,246 shares
Shares that may be sold by us in the event the underwriters exercise their over-allotment option in full	2,717,736 shares
Shares to be outstanding after the offering	43,608,956 shares
Use of proceeds	We will not receive any proceeds from the sale of our common stock by the selling stockholder. In the event the underwriters exercise their over-allotment option in full, we estimate that our net proceeds from this offering will be approximately $26.1 million (assuming a public offering price of $10.38 per share). We intend to apply any net proceeds to us from this offering for general corporate purposes.
Risk factors	See "Risk Factors" beginning on page S-6 of this prospectus supplement for a discussion of factors you should carefully consider before deciding to invest in our common stock.
New York Stock Exchange symbol	OHI

The number of our shares to be outstanding after this offering is based on the number of shares outstanding on February 20, 2004 and excludes 1,262,064 shares of our common stock issuable upon exercise of outstanding options as of February 20, 2004, with a weighted average exercise price of $3.63 per share, 554,065 shares of our common stock reserved for issuance pursuant to our 2000 Stock Incentive Plan and any shares that may be issued if the underwriters exercise their over-allotment option, in whole or in part.

Risk factors

Investment in our common stock involves significant risks. In addition to the other information in this prospectus supplement and other documents that are incorporated by reference into this prospectus supplement, you should consider carefully the following risk factors before deciding to invest in our common stock. The risks described below are not the only risks facing us. Additional risks and uncertainties not currently known to us or that we currently consider to be immaterial may also materially and adversely affect our business operations. In such case, you may lose all or part of your original investment.

RISKS RELATED TO THE OPERATORS OF OUR FACILITIES

Our financial position could be weakened and our ability to pay dividends could be limited if any of our major operators were unable to meet their obligations to us or failed to renew or extend their relationship with us as their lease terms expire, or if we were unable to lease or re-lease our facilities or make mortgage loans on economically favorable terms. These adverse developments could arise due to a number of factors, including those listed below.

Our recent efforts to restructure and stabilize our portfolio may not prove to be successful.

In large part as a result of the 1997 changes in Medicare reimbursement of services provided by skilled nursing facilities and reimbursement cuts imposed under state Medicaid programs, a number of operators of our properties have encountered significant financial difficulties during the last several years. In 1999, our investment portfolio consisted of 216 properties and our largest public operators (by investment) were Sun, Integrated Health Services, Advocat, Inc., or Advocat, and Mariner Health Care Inc., or Mariner. Some of these operators, including Sun, Integrated Health Services and Mariner, subsequently filed for bankruptcy protection. Other of our operators were required to undertake significant restructuring efforts. We have restructured our arrangements with many of our operators whereby we have renegotiated lease and mortgage terms, re-leased properties to new operators and have closed and/or disposed of properties. At December 31, 2003, our investment portfolio consisted of 211 properties and our largest public operators (by investment) were Sun (20.7%), Advocat (12.8%) and Mariner (7.4%). Our largest private company operators (by investment) were Seacrest Healthcare (6.8%) and Claremont Healthcare Holdings, Inc., or Claremont (5.7%). We have a non-binding agreement in principle with Sun, our largest operator, regarding our 51 properties that were leased to various affiliates of Sun. Finalization of our agreement with Sun is subject to negotiation and execution of definitive documentation. In addition, we continue to have ongoing restructuring discussions with Claremont regarding five facilities Claremont currently leases from us. We might not be successful in reaching definitive agreements with Sun or Claremont. We are also aware of a few properties in our portfolio where facility operations are currently insufficient to meet rental payments due to us or where the lessees have recently been delinquent in the payment of rents. In addition, one of our operators with four facilities representing 2.2% of our investments is currently operating as a debtor-in-possession under Chapter 11 of the U.S. Code, or Bankruptcy Code. It is possible that we will need to take steps to restructure these portions of our portfolio, or other properties in our portfolio with respect to which our operators encounter financial difficulty. We cannot assure you that our recent efforts to restructure and stabilize our property portfolio will be successful.

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The bankruptcy, insolvency or financial deterioration of our operators could delay our ability to collect unpaid rents or require us to find new operators for rejected facilities.

We are exposed to the risk that our operators may not be able to meet their obligations, which may result in their bankruptcy or insolvency. Although our leases and loans provide us the right to terminate an investment, evict an operator, demand immediate repayment and other remedies, the bankruptcy laws afford certain protections to a party that has filed for bankruptcy that may render these remedies unenforceable. In addition, an operator in bankruptcy may be able to restrict our ability to collect unpaid rent or mortgage payments during the bankruptcy case.

If one of our lessees seeks bankruptcy protection, Chapter 11 of the Bankruptcy Code provides that a trustee in a liquidation or reorganization case under the Bankruptcy Code, or a debtor-in-possession in a reorganization case under the Bankruptcy Code, has the option to assume or reject the unexpired lease obligations of a debtor-lessee. However, our lease arrangements with operators who operate more than one of our facilities are generally made pursuant to a single master lease covering all of that operator's facilities leased from us. Subject to certain restrictions, a debtor-lessee under a master lease agreement would generally be required to assume or reject a master lease as a whole, rather than making the decision on a facility by facility basis, thereby preventing the debtor-lessee from assuming only the better performing facilities and terminating the leasing arrangement with respect to the poorer performing facilities. Whether or not a court would require a master lease agreement to be assumed or rejected as a whole would depend on a number of factors, including applicable state law, the parties intent, whether the master lease agreement and related documents were executed contemporaneously, the nature and purpose of the relevant documents, whether there was separate and distinct consideration for each lease, and the provisions contained in the relevant documents, including whether the relevant documents are interrelated and contain ample cross-references. Therefore, it is not possible to predict how a bankruptcy court would decide this issue.

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Assumption of Leases. In the event that an unexpired lease is assumed by or on behalf of the debtor-lessee, any defaults, other than those created by the financial condition of the debtor-lessee, the commencement of its bankruptcy case or the appointment of a trustee, would have to be cured and all the rental obligations thereunder generally would be entitled to a priority over other unsecured claims. Generally, unexpired leases must be assumed in their totality, however, a bankruptcy court has the power to refuse to enforce certain provisions of a lease, such as cross-default provisions or penalty provisions, that would otherwise prevent or limit the ability of a debtor-lessee from assuming or assuming and assigning to another party the unexpired lease.

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Rejection of Leases. Generally, the debtor-lessee is required to make rent payments to us during its bankruptcy unless and until it rejects the lease. The rejection of a lease is deemed to be a pre-petition breach of the lease and the lessor will be allowed a pre-petition general unsecured claim that will be limited to any unpaid rent already due plus an amount equal to the rent reserved under the lease, without acceleration, for the greater of (a) one year and (b) fifteen percent (15%), not to exceed three years, of the remaining term of such lease, following the earlier of (i) the petition date and (ii) repossession or surrender of the leased property. Although the amount of a lease rejection claim is subject to the statutory cap described above, the lessor should receive the same percentage recovery on account of its claim as other holders of allowed pre-petition unsecured claims receive from the bankruptcy estate. If the debtor-lessee rejects the lease, the facility would be returned to us. In that event, if we were unable to re-lease the facility to a new operator on favorable terms or only after a significant delay, we could lose some or all of the associated revenue from that facility for an extended period of time.

If an operator defaults under one of our mortgage loans, we may have to foreclose on the mortgage or protect our interest by acquiring title to the property and thereafter making substantial improvements or repairs in order to maximize the facility's investment potential. Operators may contest enforcement of foreclosure or other remedies, seek bankruptcy protection against our exercise of enforcement or other remedies and/or bring claims for lender liability in response to actions to enforce mortgage obligations. If an operator seeks bankruptcy protection, the automatic stay provisions of the federal bankruptcy law would preclude us from enforcing foreclosure or other remedies against the operator unless relief is obtained from the court. High "loan to value" ratios or declines in the value of the facility may prevent us from realizing an amount equal to our mortgage loan upon foreclosure.

The receipt of liquidation proceeds or the replacement of an operator that has defaulted on its lease or loan could be delayed by the approval and licensure process of any federal, state or local agency necessary for the replacement of the previous operator licensed to manage the facility. In some instances, we may take possession of a property and such action could expose us to successor liabilities. These events, if they were to occur, could reduce our revenue and operating cash flow.

Operators that fail to comply with governmental reimbursement programs such as Medicare or Medicaid, licensing and certification requirements, fraud and abuse regulations or new legislative developments may be unable to meet their obligations to us.

Our operators are subject to numerous federal, state and local laws and regulations that are subject to frequent and substantial changes (sometimes applied retroactively) resulting from legislation, adoption of rules and regulations, and administrative and judicial interpretations of existing law. The ultimate timing or effect of these changes cannot be predicted. These changes may have a dramatic effect on our operators' costs of doing business and the amount of reimbursement by both government and other third-party payors. The failure of any of our operators to comply with these laws, requirements and regulations could adversely affect their ability to meet their obligations to us. In particular:

> *Medicare and Medicaid.* A significant portion of our skilled nursing facility operators' revenue is derived from governmentally-funded reimbursement programs, primarily Medicare and Medicaid, and failure to maintain certification and accreditation in these programs would result in a loss of funding from such programs. Loss of certification or accreditation could cause the revenues of our operators to decline, potentially jeopardizing their ability to meet their obligations to us. In that event, our revenues from those facilities could be reduced, which could in turn cause the value of our affected properties to decline. State licensing and Medicare and Medicaid laws also require operators of nursing homes and assisted living facilities to comply with extensive standards governing operations. Federal and state agencies administering those laws regularly inspect such facilities and investigate complaints. Our operators and their managers receive notices of potential sanctions and remedies from time to time, and such sanctions have been imposed from time to time on facilities operated by them. If they are unable to cure deficiencies which have been identified or which are identified in the future, such sanctions may be imposed and if imposed may adversely affect our operators' revenues, potentially jeopardizing their ability to meet their obligations to us.

> *Licensing and Certification.* Our operators and facilities are subject to regulatory and licensing requirements of federal, state and local authorities and are periodically audited by them to confirm compliance. Failure to obtain licensure or loss or suspension of licensure would prevent a facility from operating or result in a suspension of reimbursement payments until all licensure issues have been resolved and the necessary licenses obtained or reinstated. Our skilled nursing facilities require governmental approval, in the form of a certificate of need that generally varies by state and is

subject to change, prior to the addition or construction of new beds, the addition of services or certain capital expenditures. Some of our facilities may be unable to satisfy current and future certificate of need requirements and may for this reason be unable to continue operating in the future. In such event, our revenues from those facilities could be reduced or eliminated for an extended period of time.

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Fraud and Abuse Regulations. There are various extremely complex and largely uninterpreted federal and state laws governing a wide array of referrals, relationships and arrangements and prohibiting fraud by healthcare providers, including criminal provisions that prohibit filing false claims or making false statements to receive payment or certification under Medicare and Medicaid, or failing to refund overpayments or improper payments. Governments are devoting increasing attention and resources to anti-fraud initiatives against healthcare providers. The Health Insurance Portability and Accountability Act of 1996 and the Balanced Budget Act of 1997 expanded the penalties for healthcare fraud, including broader provisions for the exclusion of providers from the Medicare and Medicaid programs. Furthermore, the Office of Inspector General of the U.S. Department of Health and Human Services, or OIG, in cooperation with other federal and state agencies, continues to focus on the activities of skilled nursing facilities in certain states in which we have properties. In addition, the federal False Claims Act allows a private individual with knowledge of fraud to bring a claim on behalf of the federal government and earn a percentage of the federal government's recovery. Because of these incentives, these so-called "whistleblower" suits have become more frequent. The violation of any of these regulations by an operator may result in the imposition of fines or other penalties that could jeopardize that operator's ability to make lease or mortgage payments to us or to continue operating its facility.

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Legislative and Regulatory Developments. Each year, legislative proposals are introduced or proposed in Congress and in some state legislatures that would affect major changes in the healthcare system, either nationally or at the state level. The Medicare Prescription Drug, Improvement and Modernization Act of 2003, P.Law 108-173, which is one example of such legislation, was enacted in late 2003. The Medicare reimbursement changes for the long term care industry under this Act are limited to a temporary increase in the per diem amount paid to skilled nursing facilities for residents who have AIDS. The significant expansion of other benefits for Medicare beneficiaries under this Act, such as the expanded prescription drug benefit, could result in financial pressures on the Medicare program that might result in future legislative and regulatory changes with impacts for our operators. Other proposals under consideration include efforts by individual states to control costs by decreasing state Medicaid reimbursements, a federal "Patient Protection Act" to protect consumers in managed care plans, efforts to improve quality of care and reduce medical errors throughout the health care industry and hospital cost-containment initiatives by public and private payors. We cannot accurately predict whether any proposals will be adopted or, if adopted, what effect, if any, these proposals would have on operators and, thus, our business.

Regulatory proposals and rules are released on an ongoing basis that may have major impact on the healthcare system generally and the skilled nursing and long-term care industries in particular.

Our operators depend on reimbursement from governmental and other third-party payors and reimbursement rates from such payors may be reduced.

Changes in the reimbursement rate or methods of payment from third-party payors, including the Medicare and Medicaid programs, or the implementation of other measures to reduce reimbursements for services provided by our operators has in the past, and could in the future, result in a substantial reduction in our operators' revenues and operating margins. Additionally, net revenue realizable under

third-party payor agreements can change after examination and retroactive adjustment by payors during the claims settlement processes or as a result of post-payment audits. Payors may disallow requests for reimbursement based on determinations that certain costs are not reimbursable or reasonable or because additional documentation is necessary or because certain services were not covered or were not medically necessary. There also continue to be new legislative and regulatory proposals that could impose further limitations on government and private payments to healthcare providers. In some cases, states have enacted or are considering enacting measures designed to reduce their Medicaid expenditures and to make changes to private healthcare insurance. We cannot assure you that adequate reimbursement levels will continue to be available for the services provided by our operators, which are currently being reimbursed by Medicare, Medicaid or private third-party payors. Further limits on the scope of services reimbursed and on reimbursement rates could have a material adverse effect on our operators' liquidity, financial condition and results of operations which could cause the revenues of our operators to decline and potentially jeopardize their ability to meet their obligations to us.

Our operators may be subject to significant legal actions that could subject them to increased operating costs and substantial uninsured liabilities, which may affect their ability to pay their lease and mortgage payments to us.

As is typical in the healthcare industry, our operators are often subject to claims that their services have resulted in resident injury or other adverse effects. Many of these operators have experienced an increasing trend in the frequency and severity of professional liability and general liability insurance claims and litigation asserted against them. The insurance coverage maintained by our operators may not cover all claims made against them nor continue to be available at a reasonable cost, if at all. In some states, insurance coverage for the risk of punitive damages arising from professional liability and general liability claims and/or litigation may not, in certain cases, be available to operators due to state law prohibitions or limitations of availability. As a result, our operators operating in these states may be liable for punitive damage awards that are either not covered or are in excess of their insurance policy limits. We also believe that there has been, and will continue to be, an increase in governmental investigations of long-term care providers, particularly in the area of Medicare/Medicaid false claims, as well as an increase in enforcement actions resulting from these investigations. Insurance is not available to cover such losses. Any adverse determination in a legal proceeding or governmental investigation, whether currently asserted or arising in the future, could have a material adverse effect on an operator's financial condition. If an operator is unable to obtain or maintain insurance coverage, if judgments are obtained in excess of the insurance coverage, if an operator is required to pay uninsured punitive damages, or if an operator is subject to an uninsurable government enforcement action, the operator could be exposed to substantial additional liabilities.

One of our largest operators was recently served with six lawsuits by the State of Arkansas seeking substantial damages relating to patient care issues and alleged Medicaid false claims.

On February 19, 2004, Advocat announced that it had been served with six lawsuits by the State of Arkansas alleging violations by Advocat and certain of its subsidiaries of the Arkansas Abuse of Adults Act and the Arkansas Medicaid False Claims Act. In its announcement, Advocat stated that the complaints seek, in the aggregate, actual damages of approximately $250,000 and fines and penalties in excess of $45 million. Although Advocat stated its intention to vigorously defend itself against the subject allegations, Advocat further stated that it cannot predict the outcome of the subject lawsuits or the impact of the ultimate outcome on Advocat's financial condition, cash flows or results of

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operations. Advocat accounted for approximately 13.4% of our 2003 reported revenues. In the event that there is an adverse outcome to Advocat in these lawsuits, or in the event that Advocat's business is otherwise adversely affected as a result of the lawsuits (for example, as a result of penalties imposed in connection with a settlement of the lawsuits, as a result of licensure revocation, admission holds or similar restrictions being imposed or as a result of a decline in business due to reputational issues), and Advocat is unable to pay its full monthly rental obligation to us, then we will experience a reduction of our rental income. Should such events occur, our income and cash flows from operations would be adversely affected. We are unable currently to predict how this matter may ultimately affect us.

Increased competition as well as increased operating costs have resulted in lower revenues for some of our operators and may affect the ability of our tenants to meet their payment obligations to us.

The healthcare industry is highly competitive and we expect that it may become more competitive in the future. Our operators are competing with numerous other companies providing similar healthcare services or alternatives such as home health agencies, life care at home, community-based service programs, retirement communities and convalescent centers. We cannot be certain the operators of all of our facilities will be able to achieve occupancy and rate levels that will enable them to meet all of their obligations to us. Our operators may encounter increased competition in the future that could limit their ability to attract residents or expand their businesses and therefore affect their ability to pay their lease or mortgage payments.

The market for qualified nurses, healthcare professionals and other key personnel is highly competitive and our operators may experience difficulties in attracting and retaining qualified personnel. Increases in labor costs due to higher wages and greater benefits required to attract and retain qualified healthcare personnel incurred by our operators could affect their ability to pay their lease or mortgage payments. This situation could be particularly acute in certain states that have enacted legislation establishing minimum staffing requirements.

RISKS RELATED TO US AND OUR OPERATIONS

In addition to the operator related risks discussed above, there are a number of risks directly associated with us and our operations.

We rely on external sources of capital to fund future capital needs, and if we encounter difficulty in obtaining such capital, we may not be able to make future investments necessary to grow our business or meet maturing commitments.

In order to qualify as a REIT under the Internal Revenue Code, or the Code, we are required, among other things, to distribute each year to our stockholders at least 90% of our REIT taxable income. Because of this distribution requirement, we may not be able to fund, from cash retained from operations, all future capital needs, including capital needs to make investments and to satisfy or refinance maturing commitments. As a result, we may rely on external sources of capital. If we are unable to obtain needed capital at all or only on unfavorable terms from these sources, we might not be able to make the investments needed to grow our business, or to meet our obligations and commitments as they mature, which could negatively affect the ratings of our debt and even, in extreme circumstances, affect our ability to continue operations. Our access to capital depends upon a number of factors over which we have little or no control, including general market conditions and the market's perception of our growth potential and our current and potential future earnings and cash

distributions and the market price of the shares of our capital stock. Generally speaking, difficult capital market conditions in our industry during the past several years and our need to stabilize our portfolio have limited our access to capital. Our potential capital sources include, but are not limited to:

Equity Financing. As with other publicly-traded companies, the availability of equity capital will depend, in part, on the market price of our common stock which, in turn, will depend upon various market conditions and other factors that may change from time to time including:

- the extent of investor interest;
- the general reputation of REITs and the attractiveness of their equity securities in comparison to other equity securities, including securities issued by other real estate-based companies;
- financial performance and that of our operators;
- the contents of analyst reports about us and the REIT industry;
- general stock and bond market conditions, including changes in interest rates on fixed income securities, which may lead prospective purchasers of our common stock to demand a higher annual yield from future distributions;
- our failure to maintain or increase our dividend, which is dependent, to a large part, on growth of funds from operations which in turn depends upon increased revenues from additional investments and rental increases; and
- other factors such as governmental regulatory action and changes in REIT tax laws.

The market value of the equity securities of a REIT is generally based upon the market's perception of the REIT's growth potential and its current and potential future earnings and cash distributions. Our failure to meet the market's expectation with regard to future earnings and cash distributions would likely adversely affect the market price of our common stock and reduce the value of your investment.

Debt Financing/Leverage. Financing for future investments and our maturing commitments may be provided by borrowings under our bank line of credit, private or public offerings of debt, the assumption of secured indebtedness, mortgage financing on a portion of our owned portfolio or through joint ventures. We are subject to risks normally associated with debt financing, including the risks that our cash flow will be insufficient to make timely payments of interest, that we will be unable to refinance existing indebtedness and that the terms of refinancing will not be as favorable as the terms of existing indebtedness. If we are unable to refinance or extend principal payments due at maturity or pay them with proceeds from other capital transactions, our cash flow may not be sufficient in all years to pay distributions to our stockholders and to repay all maturing debt. Furthermore, if prevailing interest rates, changes in our debt ratings or other factors at the time of refinancing result in higher interest rates upon refinancing, the interest expense relating to that refinanced indebtedness would increase, which could reduce our profitability and the amount of dividends we are able to pay. Moreover, additional debt financing increases the amount of our leverage. Our degree of leverage could have important consequences to stockholders, including affecting our investment grade ratings, affecting our ability to obtain additional financing in the future for working capital, capital expenditures, acquisitions, development or other general corporate purposes and making us more vulnerable to a downturn in business or the economy generally.

Certain of our operators account for a significant percentage of our revenues.

Based on existing contractual rent and lease payments regarding the restructuring of certain existing investments, Advocat and Sun each account for over 10% of our current contractual monthly revenues, with Sun accounting for slightly over 20% of our current contractual monthly revenues. Additionally, our top five operators account for over 55% of our current contractual monthly revenues. The failure or inability of any of these operators to pay their obligations to us could materially reduce our revenues and net income, which could in turn reduce the amount of dividends we pay and cause our stock price to decline. For information regarding our non-binding agreement in principle with Sun, see "Recent Developments".

Unforeseen costs associated with the acquisition of new properties could reduce our profitability.

Our business strategy contemplates future acquisitions that may not prove to be successful. For example, we might encounter unanticipated difficulties and expenditures relating to any acquired properties, including contingent liabilities, or newly acquired properties might require significant management attention that would otherwise be devoted to our ongoing business. If we agree to provide funding to enable healthcare operators to build, expand or renovate facilities on our properties and the project is not completed, we could be forced to become involved in the development to ensure completion or we could lose the property. These costs may negatively affect our results of operations. While we are currently evaluating certain possible acquisitions, we are not currently a party to any definitive agreement, commitment or understanding with respect to any material acquisitions.

Our assets may be subject to impairment charges.

We periodically, but not less than annually, evaluate our real estate investments and other assets for impairment indicators. The judgment regarding the existence of impairment indicators is based on factors such as market conditions, operator performance and legal structure. If we determine that a significant impairment has occurred, we would be required to make an adjustment to the net carrying value of the asset, which could have a material adverse affect on our results of operations and funds from operations in the period in which the write-off occurs.

We may not be able to sell certain closed facilities for their book value.

From time to time we close facilities and actively market such facilities for sale. To the extent we are unable to sell these properties for our book value, we may be required to take an impairment charge or loss on the sale, either of which would reduce our net income.

Our substantial indebtedness could adversely affect our financial condition.

We have substantial indebtedness and we may increase our indebtedness in the future. As of December 31, 2003, our debt was $280.6 million, the majority of which currently comes due in 2007. Our level of indebtedness could have important consequences to our stockholders. For example, it could:

> limit our ability to satisfy our obligations with respect to holders of our capital stock;

> potentially cause us to violate a cross-default provision under our various long-term debt obligations;

> make us more vulnerable to economic downturns;

> potentially limit our ability to withstand competitive pressures if, as a result of a decline in our rating agency ratings, our cost of capital increases as compared to our competitors' cost of capital thus reducing the spread on our investments; and

>

impair our ability to obtain additional financing in the future for working capital, capital expenditures, acquisitions or general corporate purposes.

Our refinancing transactions may not be completed on the terms contemplated by us.

We have initiated discussions with potential lenders regarding a new senior credit facility. However, we have not yet received a commitment for a new senior credit facility and the exact timing of a new senior credit facility is unclear. We might not be able to enter into a new senior credit facility on favorable terms, or at all. Our existing senior credit facility imposes pre-payment penalties and, if our refinancing efforts are successful, we will incur fees and additional charges as a result of early extinguishment of our debt obligation. In addition, our existing senior credit facility is collateralized by 121 facilities representing approximately half of our invested assets. We are also the guarantor of our subsidiaries' obligations under our existing senior credit facility and have pledged to the lenders the shares of these subsidiaries. Any new senior credit facility may require collateralization equal to or in excess of these amounts, which could adversely affect our ability to engage in other financing transactions. Furthermore, as is the case with our current credit facility, we expect any new senior credit facility to contain various covenants. These covenants could, among other things, require us to meet certain financial tests and limit our ability to incur additional indebtedness, incur liens, make investments and engage in acquisitions, asset sales and mergers and consolidations. We have also announced our intention to make an offering of notes pursuant to Rule 144A under the Securities Act of 1933. This offering of notes may not be completed on the terms presently contemplated by us or at all. We expect that the notes, if issued, will contain covenants similar to those contained in similar securities issued by other companies. See "Recent Developments Proposed refinancing".

Our real estate investments are relatively illiquid.

Real estate investments are relatively illiquid and, therefore, tend to limit our ability to vary our portfolio promptly in response to changes in economic or other conditions. All of our properties are "special purpose" properties that could not be readily converted to general residential, retail or office use. Healthcare facilities that participate in Medicare or Medicaid must meet extensive program requirements, including physical plant and operational requirements, which are revised from time to time. Such requirements may include a duty to admit Medicare and Medicaid patients, limiting the ability of the facility to increase its private pay census beyond certain limits. Medicare and Medicaid facilities are regularly inspected to determine compliance, and may be excluded from the programs in some cases without a prior hearing for failure to meet program requirements. Transfers of operations of nursing homes and other healthcare-related facilities are subject to regulatory approvals not required for transfers of other types of commercial operations and other types of real estate. Thus, if the operation of any of our properties becomes unprofitable due to competition, age of improvements or other factors such that our lessee or mortgagor becomes unable to meet its obligations on the lease or mortgage loan, the liquidation value of the property may be substantially less, particularly relative to the amount owing on any related mortgage loan, than would be the case if the property were readily adaptable to other uses. The receipt of liquidation proceeds or the replacement of an operator that has defaulted on its lease or loan could be delayed by the approval process of any federal, state or local agency necessary for the transfer of the property or the replacement of the operator with a new

operator licensed to manage the facility. In addition, certain significant expenditures associated with real estate investment, such as real estate taxes and maintenance costs, are generally not reduced when circumstances cause a reduction in income from the investment. Should such events occur, our income and cash flows from operations would be adversely affected.

As an owner or lender with respect to real property, we may be exposed to possible environmental liabilities.

Under various federal, state and local environmental laws, ordinances and regulations, an owner of real property or a secured lender, such as us, may be liable in certain circumstances for the costs of removal or remediation of certain hazardous or toxic substances at, under or disposed of in connection with such property, as well as certain other potential costs relating to hazardous or toxic substances, including government fines and damages for injuries to persons and adjacent property. Such laws often impose liability without regard to whether the owner knew of, or was responsible for, the presence or disposal of such substances and liability may be imposed on the owner in connection with the activities of an operator of the property. The cost of any required remediation, removal, fines or personal or property damages and the owner's liability therefore could exceed the value of the property, and/or the assets of the owner. In addition, the presence of such substances, or the failure to properly dispose of or remediate such substances, may adversely affect the owner's ability to sell or rent such property or to borrow using such property as collateral which, in turn, would reduce the owner's revenues.

Although our leases and mortgage loans require the lessee and the mortgagor to indemnify us for certain environmental liabilities, the scope of such obligations may be limited, and we cannot assure you that any such mortgagor or lessee would be able to fulfill its indemnification obligations.

The industry in which we operate is highly competitive. This competition may prevent us from raising prices at the same pace as our costs increase.

We compete for additional healthcare facility investments with other healthcare investors, including other REITs. The operators of the facilities compete with other regional or local nursing care facilities for the support of the medical community, including physicians and acute care hospitals, as well as the general public. Some significant competitive factors for the placing of patients in skilled and intermediate care nursing facilities include quality of care, reputation, physical appearance of the facilities, services offered, family preferences, physician services and price. If our cost of capital should increase relative to the cost of capital of our competitors, the spread that we realize on our investments may decline if competitive pressures limit or prevent us from charging higher lease or mortgage rates.

We are named as defendants in litigation arising out of professional liability and general liability claims relating to our previously owned and operated facilities which if decided against us, could adversely affect our financial condition.

We and several of our wholly-owned subsidiaries have been named as defendants in professional liability and general liability claims related to our owned and operated facilities. Other third-party managers responsible for the day-to-day operations of these facilities have also been named as defendants in these claims. In these suits, patients of certain previously owned and operated facilities have alleged significant damages, including punitive damages, against the defendants. The lawsuits are in various stages of discovery and we are unable to predict the likely outcome at this time. We

continue to vigorously defend these claims and pursue all rights we may have against the managers of the facilities, under the terms of the management agreements. We have insured these matters, subject to self-insured retentions of various amounts. There can be no assurance that we will be successful in our defense of these matters or in asserting our claims against various managers of the subject facilities or that the amount of any settlement or judgment will be substantially covered by insurance or that any punitive damages will be covered by insurance.

We are subject to significant anti-takeover provisions.

Our articles of incorporation and bylaws contain various procedural and other requirements which could make it difficult for stockholders to effect certain corporate actions. In order to protect us against the risk of losing our REIT status for federal income tax purposes, our charter prohibits the ownership by any single person of more than 9.9% of the issued and outstanding shares of our voting stock. Our board of directors is divided into three classes and our board members are elected for terms that are staggered. Our board of directors also has the authority to issue additional shares of preferred stock and to fix the preferences, rights and limitations of the preferred stock without stockholder approval. We have also adopted a stockholders rights plan which provides for share purchase rights to become exercisable at a discount if a person or group acquires more than 9.9% of our common stock or announces a tender or exchange offer for more than 9.9% of our common stock. These provisions could discourage unsolicited acquisition proposals or make it more difficult for a third party to gain control of us, which could adversely affect the market price of our securities.

We may change our investment strategies and policies and capital structure.

Our board of directors, without the approval of our stockholders, may alter our investment strategies and policies if it determines in the future that a change is in our and our stockholders' best interests. The methods of implementing our investment strategies and policies may vary as new investments and financing techniques are developed.

If we fail to maintain our REIT status, we will be subject to federal income tax on our taxable income at regular corporate rates.

We were organized to qualify for taxation as a real estate investment trust, or REIT, under Sections 856 through 860 of the Internal Revenue Code. We believe we have conducted, and we intend to continue to conduct, our operations so as to qualify as a REIT. Qualification as a REIT involves the satisfaction of numerous requirements, some on an annual and some on a quarterly basis, established under highly technical and complex provisions of the Internal Revenue Code for which there are only limited judicial and administrative interpretations and involve the determination of various factual matters and circumstances not entirely within our control. For example, in order to qualify as a REIT, each year we must distribute to our stockholders at least 90% of our REIT taxable income. We cannot assure you that we will at all times satisfy these rules and tests.

If we were to fail to qualify as a REIT in any taxable year, as a result of a determination that we failed to meet the annual distribution requirement or otherwise, we would be subject to federal income tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates. Moreover, unless entitled to relief under certain statutory provisions, we also would be disqualified from treatment as a REIT for the four taxable years following the year during which qualification is lost. This treatment would reduce our net earnings and cash flow available for

investment, debt service or distribution to stockholders because of our additional tax liability for the years involved. In addition, distributions to stockholders would no longer be required to be made.

We will not receive any proceeds from this offering unless the underwriters exercise the over-allotment option.

We will not receive any proceeds from the sale of our shares by the selling stockholder. We will only receive proceeds if the underwriters exercise the over-allotment option and, then, only to the extent of such exercise.

We hedge floating rate debt with an interest rate cap, and may record charges associated with the termination or change in value of the interest rate cap.

We utilize an interest rate cap to reduce certain exposures to interest rate fluctuations. We do not use derivatives for trading or speculative purposes. We have a policy of only entering into contracts with major financial institutions based upon their credit ratings and other factors. We will assess the probability that our expected future floating rate debt is sufficient for our cap and may recognize a charge to earnings to reverse amounts previously recorded as a component of comprehensive income.

RISKS RELATED TO OUR COMMON STOCK

The market value of our common stock could be substantially affected by various factors.

The share price of our common stock will depend on many factors, which may change from time to time, including:

> the market for similar securities issued by REITs;

> changes in estimates by analysts;

> our ability to meet analysts' estimates;

> general economic and financial market conditions; and

> our financial condition, performance and prospects.

Our issuance of additional capital stock, warrants or debt securities, whether or not convertible, may reduce the market price for our shares.

We cannot predict the effect, if any, that future sales of our capital stock, warrants or debt securities, or the availability of our securities for future sale, will have on the market price of our shares, including our common stock. Sales of substantial amounts of our common stock or preferred shares, warrants or debt securities convertible into or exercisable or exchangeable for common stock in the public market or the perception that such sales might occur could reduce the market price of our common stock and the terms upon which we may obtain additional equity financing in the future.

In addition, we may issue additional capital stock in the future to raise capital or as a result of the following:

> The issuance and exercise of options to purchase our common stock. As of December 31, 2003, we had outstanding options to acquire approximately 2.3 million shares of our common stock. In addition, we may in the future issue additional options or other securities

convertible into or

exercisable for our common stock under our 2000 Stock Incentive Plan, as amended, or other remuneration plans. We may also issue options or convertible securities to our employees in lieu of cash bonuses or to our directors in lieu of director's fees.

- The issuance of debt securities exchangeable for our common stock.
- The exercise of warrants we may issue in the future.
- Lenders sometimes ask for warrants or other rights to acquire shares in connection with providing financing. We cannot assure you that our lenders will not request such rights.

There are no assurances of our ability to pay dividends in the future.

In 2001, our board of directors suspended dividends on our common stock and all series of preferred stock in an effort to generate cash to address then impending debt maturities. In 2003, we paid all accrued but unpaid dividends on all series of preferred stock and reinstated dividends on our common stock and all series of preferred stock. However, our ability to pay dividends may be adversely affected if any of the risks described in this prospectus supplement were to occur. Our payment of dividends is subject to compliance with restrictions contained in our bank credit facilities and our preferred stock. All dividends will be paid at the discretion of our board of directors and will depend upon our earnings, our financial condition, maintenance of our REIT status and such other factors as our board may deem relevant from time to time. There are no assurances of our ability to pay dividends in the future. In addition, our dividends in the past have included, and may in the future include, a return of capital.

Holders of our outstanding preferred stock have liquidation and other rights that are senior to the rights of the holders of our common stock.

Our board of directors has the authority to designate and issue preferred stock that may have dividend, liquidation and other rights that are senior to those of our common stock. As of February 11, 2004, 2,300,000 shares of our 9.25% Series A cumulative preferred stock, 2,000,000 shares of our 8.625% Series B cumulative preferred stock and 4,739,500 shares of our 8.375% Series D cumulative redeemable preferred stock were issued and outstanding. Holders of our preferred stock are generally entitled to cumulative dividends before any dividends may be declared or set aside on our common stock. Upon our voluntary or involuntary liquidation, dissolution or winding up, before any payment is made to holders of our common stock, holders of our preferred stock are entitled to receive a liquidation preference of $25 per share with respect to the Series A, Series B and Series D preferred stock, plus any accrued and unpaid distributions. This will reduce the remaining amount of our assets, if any, available to distribute to holders of our common stock. In addition, holders of our preferred stock have the right to elect two additional directors to our board of directors if six quarterly preferred dividends are in arrears.

Legislative or regulatory action could adversely affect purchasers of our common stock.

In recent years, numerous legislative, judicial and administrative changes have been made in the provisions of the federal income tax laws applicable to investments similar to an investment in our common stock. Changes are likely to continue to occur in the future, and we cannot assure you that any of these changes will not adversely affect your taxation as a holder of our common stock. Any of these changes could have an adverse effect on an investment in our common stock or on market value

or resale potential. You are urged to consult with your own tax advisor with respect to the impact that recent legislation may have on your investment and the status of legislative regulatory or administrative developments and proposals and their potential effect.

Recent changes in taxation of corporate dividends may adversely affect the value of our common stock.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 that was enacted into law on May 28, 2003, among other things, generally reduces to 15% the maximum marginal rate of tax payable by individuals on dividends received from a regular C corporation. This reduced tax rate, however, will not apply to dividends paid to individuals by a REIT on its shares, except for certain limited amounts. While the earnings of a REIT that are distributed to its stockholders still generally will be subject to less combined federal income taxation than earnings of a non-REIT C corporation that are distributed to its stockholders net of corporate-level tax, this legislation could cause individual investors to view the stock of regular C corporations as more attractive relative to the shares of a REIT than was the case prior to the enactment of the legislation. Individual investors could hold this view because the dividends from regular C corporations will generally be taxed at a lower rate while dividends from REITs will generally be taxed at the same rate as the individual's other ordinary income. We cannot predict what effect, if any, the enactment of this legislation may have on the value of the shares of REITs in general or on the value of our common stock in particular, either in terms of price or relative to other investments.

Forward-looking statements

This prospectus supplement includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements other than statements of historical facts included in this prospectus supplement may constitute forward-looking statements. We have based these forward-looking statements on our current expectations and projections about future events. Although we believe that our assumptions made in connection with the forward-looking statements are reasonable, we cannot assure you that our assumptions and expectations will prove to have been correct. Important factors that could cause our actual results to differ materially from our expectations are disclosed in this prospectus supplement, including factors disclosed under "Risk factors" beginning on page S-6 of this prospectus supplement. These forward-looking statements are subject to various risks, uncertainties and assumptions including, among other things:

- uncertainties relating to the business operations of the operators of our assets, including those relating to reimbursement by third party payors, regulatory matters and occupancy levels;
- the ability of any operators in bankruptcy to reject unexpired lease obligations, modify the terms of our mortgages, and impede our ability to collect unpaid rent or interest during the process of a bankruptcy proceeding and retain security deposits for the debtors' obligations;
- our ability to sell closed assets on a timely basis and at terms that allow us to realize the carrying value of these assets;
- our ability to negotiate appropriate modifications to the terms of our credit facilities;
- our ability to complete the proposed refinancing with respect to our existing credit facilities;
- our ability to manage, re-lease, or sell any owned and operated facilities;
- the availability and cost of capital;
- competition in the financing of healthcare facilities;
- regulatory and other changes in the healthcare sector;
- the effect of economic and market conditions generally and, particularly, in the healthcare industry;
-

changes in interest rates;

>
the amount and yield of any additional investments;

>
changes in tax laws and regulations affecting real estate investment trusts; and

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changes in the ratings of our debt and preferred securities.

Use of proceeds

We will receive no proceeds from the sale of our shares by the selling stockholder in this offering.

If the underwriters exercise the over-allotment option in full, the net proceeds to us from this offering, after deducting the underwriting discount and our other estimated offering expenses, will be approximately $26.1 million (assuming a public offering price of $10.38 per share). The underwriters are under no obligation to exercise the over-allotment option and, to the extent it is exercised, it may be exercised for less than the full amount of the option. We intend to apply any net proceeds to us from this offering for general corporate purposes.

Capitalization

The following table presents our capitalization as of December 31, 2003:

>
on an actual basis; and

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on a pro forma basis to give effect to our February 2004 issuance of Series D preferred stock and the conversion and redemption of Series C preferred stock.

	As of December 31, 2003 Unaudited	
(dollars and share counts in thousands)	**Actual**	**Pro Forma(1)**
Cash	$ 3,094	$ 15,100
Debt:		
Revolving lines of credit	$ 177,074	$ 177,074
Unsecured borrowings	100,000	100,000
Other long-term borrowings	3,520	3,520

	As of December 31, 2003 Unaudited	
Total debt	280,594	280,594
Stockholders' Equity:		
Preferred stock $1.00 par value; authorized 10,000 shares:		
Issued and Outstanding 2,300 shares Series A with an aggregate liquidation preference of $57,500 as of December 31, 2003	57,500	57,500
Issued and Outstanding 2,000 shares Series B with an aggregate liquidation preference of $50,000 as of December 31, 2003	50,000	50,000
Issued and Outstanding 1,048 shares Series C with an aggregate liquidation preference of $104,842 as of December 31, 2003; $0 pro forma	104,842	
Issued and Outstanding 4,740 shares Series D with an aggregate liquidation preference of $0 as of December 31, 2003; $118,488 pro forma		118,488
Common Stock $.10 par value:		
Authorized 100,000 shares		
Issued and Outstanding 37,291 shares as of December 31, 2003; 42,865 pro forma	3,729	4,287
Additional paid in Capital	481,467	518,012
Cumulative net earnings	174,275	174,275
Cumulative dividends paid	(431,123)	(469,866)
Accumulated other comprehensive income	(4,455)	(4,455)
Total Stockholders' Equity	436,235	448,241
Total Capitalization	$ 716,829	$ 728,835

(1) *Pro forma amounts give effect to the issuance of Series D preferred stock and the conversion and redemption of Series C preferred stock, which occurred in February 2004.*

The information in the preceding table excludes:

> 2,283 shares of our common stock issuable upon exercise of options outstanding as of December 31, 2003, at a weighted average exercise price of $3.20 per share;

> 566 shares of our common stock available for future grant under our common stock option and restricted stock plan as of December 31, 2003;

> up to approximately 2,718 shares of our common stock that may be purchased by the underwriters to cover over-allotments, if any, and receipt of any proceeds in connection therewith; and

> any redemption of our Series A preferred stock with the remaining proceeds from the sale of our Series D preferred stock.

Selected consolidated financial data

In considering the following selected consolidated financial data, you should also read our consolidated financial statements and notes incorporated by reference to our Annual Report on Form 10-K filed on February 20, 2004 for the year ending December 31, 2003 and the section captioned "Management's discussion and analysis of financial condition and results of operations" contained in this prospectus supplement. The consolidated statements of operations for the five-year period ended December 31, 2003 and the consolidated balance sheets data as of December 31, 1999, 2000, 2001, 2002 and 2003 are derived from our audited consolidated financial statements.

Consolidated operating data:	Year Ended December 31,				
	1999	**2000**	**2001**	**2002**	**2003**
	(In thousands, except per share amounts)				
Revenues from core operations	$ 120,385	$ 98,325	$ 88,082	$ 90,699	$ 86,267
Revenues from nursing home operations(1)	1,050	167,287	162,042	42,905	
Total revenues	$ 121,435	$ 265,612	$ 250,124	$ 133,604	$ 86,267
Income (loss) from continuing operations	$ 18,966	$ (43,250)	$ (15,588)	$ (3,744)	$ 23,341
Net income (loss) available to common	10,040	(66,485)	(36,651)	(34,761)	2,915
Per share amounts:					
Income (loss) from continuing operations:					
Basic	$ 0.47	$ (3.00)	$ (1.78)	$ (0.69)	$ 0.09
Diluted	0.47	(3.00)	(1.78)	(0.69)	0.08
Net income (loss) available to common:					
Basic	$ 0.51	$ (3.32)	$ (1.83)	$ (1.00)	$ 0.08
Diluted	0.51	(3.32)	(1.83)	(1.00)	0.08
Dividends, Common Stock(2)	2.80	1.00			0.15
Dividends, Series A Preferred(2)	2.31	2.31			6.937
Dividends, Series B Preferred(2)	2.16	2.16			6.469
Dividends, Series C Preferred(3)		0.25			29.807
Weighted-average common shares outstanding, basic	19,877	20,052	20,038	34,739	37,189
Weighted-average common shares outstanding, diluted	19,877	20,052	20,038	34,739	38,154

Consolidated balance sheet data:	December 31,				
	1999	**2000**	**2001**	**2002**	**2003**
	(In thousands, except per share amounts)				
Gross investments	$ 1,072,398	$ 974,507	$ 983,228	$ 882,313	$ 842,056
Total assets	1,040,688	950,213	892,414	804,009	725,054
Revolving lines of credit	166,600	185,641	193,689	177,000	177,074
Other long-term borrowings	339,764	249,161	219,483	129,462	103,520
Subordinated convertible debentures	48,405	16,590			
Stockholders equity	457,081	464,313	450,690	479,701	436,235

(1) *Nursing home revenues and expenses of owned and operated assets are shown on a net basis for the year ended December 31, 2003 and are shown on a gross basis for the years ended December 31, 1999, 2000, 2001 and 2002.*

(2) *Dividends per share are those declared and paid during such period.*

(3) *Dividends per share are those declared during such period, based on the number of shares of common stock issuable upon conversion of the outstanding Series C preferred stock.*

Management's discussion and analysis of financial condition and results of operations

Overview

As of December 31, 2003, our portfolio consisted of 211 healthcare facilities, located in 28 states and operated by 39 third-party operators. Our gross investment in these facilities, net of impairments, totaled $812.3 million at December 31, 2003, with 97.1% of our real estate investments related to long-term care facilities. Our portfolio is made up of 151 long-term healthcare facilities and two rehabilitation hospitals owned and leased to third parties, fixed rate mortgages on 51 long-term healthcare facilities, one long-term healthcare facility that was recovered from a customer and was operated through a third-party management contract for our own account and six long-term healthcare facilities that were recovered from customers and are currently closed. At December 31, 2003, we also held miscellaneous investments of approximately $29.8 million.

Nearly all of our properties are used as healthcare facilities; therefore, we are directly affected by the risk associated with the healthcare industry. Our lessees and mortgagors, as well as any facilities owned and operated for our own account, derive a substantial portion of their net operating revenues from third-party payors, including the Medicare and Medicaid programs. These programs are highly regulated by federal, state and local laws, rules and regulations and subject to frequent and substantial change. The Balanced Budget Act of 1997, or Balanced Budget Act, significantly reduced spending levels for the Medicare and Medicaid programs. Due to the implementation of the terms of the Balanced Budget Act, effective July 1, 1998, the majority of skilled nursing facilities shifted from payments based on reasonable cost to a prospective payment system for services provided to Medicare beneficiaries. Under the prospective payment system, skilled nursing facilities are paid on a per diem prospective case-mix adjusted basis for all covered services. Implementation of the prospective payment system has affected each long-term care facility to a different degree, depending upon the amount of revenue it derives from Medicare patients.

Legislation adopted in 1999 and 2000 increased Medicare payments to nursing facilities and specialty care facilities on an interim basis. Section 101 of the Balanced Budget Relief Act of 1999, or Balanced Budget Relief Act, included a 20% increase for 15 patient acuity categories (known as Resource Utilization Groups, or RUGS) and a 4% across the board increase of the adjusted federal per diem payment rate. The 20% increase was implemented in April 2000 and will remain in effect until the implementation of refinements in the current RUG case-mix classification system to more accurately estimate the cost of non-therapy ancillary services. The 4% increase was implemented in April 2000 and expired October 1, 2002.

The Benefits Improvement and Protection Act of 2000, or Benefits Improvement and Protection Act, included a 16.7% increase in the nursing component of the case-mix adjusted federal periodic payment rate and a 6.7% increase in the 14 RUG payments for rehabilitation therapy services. The 16.7% increase was implemented in April 2000 and expired October 1, 2002. The 6.7% increase is an adjustment to the 20% increase granted in the Balance Budget Relief Act and spreads the funds directed at three of those 15 RUGs to an additional 11 rehabilitation RUGs. The increase was implemented in April 2001 and will remain in effect until the implementation of refinements in the current RUG case-mix classification system.

The expiration of the 4% and 16.7% increases under these statutes as of October 1, 2002 has had an adverse impact on the revenues of the operators of nursing facilities and has negatively impacted some operators' ability to satisfy their monthly lease or debt payments to us. Medicare reimbursement could be further reduced when the Centers for Medicare & Medicaid Services, or CMS, completes its RUG refinement, thereby triggering the sunset of the temporary 20% and 6.7% increases also established under these statutes.

On August 4, 2003, CMS published the payment rates for skilled nursing facilities, or SNFs, for federal fiscal year 2004 (effective on October 1, 2003). CMS announced that the SNF update would be a 3.0% increase in Medicare payments for federal fiscal year 2004. In addition, CMS announced that the two temporary payment increases the 20% and 6.7% add-ons for certain payment categories will continue to be effective for federal fiscal year 2004.

Also in the August 4, 2003 announcement, CMS confirmed its intention to incorporate a forecast error adjustment that takes into account previous years' update errors. According to CMS, there was a cumulative SNF market basket, or inflation adjustment, forecast error of 3.26% for federal fiscal years 2000 through 2002. As a result, CMS has increased the national payment rate by an additional 3.26% above the 3.0% increase for federal fiscal year 2004.

Due to the temporary nature of the 20% and 6.7% payment increases established under the Balanced Budget Relief Act and Benefits Improvement and Protection Act, we cannot be assured that the federal reimbursement will remain at levels comparable to present levels and that such reimbursement will be sufficient for our lessees or mortgagors to cover all operating and fixed costs necessary to care for Medicare and Medicaid patients. We also cannot be assured that there will be any future legislation to increase payment rates for skilled nursing facilities. If payment rates for skilled nursing facilities are not increased in the future, some of our lessees and mortgagors may have difficulty meeting their payment obligations to us.

In addition, each state has its own Medicaid program that is funded jointly by the state and federal government. Federal law governs how each state manages its Medicaid program, but there is wide latitude for states to customize Medicaid programs to fit the needs and resources of its citizens. Rising Medicaid costs and decreasing state revenues caused by current economic conditions have prompted an increasing number of states to cut or consider reductions in Medicaid funding as a means of balancing their respective state budgets. Existing and future initiatives affecting Medicaid reimbursement may reduce utilization of (and reimbursement for) services offered by the operators of our properties. In early 2003, many states announced actual or potential budget shortfalls. As a result of these budget shortfalls, many states have announced that they are implementing or considering implementing "freezes" or cuts in Medicaid reimbursement rates, including rates paid to SNF providers, or reductions in Medicaid enrollee benefits, including long-term care benefits. We cannot predict the extent to which Medicaid rate freezes or cuts or benefit reductions will ultimately be adopted, the number of states that will adopt them nor the impact of such adoption on our operators. However, extensive Medicaid rate cuts or freezes or benefit reductions could have a material adverse effect on our operators' liquidity, financial condition and results of operations, which could affect adversely their ability to make lease or mortgage payments to us.

On May 28, 2003, the federal Jobs and Growth Tax Relief Reconciliation Act, or Tax Relief Act, was signed into law, which included an increase in Medicaid federal funding for five fiscal quarters (April 1, 2003 through June 30, 2004). In addition, the Tax Relief Act provides state fiscal relief for federal fiscal years 2003 and 2004 to assist states with funding shortfalls. It is anticipated that these temporary federal funding provisions could mitigate state Medicaid funding reductions through federal fiscal year 2004.

In addition, private payors, including managed care payors, are increasingly demanding discounted fee structures and the assumption by healthcare providers of all or a portion of the financial risk of operating a healthcare facility. Efforts to impose greater discounts and more stringent cost controls are expected to continue. Any changes in reimbursement policies which reduce reimbursement levels could

adversely affect the revenues of our lessees and mortgagors and thereby adversely affect those lessees' and mortgagors' abilities to make their monthly lease or debt payments to us.

At December 31, 2002, we owned three long-term healthcare facilities that had been recovered from customers and were operated for our own account. During 2001 and 2002, we experienced a significant increase in nursing home revenues attributable to the increase in owned and operated assets. During 2003, these increases abated as we re-leased, sold or closed all but one of these facilities. In addition, in connection with the recovery of these assets, we often fund working capital and deferred capital expenditure needs for a transitional period until license transfers and other regulatory matters are completed and reimbursement from third-party payors recommences. As of January 1, 2004, we had sold or re-leased all of the owned and operated facilities in our portfolio and had six closed facilities in our portfolio. Our management intends to sell these assets as promptly as possible, consistent with achieving valuations that reflect our management's estimate of fair value of the assets. We do not know, however, if, or when, the dispositions will be completed or whether the dispositions will be completed on terms that will enable us to realize the fair value of such assets.

The following significant highlights occurred during the twelve-month period ended December 31, 2003.

Financing

- In June 2003, we obtained a $225 million Senior Secured Credit Facility, or Credit Facility, to repay borrowings under our two previous credit facilities, replace letters of credit and pay cumulative unpaid preferred dividends.
- In December 2003, we secured a $50 million acquisition credit facility, which we believe, combined with the $225 million Credit Facility and cash on hand, will provide us the flexibility to initiate a growth strategy in 2004.

Dividends

- In July 2003, our board of directors declared a full catch-up of cumulative, unpaid dividends and regular quarterly dividends for all classes of preferred stock and such dividends were paid on August 15, 2003 to preferred stockholders of record on August 5, 2003.
- In September 2003, our board of directors reinstated our common stock dividend and a dividend of $0.15 per share of common stock was paid on November 17, 2003 to common stockholders of record on October 31, 2003.

Re-leasing

- In March 2003, we re-leased nine SNFs formerly operated by Integrated Health Services, Inc. to four unaffiliated third-party operators.
- In July 2003, we amended our Master Lease with a subsidiary of Alterra Healthcare Corporation, or Alterra, whereby the number of leased facilities was reduced from eight to five.
- In November 2003, we re-leased two SNFs formerly leased by Claremont located in Ohio and representing 270 beds, to a new operator under a Master Lease.
- Throughout 2003, we re-leased 12 SNFs formerly operated by Sun to six unaffiliated third-party operators.

Asset sales

- In May 2003, we sold an investment in a Baltimore, Maryland asset, leased by the United States Postal Service, or USPS, for approximately $19.6 million. The purchaser paid us proceeds of $1.8 million and assumed the first mortgage of approximately $17.6 million.
- In December 2003, we sold one SNF formerly leased by Claremont, located in Illinois and representing 150 beds, for $9.0 million. We received net proceeds of approximately $6.0 million in cash and a $3.0 million, five-year, 10.5% secured note for the balance. We also sold our investment in Principal Healthcare Finance Trust for proceeds of approximately $1.6 million.
- Throughout 2003, we sold eight closed facilities and four assets held for sale for proceeds of approximately $9.0 million.

Critical accounting policies and estimates

The preparation of financial statements in conformity with generally accepted accounting principles, or GAAP, in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the 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. Our significant accounting policies are described in Note 2 to our audited consolidated financial statements incorporated by reference herein. These policies were followed in preparing the consolidated financial statements for all periods presented therein. Actual results could differ from those estimates.

We have identified six significant accounting policies which we believe are critical accounting policies. These critical accounting policies are those that have the most impact on the reporting of our financial condition and those requiring significant judgments and estimates. With respect to these critical accounting policies, we believe the application of judgments and assessments is consistently applied and produces financial information that fairly presents the results of operations for all periods incorporated by reference herein. The six critical accounting policies are:

Revenue recognition

Rental income and mortgage interest income are recognized as earned over the terms of the related Master Leases and mortgage notes, respectively. Such income includes periodic increases based on pre-determined formulas (i.e., such as increases in the Consumer Price Index, or CPI) as defined in the Master Leases and mortgage loan agreements. Reserves are taken against earned revenues from leases and mortgages when collection of amounts due become questionable or when negotiations for restructurings of troubled operators lead to lower expectations regarding ultimate collection. When collection is uncertain, lease revenues are recorded as received, after taking into account application of security deposits. Interest income on impaired mortgage loans is recognized as received after taking into account application of security deposits.

Nursing home revenues from owned and operated assets (primarily Medicare, Medicaid and other third-party insurance) are recognized as patient services are provided.

Asset impairment

Management periodically but not less than annually evaluates the real estate investments for impairment indicators. The judgment regarding the existence of impairment indicators is based on factors such as market conditions, operator performance and legal structure. If indicators of impairment are present, management evaluates the carrying value of the related real estate investments

in relation to the future undiscounted cash flows of the underlying facilities. Provisions for impairment losses related to long-lived assets are recognized when expected future undiscounted cash flows are less than the carrying values of the assets. If the sum of the expected future undiscounted cash flow, including sales proceeds, is less than carrying value, then an adjustment is made to the net carrying value of the leased properties and other long-lived assets to the present value of expected future undiscounted cash flows**.** The fair value of the real estate investment is determined by market research, which includes valuing the property as a nursing home as well as other alternative uses.

Loan impairment

Management periodically but not less than annually evaluates the outstanding loans and notes receivable. When management identifies potential loan impairment indicators, such as non-payment under the loan documents, impairment of the underlying collateral, financial difficulty of the operator or other circumstances that may impair full execution of the loan documents, then the loan is written down to the present value of the expected future cash flows. In cases where expected future cash flows cannot be estimated, the loan is written down to the fair value of the collateral. The fair value of the loan is determined by market research, which includes valuing the property as a nursing home as well as other alternative uses.

Accounts receivable

Accounts receivable consists primarily of lease and mortgage interest payments. Amounts recorded include estimated provisions for loss related to uncollectible accounts and disputed items. On a monthly basis, we review the contractual payment versus actual cash payment received and the contractual payment due date versus actual receipt date. When management identifies delinquencies, a judgment is made as to the amount of provision, if any, that is needed.

Accounts receivable owned and operated assets

Accounts receivable from owned and operated assets consist of amounts due from Medicare and Medicaid programs, other government programs, managed care health plans, commercial insurance companies and individual patients. Amounts recorded include estimated provisions for loss related to uncollectible accounts and disputed items.

Owned and operated assets and assets held for sale

When we acquire real estate pursuant to a foreclosure proceeding, it is designated as "owned and operated assets" and is recorded at the lower of cost or fair value and is included in real estate properties on our audited consolidated balance sheet incorporated by reference herein. For 2003, operating assets and operating liabilities for our owned and operated properties are shown on a net basis on the face of our audited consolidated balance sheet incorporated by reference herein. For 2002, operating assets and operating liabilities for our owned and operated properties are shown on a gross basis on the face of our audited consolidated balance sheet incorporated by reference herein and are detailed in Note 16 Segment Information to the financial statements incorporated by reference herein. The net basis presentation in 2003 is due to the decrease in the size of the owned and operated portfolio (one facility at December 31, 2003).

When a formal plan to sell real estate is adopted and we hold a contract for sale, the real estate is classified as "assets held for sale," with the net carrying amount adjusted to the lower of cost or estimated fair value, less cost of disposal. Depreciation of the facilities is excluded from operations

after management has committed to a plan to sell the asset. Upon adoption of SFAS 144 as of January 1, 2002, long-lived assets sold or designated as held for sale after January 1, 2002 are reported as discontinued operations in our financial statements incorporated by reference herein.

Results of operations

The following is our discussion of the consolidated results of operations, financial position and liquidity and capital resources, which should be read in conjunction with our audited consolidated financial statements and accompanying notes incorporated by reference herein.

Year ended December 31, 2003 compared to year ended December 31, 2002

Revenues

Our revenues for the year ended December 31, 2003 totaled $86.3 million, a decrease of $47.3 million from 2002 revenues. When excluding nursing home revenues of owned and operated assets, revenues were $86.3 million for the year ended December 31, 2003, a decrease of $4.4 million from the comparable prior year period. The decrease during the year was primarily the result of operator restructurings, the sale of our investment in a Baltimore, Maryland asset leased by the USPS, partially offset by a legal settlement.

Detail changes in revenues during the year ended December 31, 2003 are as follows:

> Rental income for the year ended December 31, 2003 totaled $65.1 million, an increase of $2.4 million over 2002 rental income.

> Mortgage interest income for the year ended December 31, 2003 totaled $14.7 million, decreasing $6.2 million.

> Other investment income for the year ended December 31, 2003 totaled $3.0 million, decreasing $2.3 million.

> In 2000, we filed suit against a title company (later adding a law firm as a defendant), seeking damages based on claims of breach of contract and negligence, among other things, as a result of the alleged failure to file certain Uniform Commercial Code financing statements in our favor. We filed a subsequent suit seeking recovery under title insurance policies written by the title company. The defendants denied the allegations made in the lawsuits. In settlement of our claims against the defendants, we agreed in the first quarter of 2003 to accept a lump sum cash payment of $3.2 million. The cash proceeds were offset by related expenses incurred of $1.0 million resulting in a net gain of $2.2 million.

We believe that the presentation of our revenues and expenses, excluding nursing home owned and operated assets, provides a useful measure of the operating performance of our core portfolio as a real estate investment trust, or REIT, in view of the disposition of all but one of our owned and operated assets as of December 31, 2003.

Expenses

Our expenses for the year ended December 31, 2003 totaled $63.6 million, decreasing approximately $76.3 million from expenses of $139.9 million during 2002. When excluding nursing home expenses of owned and operated assets, expenses were $62.1 million for the year ended December 31, 2003, a decrease of $14.0 million from the comparable prior year period. The decrease during the year was primarily the result of $4.0 million of lower interest expense, $0.9 million favorable reduction in general and administrative and legal expenses, $8.8 million favorable reduction in provision for

uncollectible mortgages, notes and accounts receivable, off set by an increase of $5.2 million in provision for impairment and $0.9 million in adjustments of derivatives to fair value.

Our nursing home expenses, net of nursing home revenues, for owned and operated assets decreased to $19.4 million from $20.9 million in 2002 due to the releasing efforts, sales and/or closures during the year. In 2002, nursing home expenses included a $5.9 million provision for uncollectible accounts receivable and $4.3 million of expenses related to leasehold buy outs.

Effective January 1, 2004, our remaining owned and operated asset was re-leased to an existing operator. This facility, located in Illinois, was re-leased under a new Master Lease which encompasses four additional facilities.

An analysis of significant changes in our expenses during the years ended December 31, 2003 and 2002 is as follows:

> Our general and administrative expenses for 2003 totaled $5.9 million as compared to $6.3 million for 2002, a decrease of $0.4 million. The decrease is due to lower consulting costs, primarily related to the owned and operated facilities and cost reductions due to reduced staffing, travel and other employee-related expenses.

> Our legal expenses for 2003 totaled $2.3 million as compared to $2.9 million in 2002. The decrease is largely attributable to a reduction of legal costs associated with our owned and operated facilities due to the releasing efforts, sales and/or closures of 32 owned and operated assets since December 31, 2001.

> Our interest expense for the year ended December 31, 2003 was approximately $23.4 million, compared with $27.4 million for 2002. The decrease in 2003 is due to lower average borrowings on our credit facilities as well as the impact of our current year refinancings and the payoff in 2002 of $97.5 million of 6.95% Notes that matured in June 2002.

> In 2002, we recognized a $7.0 million refinancing expense as we were unable to complete a planned commercial mortgage-backed securities transaction due to the impact on our operators resulting from reductions in Medicare reimbursement and concerns about potential Medicaid rate reductions.

> Provisions for impairment of $8.9 million and $3.7 million are included in expenses for 2003 and 2002, respectively. The 2003 provision of $8.9 million was to reduce the carrying value of two closed facilities to their fair value less cost to dispose. The 2002 provision of $3.7 million reduced the carrying value of three closed facilities to their fair value less cost to dispose.

> We recognized a provision for loss on uncollectible mortgages, notes and accounts receivable of $8.8 million in 2002. The provision included $4.9 million associated with the write down of two mortgage loans to bankrupt operators and $3.5 million related to the restructuring of debt owed by Madison/OHI Liquidity Investors, LLC, or Madison, as part of the compromise and settlement of a lawsuit with Madison. (See Note 14 Litigation to the financial statements incorporated by reference herein). The 2002 provision also included $0.4 million to adjust accounts receivable to their net realizable value.

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During 2002, we recorded a non-cash gain of $0.9 million related to the maturity and payoff of two interest rate swaps with a notional amount of $32.0 million each.

Other

During 2003, we recognized a gain on assets sold of $0.7 million, primarily a result of the following transactions:

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The sale of our investment in a Baltimore, Maryland asset, leased by the USPS, for approximately $19.6 million. The purchaser paid us proceeds of $1.8 million and assumed the first mortgage of approximately $17.6 million. As a result, we recorded a gain of $1.3 million, net of closing costs and other expenses.

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The sale of four closed buildings, which were classified as assets held for sale in 2001, in four separate transactions, realizing proceeds, net of closing costs, of $2.0 million, resulting in a net loss of approximately $0.7 million.

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The sale of our investment in Principal Healthcare Finance Trust realizing proceeds of approximately $1.6 million, net of closing costs, resulting in an accounting gain of approximately $0.1 million

Loss from discontinued operations

Discontinued operations relates to properties we disposed of in 2003 that are accounted for as discontinued operations under SFAS No. 144. The loss of $0.3 million in 2003 versus the loss of $10.9 million in 2002 was primarily due to provisions for impairment of $11.7 million on seven facilities in 2002 as compared to none in 2003.

Funds from operations

Our funds from operations, or FFO, for the year ended December 31, 2003, on a diluted basis was $35.0 million, an increase of $41.5 million as compared to a deficit of $6.5 million for 2002 due to factors mentioned above. Funds from operations is net earnings available to common stockholders, excluding any gains or losses from debt restructuring and the effects of asset dispositions, plus depreciation and amortization associated with real estate investments. Diluted funds from operations is the lower of funds from operations and funds from operations adjusted for the assumed conversion of Series C preferred stock and the exercise of in-the-money stock options. We consider funds from operations to be one performance measure which is helpful to investors of real estate companies because, along with cash flows from operating activities, financing activities and investing activities, it provides investors an understanding of our ability to incur and service debt and to make expenditures. Funds from operations in and of itself does not represent cash generated from operating activities in accordance with GAAP and therefore should not be considered an alternative to net earnings as an indication of operating performance, or to net cash flow from operating activities as determined by GAAP in the United States, as a measure of liquidity and is not necessarily indicative of cash available to fund cash needs.

In October 2003, the National Association of Real Estate Investment Trusts, or NAREIT, informed its member companies that the Securities and Exchange Commission has taken the position that asset impairment charges should not be excluded in calculating FFO. The SEC's interpretation is that recurring impairments on real property are not an appropriate adjustment. In the tables below, we have applied the SEC's interpretation of FFO and have not added back asset impairment charges. As a result, our basic FFO and diluted FFO set forth in the tables below are not comparable to similar measures reported in previous disclosures.

The following table presents our FFO results reflecting the impact of asset impairment charges (the SEC's interpretation) for the years ended December 31, 2003 and 2002:

Year Ended December 31,

	2003	2002
Net income (loss) available to common	$ 2,915	$ (34,761)
Add back loss (deduct gain) from real estate dispositions(1)	149	(2,548)
	3,064	(37,309)
Elimination of non-cash items included in net income (loss):		
Depreciation and amortization(2)	21,426	21,270
Adjustment of derivatives to fair value		(946)
Funds from operations, basic	24,490	(16,985)
Series C Preferred Dividends	10,484	10,484
Funds from operations, diluted	$ 34,974	$ (6,501)

(1) The add back of loss/deduction of gain from real estate dispositions includes the facilities classified as discontinued operations in our consolidated financial statements incorporated by reference herein. The 2003 net loss add back includes $0.8 million loss related to facilities classified as discontinued operations.

(2) The add back of depreciation and amortization includes the facilities classified as discontinued operations in our consolidated financial statements incorporated by reference herein. The 2003 and 2002 includes depreciation and amortization of $0.4 million and $0.7 million, respectively, related to facilities classified as discontinued operations.

Taxes

No provision for federal income taxes has been made since we qualify as a REIT under the provisions of Sections 856 through 860 of the Internal Revenue Code of 1986, as amended. For tax year 2003, preferred and common dividend payments of $65.5 million made throughout 2003 satisfy the 2003 REIT requirements (must distribute at least 90% of our REIT taxable income for the taxable year and meet certain other conditions).

Year ended December 31, 2002 compared to year ended December 31, 2001

Revenues

Our revenues for the year ended December 31, 2002 totaled $133.6 million, a decrease of $116.5 million from 2001 revenues. Excluding nursing home revenues of owned and operated assets, revenues were $90.7 million for the year ended December 31, 2002, an increase of $2.6 million from the comparable prior year period.

Detail changes in revenues during the year ended December 31, 2002 are as follows:

> Our rental income for the year ended December 31, 2002 totaled $62.7 million, an increase of $2.6 million from 2001 rental income. The increase is due to $8.0 million from new leases on assets previously classified as owned and operated and $0.9 million of contractual rent increases on the existing portfolio. This increase is partially offset by a reduction of revenues of $6.3 million due to bankruptcies, restructurings and other.

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Our mortgage interest income for the year ended December 31, 2002 totaled $20.9 million, increasing $0.4 million over 2001 mortgage interest. The increase is due to $1.1 million for new investments placed during 2001 and receipt in 2002 of $1.6 million of interest due in 2001 and not received until 2002, offset by $1.5 million from loans paid off, $0.7 million due to restructurings and bankruptcies and $0.1 million due to normal amortization of the portfolio.

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Our nursing home revenues of owned and operated assets for the year ended December 31, 2002 totaled $42.9 million, decreasing $119.1 million over 2001 nursing home revenues. This decrease is due to the re-leasing, sale and/or closure of 30 assets in 2002.

Expenses

Our expenses for the year ended December 31, 2002 totaled $139.9 million, decreasing approximately $125.1 million over expenses of $265.0 million for 2001.

Our nursing home expenses for owned and operated assets decreased to $63.8 million from $169.9 million in 2001 due to the re-leasing, sale and/or closure of 30 owned and operated assets during the year. In 2002, nursing home expenses included a $5.9 million provision for uncollectible accounts receivable and $4.3 million of expenses related to leasehold buy outs. Nursing home expenses in 2001 included a $7.3 million provision for uncollectible accounts receivable.

An analysis of significant changes in our expenses during the years ended December 31, 2002 and 2001 is as follows:

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Our general and administrative expenses for 2002 totaled $6.3 million as compared to $10.4 million for 2001, a decrease of $4.1 million. The decrease is due to lower consulting costs, primarily related to the owned and operated facilities and cost reductions due to reduced staffing, travel and other employee-related expenses.

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Our legal expenses for 2002 totaled $2.9 million as compared to $4.3 million in 2001. The decrease is largely attributable to a reduction of legal costs associated with our owned and operated facilities due to the re-leasing, sale and/or closure of 30 owned and operated assets during 2002.

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Depreciation and amortization of real estate totaled $20.5 million in 2002, decreasing $0.8 million from 2001. The decrease consists primarily of $0.4 million of leasehold amortization expense for leaseholds written down in 2001 or sold in 2002 and $0.6 million from properties sold, impaired or reclassified to held for sale, offset by $0.2 million from properties previously classified as mortgages.

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Our interest expense for the year ended December 31, 2002 was approximately $27.4 million, compared with $33.2 million for 2001. The decrease in 2002 is due to the payoff of $97.5 million of 6.95% Notes that matured in June 2002 and lower average borrowings on our credit facilities.

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In 2002, we recognized a $7.0 million refinancing expense as we were unable to complete a planned commercial mortgage-backed securities transaction due to the impact on our operators resulting from reductions in Medicare reimbursement and concerns about potential Medicaid rate reductions.

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Provisions for impairment of $3.7 million and $8.1 million are included in expenses for 2002 and 2001, respectively. The 2002 provision of $3.7 million reduced the carrying value of three closed facilities to their fair value less cost to dispose. The 2001 provision of $8.1 million included $6.9 million to reduce facilities recovered from operators and classified as held for sale assets to fair value less cost to dispose, and $1.2 million related to other real estate assets that management determined were impaired.

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We recognized a provision for loss on uncollectible mortgages, notes and accounts receivable of $8.8 million in 2002. The provisions included $4.9 million associated with the write down of two mortgage loans to bankrupt operators and $3.5 million related to the restructuring of debt owed by Madison as part of the compromise and settlement of a lawsuit with Madison. (See Note 14 Litigation to our audited consolidated financial statements incorporated by reference herein). The 2002 provisions also included $0.4 million to adjust accounts receivable to their net realizable value. In 2001, we recognized a provision for uncollectible mortgages, notes and accounts receivable of $0.7 million to adjust the carrying value of accounts receivable to net realizable value.

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In 2001, we recorded a $5.1 million charge for severance, moving and consulting agreement costs. This charge was comprised of $4.6 million for relocation of our corporate headquarters and $0.5 million for consulting and severance payments to a former executive.

>

In 2001, we recorded a $10 million litigation settlement to settle a suit brought by Karrington Health, Inc. in 1998. This settled all claims arising from the suit, but without our admission of any liability or fault, which liability is expressly denied. Based on the settlement, the suit was dismissed with prejudice.

>

During 2002, we recorded a non-cash gain of $0.9 million related to the maturity and payoff of two interest rate swaps with a notional amount of $32.0 million each. We recorded a non-cash charge of $1.3 million for 2001 related to the adoption of Statement of Financial Account Standard, or SFAS, No. 133, *Accounting for Derivative Instruments and Hedging Activities.*

Other

During 2002, we recognized a gain on assets sold of $2.5 million, primarily a result of the following transactions.

>

The sale of our investment in Omega Worldwide, Inc., or Worldwide. Pursuant to a tender offer by Four Seasons Health Care Limited, or Four Seasons, for all of the outstanding shares of common stock of Worldwide, we sold our investment, which consisted of 1.2 million shares of common stock and 260,000 shares of preferred stock, to Four Seasons for cash proceeds of approximately $7.4 million (including $3.5 million for preferred stock liquidation preference and accrued preferred dividends).

>

The sale of our investment in Principal Healthcare Finance Limited, an Isle of Jersey company, or PHFL, which consisted of 990,000 ordinary shares and warrants to purchase 185,033 ordinary shares, to an affiliate of Four Seasons for cash proceeds of $2.8 million.

>

In addition, we sold certain other assets in 2002 realizing cash proceeds of $7.5 million, resulting in a net accounting gain of $0.3 million.

Loss from discontinued operations

Discontinued operations relates to properties we disposed of in 2003 that are accounted for as discontinued operations under SFAS No. 144. The loss of $10.9 million in 2002 versus the loss of $1.1 million in 2001 was primarily due to provisions for impairment of $11.7 million on seven facilities in 2002 as compared to $1.5 million on one facility in 2001.

Funds from operations

Our FFO for the year ended December 31, 2002, on a diluted basis was a deficit of $6.5 million, an increase in the deficit of $4.3 million as compared to a deficit of $2.2 million for 2001 due to factors mentioned above. Funds from operations is net earnings available to common stockholders, excluding any gains or losses from debt restructuring and the effects of asset dispositions, plus depreciation and amortization associated with real estate investments. Diluted funds from operations is the lower of funds from operations and funds from operations adjusted for the assumed conversion of Series C preferred stock and the exercise of in-the-money stock options. We consider funds from operations to be one performance measure which is helpful to investors of real estate companies because, along with cash flows from operating activities, financing activities and investing activities, it provides investors an understanding of our ability to incur and service debt and to make expenditures. Funds from operations in and of itself does not represent cash generated from operating activities in accordance with GAAP and therefore should not be considered an alternative to net earnings as an indication of operating performance, or to net cash flow from operating activities as determined by GAAP in the United States, as a measure of liquidity and is not necessarily indicative of cash available to fund cash needs.

In October 2003, NAREIT informed its member companies that the SEC has taken the position that asset impairment charges should not be excluded in calculating FFO. The SEC's interpretation is that recurring impairments on real property are not an appropriate adjustment. In the tables below, we have applied the SEC's interpretation of FFO and have not added back asset impairment charges. As a result, our basic FFO and diluted FFO set forth in the tables below are not comparable to similar measures reported in previous disclosures.

The following table presents our FFO results reflecting the impact of asset impairment charges (the SEC's interpretation) for the years ended December 31, 2002 and 2001:

	Year Ended December 31,	
	2002	2001
Net loss available to common	$ (34,761)	$ (36,651)
(Deduct gain) add back loss from real estate dispositions	(2,548)	677
	(37,309)	(35,974)
Elimination of non-cash items included in net income (loss):		
Depreciation and amortization(1)	21,270	22,066
Adjustment of derivatives to fair value	(946)	1,317
Funds from operations, basic	(16,985)	(12,591)
Series C Preferred Dividends	10,484	10,363
Funds from operations, diluted	$ (6,501)	$ (2,228)

(1) The add back of depreciation and amortization includes the facilities classified as discontinued operations in our consolidated financial statements as incorporated by reference herein. The 2002 and 2001 includes depreciation and amortization of $0.7 million and $0.8 million, respectively, related to facilities classified as discontinued operations.

Portfolio developments

The partial expiration of certain Medicare rate increases has had an adverse impact on the revenues of the operators of nursing home facilities and has negatively impacted some operators' ability to satisfy

their monthly lease or debt payment to us. In several instances we hold security deposits that can be applied in the event of lease and loan defaults, subject to applicable limitations under bankruptcy law with respect to operators seeking protection under Chapter 11 of the Bankruptcy Act. (See "Prospectus Supplement Summary Our Company").

Alterra Healthcare Corporation

Alterra announced during the first quarter of 2003, that, in order to facilitate and complete its on-going restructuring initiatives, they had filed a voluntary petition with the U.S. Bankruptcy Court for the District of Delaware to reorganize under Chapter 11 of the U.S. Bankruptcy Code. At that time, we leased eight assisted living facilities (325 units) located in seven states to subsidiaries of Alterra.

Effective July 7, 2003, we amended our Master Lease with a subsidiary of Alterra whereby the number of leased facilities was reduced from eight to five. The amended Master Lease has a remaining term of approximately ten years with an annual rent requirement of approximately $1.5 million. This compares to the 2002 annualized revenue of $2.6 million. On November 1, 2003, we re-leased one assisted living facility formerly leased by Alterra, located in Washington and representing 52 beds, to a new operator under a lease, which has a ten-year term and has an initial annual lease rate of $0.2 million. We are in the process of negotiating terms and conditions for the re-lease of the remaining two properties. In the interim, Alterra will continue to operate the two facilities. The Amended Master Lease was approved by the U.S. Bankruptcy Court in the District of Delaware.

Claremont Healthcare Holdings, Inc.

Effective December 1, 2003, we sold one SNF formerly leased by Claremont, located in Illinois and representing 150 beds, for $9.0 million. We received net proceeds of approximately $6.0 million in cash and a $3.0 million, five-year, 10.5% secured note for the balance. This transaction results in a non-cash, non-FFO accounting loss of approximately $3.8 million, which was recorded in the fourth quarter of 2003.

On November 7, 2003, we re-leased two SNFs formerly leased by Claremont, located in Ohio and representing 270 beds, to a new operator under a Master Lease, which has a ten-year term and has an initial annual lease rate of $1.1 million.

Separately, we continue our ongoing restructuring discussions with Claremont regarding the five facilities Claremont currently leases from us. At the time of this filing, we cannot determine the timing or outcome of these discussions. Claremont failed to pay base rent due during the fourth quarter of 2003 in the amount of $1.5 million. During the fourth quarter of 2003, we applied security deposits in the amount of $1.0 million to pay Claremont's rent payments and the Company demanded that Claremont restore the $1.5 million security deposit. At December 31, 2003, we had no additional security deposits with Claremont. Due to the significant uncertainty of collection, we recognize revenue from Claremont on a cash-basis as it is received.

Sun Healthcare Group, Inc.

On February 7, 2003, Sun announced "that it has opened dialogue with many of its landlords concerning the portfolio of properties leased to Sun and various of its consolidated subsidiaries (collectively, the "Company'). The Company is seeking a rent moratorium and/or rent concessions with respect to certain of its facilities and is seeking to transition its operations of certain facilities to new operators while retaining others." To this end, Sun has initiated conversations with us regarding a

restructure of our lease. As a result, during 2003, we re-leased 12 SNFs, formerly leased by Sun, in the following transactions:

- On July 1, 2003, we re-leased one SNF in Louisiana and representing 131 beds, to an existing operator under a Master Lease, which lease has a eight-year term and requires an initial annual lease rate of $400,000;
- On July 1, 2003, we re-leased two SNFs located in Texas and representing 256 beds, to an existing operator under a Master Lease, which has a ten-year term and has an initial annual lease rate of $800,000;
- On July 1, 2003, we re-leased two SNFs located in Florida and representing 350 beds, to an existing operator under a Master Lease, which has a ten-year term and has an initial annual lease rate of $1.3 million;
- On October 1, 2003, we re-leased three SNFs located in California and representing 271 beds, to a new operator under a Master Lease, which has a 15-year term and has an initial annual lease rate of $1.25 million;
- On November 1, 2003, we re-leased two SNFs located in California and representing 185 beds, to a new operator under a Master Lease, which has a ten-year term and has an initial annual lease rate of $0.6 million;
- On December 1, 2003, we re-leased one SNF located in California and representing 59 beds, to a new operator under a lease, which has a ten-year term and has an initial annual lease rate of $0.12 million; and
- On December 1, 2003, we re-leased one SNF located in Indiana and representing 99 beds, to an existing operator under a lease, which has a five-year term.

As a result of the above-mentioned transitions of the 12 former Sun facilities, Sun operated 38 of our facilities at December 31, 2003.

Effective January 1, 2004, we re-leased four SNFs to an existing operator under a new Master Lease, which has a five-year term and has an initial annual lease rate of $0.75 million. Three SNFs formerly leased by Sun, located in Illinois, representing 350 total beds, were part of this transaction. The fourth SNF in the transaction, located in Illinois, representing 128 beds, was the last remaining owned and operated facility in our portfolio. A fifth facility, leased in December 2003, was incorporated in this Master Lease.

On January 26, 2004, we announced the signing of a non-binding term sheet representing an agreement in principle with Sun regarding properties we own that were leased to various affiliates of Sun prior to the impact of the transactions above. Under the arrangement contemplated by the non-binding term sheet, Sun would continue to operate and occupy 23 long-term care facilities, five behavioral properties and two hospital properties. One property in the State of Washington, formerly operated by a Sun affiliate, has already been closed and the lease relating to that property will be terminated. With respect to the remaining 20 facilities, 15 have already been transitioned to new operators and five are in the process of being transferred to new operators.

The non-binding term sheet contemplates execution and delivery of a new master lease with the following general terms:

> *Term:* Through December 31, 2013.

> *Base Rent:* Commencing February 1, 2004, monthly base rent would be $1.56 million, subject to annual increases not to exceed 2.5% per year.

> *Deferred Base Rent:* $7.76 million would be deferred and bear interest at a floating rate with a floor of 6% per year. That interest would accrue but would not be payable to us through January 3, 2008. Interest thereafter accruing would be paid monthly. We are releasing all other claims for base rent which otherwise would be due under the current leases.

> *Conversion of Deferred Base Rent*: We would have the right at any time to convert the deferred base rent into 800,000 shares of Sun's common stock, subject to certain non-dilution provisions and the right of Sun to pay cash in an amount equal to the value of that stock in lieu of issuing stock to Omega. If the value of the common stock exceeds 140% of the deferred base rent, Sun can require Omega to convert the deferred base rent into Sun's common stock. We would have the right to require Sun to prepare and file a registration statement to facilitate resale of the Sun Stock.

The terms described above are subject to the negotiation and execution of definitive documents satisfactory to us and Sun. Separately, we continue our ongoing restructuring discussions with Sun. We cannot determine the timing or outcome of these discussions at the time of this filing. There can be no assurance that Sun will continue to pay rent at the current level, although, we believe that alternative operators would be available to lease or buy the remaining Sun facilities if an appropriate agreement is not completed with Sun.

Asset dispositions in 2003

Other Assets

> We sold an investment in a Baltimore, Maryland asset, leased by the USPS, for approximately $19.6 million. The purchaser paid us gross proceeds of $1.8 million and assumed the first mortgage of approximately $17.6 million. As a result, we recorded a gain of $1.3 million, net of closing costs and other expenses. (See Note 3 Properties; Other Non-Core Assets to the financial statements incorporated by reference herein).

> We sold our investment in Principal Healthcare Finance Trust realizing proceeds of approximately $1.6 million, net of closing costs, resulting in an accounting gain of approximately $0.1 million. (See Note 3 Properties; Other Non-Core Assets to the financial statements incorporated by reference herein).

Closed facilities

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We sold eight closed facilities realizing proceeds of approximately $7.0 million, net of closing costs, resulting in a net gain of approximately $3.0 million. In accordance with SFAS No. 144, the $3.0 million realized net gain is reflected in our audited consolidated statements of operations as discontinued operations. (See Note 3 Properties; Closed Facilities and Note 19 Discontinued Operations to the financial statements incorporated by reference herein).

Assets held for sale

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We sold the four remaining facilities, which were classified as assets held for sale in 2001, realizing proceeds of $2.0 million, net of closing costs, resulting in a net loss of approximately $0.7 million. (See Note 3 Properties; Assets Held for Sale to the financial statements incorporated by reference herein).

Liquidity and capital resources

At December 31, 2003, we had total assets of $725.1 million, stockholders equity of $436.2 million and long-term debt of $280.6 million, representing approximately 39.1% of total capitalization. In addition, as of December 31, 2003, we had an aggregate of $2.3 million of scheduled principal payments in 2004.

The following table shows the amounts due in connection with the contractual obligations described below as of December 31, 2003.

	Payments due by period				
	Total	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
	(In thousands)				
Long-term debt(1)	$ 280,594	$ 2,319	$ 276,280	$ 900	$ 1,095
Other long-term liabilities	1,051	198	630	223	
Total	$ 281,645	$ 2,517	$ 276,910	$ 1,123	$ 1,095

(1)

The $276.3 million due in one to three years includes the $100.0 million 6.95% Notes due 2007, and the $170.1 million of credit facility and term loan borrowings, which mature in June 2007.

Bank credit agreements

We have two secured credit facilities totaling $275 million, consisting of a $225 million Senior Secured Credit Facility and a $50 million acquisition credit facility, or Acquisition Line. At December 31, 2003, $177.1 million was outstanding under the Credit Facility and $12.1 million was utilized for the issuance of letters of credit, leaving availability of $85.0 million. The $177.1 million of outstanding borrowings had an interest rate of 6.00% at December 31, 2003; however, no funds have been drawn under the Acquisition Line. In addition, during 2003, we paid off four Industrial Revenue Bonds totaling $7.8 million with a fixed blended rate of approximately 9.66%.

In 2003, we completed the $225 million Credit Facility arranged and syndicated by GE Healthcare Financial Services, with General Electric Capital Corporation, or GECC, as agent and lender. At the closing, we borrowed $187.1 million under the Credit Facility to repay borrowings under our two previous credit facilities and replace letters of credit totaling $12.5 million. In addition, proceeds from the loan were permitted to be used to pay cumulative unpaid preferred dividends and for general corporate purposes.

The Credit Facility includes a $125 million term loan, or Term Loan, and a $100 million revolving line of credit, or Revolver, collateralized by our interests in 121 facilities representing approximately half of our invested assets. In addition, we are the guarantor of our subsidiaries' obligations under the Credit Facility and have pledged to the lenders the shares of these subsidiaries. Both the Term Loan and Revolver have a four-year maturity with a one-year extension at our option. The Term Loan amortizes on a 25-year basis and is priced at London Interbank Offered Rate, or LIBOR, plus a spread of 3.75%, with a floor of 6.00%. The Revolver is also priced at LIBOR plus a 3.75% spread, with a 6.00% floor.

Borrowings under our old $160.0 million secured revolving line of credit facility of $112.0 million were paid in full upon the closing of the Credit Facility and the agreements were terminated. Additionally, $12.5 million of letters of credit previously outstanding against this credit facility were

reissued under the new Credit Facility. LIBOR-based borrowings under this previous credit facility had a weighted-average interest rate of approximately 4.5% at the payoff date.

Borrowings under our old $65.0 million line of credit facility, which was fully drawn, were paid in full upon the closing of our Credit Facility. LIBOR-based borrowings under this previous credit facility had a weighted-average interest rate of approximately 4.6% at the payoff date.

As a result of the new Credit Facility, for the twelve-month period ended December 31, 2003, our interest expense includes $2.6 million of non-cash interest expense (financing costs) related to the termination of our two previous credit facilities mentioned above.

In December 2003, we closed on a four-year, $50 million revolving acquisition line of credit arranged by GE Healthcare Financial Services. The Acquisition Line will be secured by first liens on facilities acquired or assignments of mortgages made on new acquisitions. The interest rate of LIBOR plus 3.75% with a 6% floor on the revolving acquisition line of credit is identical to our existing Credit Facility.

We are required to meet certain property level financial covenants and corporate financial covenants, including prescribed leverage, fixed charge coverage, minimum net worth, limitation on additional indebtedness and limitations on dividend payout on our long-term borrowings. We are also required to fix a certain portion of our interest rate. We utilize interest rate caps to fix interest rates on variable rate debt and reduce certain exposures to interest rate fluctuations. (See Note 9 Financial Instruments to the financial statements incorporated by reference herein).

Dividends

In order to qualify as a REIT, we are required to distribute dividends (other than capital gain dividends) to our stockholders in an amount at least equal to (A) the sum of (i) 90% of our "REIT taxable income" (computed without regard to the dividends paid deduction and our net capital gain) and (ii) 90% of the net income (after tax), if any, from foreclosure property, minus (B) the sum of certain items of non-cash income. In addition, if we dispose of any built-in gain asset during a recognition period, we will be required to distribute at least 90% of the built-in gain (after tax), if any, recognized on the disposition of such asset. Such distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before we timely file our tax return for such year and paid on or before the first regular dividend payment after such declaration. In addition, such distributions are required to be made pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that such class is entitled to such a preference. To the extent that we do not distribute all of our net capital gain or do distribute at least 90%, but less than 100% of our "REIT taxable income," as adjusted, we will be subject to tax thereon at regular ordinary and capital gain corporate tax rates.

On February 1, 2001, we announced the suspension of all common and preferred dividends. Prior to recommencing the payment of dividends on our common stock, all accrued and unpaid dividends on our Series A, B and C preferred stock must be paid in full. Due to our 2002 taxable loss, no distribution was necessary to maintain our REIT status for 2002.

In September 2003, our Board of Directors reinstated our common stock dividend that was paid on November 17, 2003 to common stockholders of record on October 31, 2003 in the amount of $0.15 per common share. Total common stock cash dividends were approximately $5.6 million for the twelve months ended December 31, 2003.

In addition, our Board of Directors declared its regular quarterly dividends for all classes of preferred stock that was paid on November 17, 2003 to preferred stockholders of record on October 31, 2003. Series A and Series B preferred stockholders of record on October 31, 2003 were paid dividends in the amount of approximately $0.578 and $0.539 per preferred share, respectively, on November 17, 2003. Our Series C preferred stockholder was paid dividends of $2.50 per Series C preferred share on November 17, 2003. The liquidation preference for our Series A, B and C preferred stock is $25.00, $25.00 and $100.00 per share, respectively. Regular quarterly dividends represented dividends for the period August 1, 2003 through October 31, 2003. Total preferred cash dividend payments for all classes of preferred stock totaled approximately $59.9 million for the twelve months ended December 31, 2003.

In July 2003, our Board of Directors declared a full catch-up of cumulative, unpaid dividends for all classes of preferred stock and such dividends were paid on August 15, 2003 to preferred stockholders of record on August 5, 2003. In addition, our Board of Directors declared the regular quarterly dividend for all classes of preferred stock that also was paid on August 15, 2003 to preferred stockholders of record on August 5, 2003. Series A and Series B preferred stockholders of record on August 5, 2003 were paid dividends in the amount of approximately $6.36 and $5.93 per preferred share, respectively, on August 15, 2003. Our Series C preferred stockholder was paid dividends of approximately $27.31 per Series C preferred share on August 15, 2003.

Liquidity

We believe our liquidity and various sources of available capital, including funds from operations, our existing availability under our Credit Facility and expected proceeds from planned asset sales are adequate to finance operations, meet recurring debt service requirements and fund future investments through the next twelve months.

Series D preferred offering; Series C preferred repurchase and conversion

On February 5, 2004, we entered into a Repurchase and Conversion Agreement with Explorer pursuant to which Explorer granted us an option to repurchase up to 700,000 shares of Series C preferred stock at $145.92 per share (or $9.12 per share of common stock on an as converted basis), provided we purchased a minimum of $100 million on or prior to February 27, 2004. Explorer also agreed to convert all of its remaining shares of Series C preferred stock into shares of our common stock upon exercise of the repurchase option. At the time Explorer entered into the Repurchase and Conversion Agreement, Explorer held all of our outstanding Series C preferred stock, which had an aggregate liquidation preference of $104,842,000, and was convertible at the holder's option into our common stock at a conversion price of $6.25 per share.

On February 10, 2004, we sold in a registered direct placement 4,739,500 shares of our 8.375% Series D cumulative redeemable preferred stock at $25 per share for net proceeds, after fees and expenses, of approximately $114.9 million. The Series D preferred stock may be redeemed at par at our election on or after the fifth anniversary of the original issue date. These securities rank *pari passu* with the Series A and Series B preferred stock and are not convertible into any other Omega securities. The Series D preferred stock has no stated maturity and will not be subject to a sinking fund or mandatory redemption.

We used approximately $102.1 million of the net proceeds of the Series D preferred stock offering to repurchase 700,000 shares of Series C preferred stock from Explorer as of February 10, 2004 pursuant to the repurchase option. In connection with the transaction, Explorer converted its remaining 348,420 shares of Series C preferred stock into 5,574,720 shares of common stock.

As a result of the offering of Series D preferred stock, the application of $102.1 million of the net proceeds received to repurchase 700,000 shares of Series C preferred, and the conversion of the remaining Series C preferred stock into shares of our common stock, (i) no Series C preferred stock is outstanding, and we plan to re-classify the remaining authorized shares of Series C preferred stock as authorized but unissued preferred stock, without designation as to class; (ii) 4,739,500 shares of our 8.375% Series D cumulative redeemable preferred stock, with an aggregate liquidation preference of $118,487,500, have been issued; and (iii) Explorer holds, as of February 20, 2004, 18,118,246 shares of our common stock, representing approximately 41.5% of our outstanding common stock. Under the stockholders agreement between Explorer and us, Explorer continues to be entitled to designate four of our ten directors.

In connection with our repurchase of a portion of Explorer's Series C preferred stock, our results for the first quarter of 2004 will include a non-recurring reduction in net income attributable to common stockholders of approximately $39 million. This amount reflects the sum of (i) the difference between the deemed redemption price of $145.92 per share of our Series C preferred stock and the carrying amount of $100 per share of Series C preferred stock multiplied by the number of shares of Series C preferred stock repurchased upon exercise of our option to repurchase shares of Series C preferred stock, and (ii) the cost associated with the original issuance of our Series C preferred stock that was previously classified as additional paid in capital, pro rated for the repurchase. On July 31, 2003, the SEC issued its interpretation of FASB-EITF Issue D-42, "The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock." Under the SEC's interpretation relating to the redemption of preferred stock, the difference between the carrying amount of the shares and the redemption price must be recorded as a reduction in net income attributable to common stockholders. The SEC's interpretation also included a statement that, upon conversion or redemption, all costs associated with the original issuance of such preferred stock should be recorded as a reduction of net income attributable to common stockholders. These non-recurring reductions in net income attributable to common stockholders will reduce our earnings per share and funds from operations for the first quarter of 2004.

In June 2003, we provided a guaranty of the obligations of our various subsidiaries that are the borrowers under a loan agreement with GECC, on its own behalf and as agent for certain other banks who are participating in our Credit Facility. Our guaranty contains various affirmative and negative covenants typical for such transactions including a limitation on the amount of dividends that we can pay that is equal to 95% of our "Funds from Operations" as defined in the White Paper on Funds from Operations approved by the Board of Governors of the National Association of Real Estate Investment Trusts in April 2002. GECC and certain of the other banks participating in our Credit Facility have confirmed that the non-recurring reduction in net income attributable to common stockholders resulting from our repurchase of a portion of Explorer's Series C preferred stock and the cost associated with the original issuance of our Series C preferred stock will not be included in the calculation pursuant to our guaranty of the maximum amount of dividends that we can pay.

130

Preferred Stock

500 129

Total Spatial Photonics Inc.

2,429 1,929

VeriWave, Inc.

Electronics & Computer Hardware

Preferred Stock Warrants

54

Preferred Stock Warrants

46

Total VeriWave, Inc.

100

Total Electronics & Computer Hardware (4.61%)*

17,967 16,900

Aegerion Pharmaceuticals, Inc. (4)

Specialty

Pharmaceuticals

Senior Debt

Matures September 2011

Interest rate Prime + 2.50% or

Floor rate of 11.00%

$4,763 4,763 4,763

Convertible Senior Debt

Matures December 2010

$340 340 340

Preferred Stock Warrants

69 142

Preferred Stock

1,000 710

Total Aegerion Pharmaceuticals, Inc.

6,172 5,955

QuatRx Pharmaceuticals Company

Specialty

Pharmaceuticals

Senior Debt

Matures October 2011

Interest rate Prime + 8.90% or

Floor rate of 12.15%

$14,306 14,212 14,212

Convertible Senior Debt

Matures March 2012

$1,888 1,888 2,861

Preferred Stock Warrants

220

Preferred Stock Warrants

308

Preferred Stock

750

Total Quatrx Pharmaceuticals Company

17,378 17,073

Total Specialty Pharmaceuticals (6.28%)*

23,550 23,028

Annie s, Inc.

Consumer & Business Products

Senior Debt - Second Lien

Matures April 2011

Interest rate LIBOR + 6.50%

or Floor rate of 10.00%

$6,000 6,119 6,119

Preferred Stock Warrants

321 85

Total Annie's, Inc.

6,440 6,204

See Notes to Consolidated Financial Statements

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HERCULES TECHNOLOGY GROWTH CAPITAL, INC.

CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)

March 31, 2010

(unaudited)

(dollars in thousands)

Portfolio Company	Industry	Type of Investment	Principal Amount	Cost[2]	Value[3]
IPA Holdings, LLC. [4]	Consumer & Business Products	Senior Debt Matures November 2012 Interest rate Prime + 8.25% or Floor rate of 12.5%	$ 9,250	$ 9,442	$ 9,442
		Senior Debt Matures May 2013 Interest rate Prime + 11.25% or Floor rate of 15.5%	$ 6,500	6,709	6,709
		Revolving Line of Credit Matures November 2012 Interest rate Prime + 7.75% or Floor rate of 12.00%	$ 1,356	1,356	1,356
		Preferred Stock Warrants		275	
		Common Stock		500	120
Total IPA Holding, LLC.				18,282	17,627
Market Force Information, Inc.	Consumer & Business Products	Preferred Stock Warrants		24	42
		Preferred Stock		500	500
Total Market Force Information, Inc.				524	542
OnTech Operations, Inc.	Consumer & Business Products	Senior Debt Matures June 2010 Interest rate 16.00%	$ 106	106	
		Preferred Stock Warrants		452	
		Preferred Stock Warrants		218	
		Preferred Stock		1,000	
Total OnTech Operations, Inc.				1,776	
Velocity Technology Solutions	Consumer & Business Products	Senior Debt Matures February 2015	$ 16,667	16,667	16,667

		Interest rate LIBOR + 8% Senior Debt Matures February 2015				
		Interest rate LIBOR + 8%	$	8,333	8,339	8,339
Total Velocity Technology Solutions					25,006	25,006
Wageworks, Inc.	Consumer & Business Products	Preferred Stock Warrants			252	1,371
		Preferred Stock			250	368
Total Wageworks, Inc.					502	1,739
Total Consumer & Business Products (13.95%)*					52,530	51,118
Enpirion, Inc.	Semiconductors	Senior Debt Matures August 2011				
		Interest rate Prime + 2.00% or				
		Floor rate of 7.625%	$	4,341	4,313	4,313
		Preferred Stock Warrants			157	0
Total Enpirion, Inc.					4,470	4,313

See Notes to Consolidated Financial Statements

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HERCULES TECHNOLOGY GROWTH CAPITAL, INC.

CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)

March 31, 2010

(unaudited)

(dollars in thousands)

Portfolio Company	Industry	Type of Investment	Principal Amount	Cost(2)	Value(3)
iWatt Inc.	Semiconductors	Preferred Stock Warrants		$ 46	$
		Preferred Stock Warrants		51	
		Preferred Stock Warrants		73	
		Preferred Stock Warrants		458	
		Preferred Stock		490	950
Total iWatt Inc.				1,118	950
NEXX Systems, Inc. (4)	Semiconductors	Revolving Line of Credit Matures June 2010 Interest rate Prime + 8.00% or Floor rate of 13.25%	$ 3,000	2,923	2,923
		Revolving Line of Credit Matures June 2010 Interest rate Prime + 8.00% or Floor rate of 17.50%	$ 2,500	2,500	2,500
		Preferred Stock Warrants		297	489
		Preferred Stock		277	733
Total NEXX Systems, Inc.				5,997	6,645
Quartics, Inc.	Semiconductors	Senior Debt Matures May 2010 Interest rate 10.00%	$ 55	55	55
		Preferred Stock Warrants		53	
Total Quartics, Inc.				108	55
Solarflare Communications, Inc.	Semiconductors	Senior Debt Matures August 2010 Interest rate 11.75%	$ 125	116	116
		Preferred Stock Warrants		83	
		Common Stock		641	
Total Solarflare Communications, Inc.				840	116
Total Semiconductors (3.30%)*				12,533	12,079

Labopharm USA, Inc. (5)	Drug Delivery	Senior Debt Matures June 2012			
		Interest rate 10.95%	$ 20,000	19,765	19,765
		Common Stock Warrants		635	710
Total Labopharm USA, Inc.				20,400	20,475
Transcept Pharmaceuticals, Inc.	Drug Delivery	Common Stock Warrants		36	52
		Common Stock Warrants		51	45
		Common Stock		500	331
Total Transcept Pharmaceuticals, Inc.				587	428
Total Drug Delivery (5.70%)*				20,987	20,903

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HERCULES TECHNOLOGY GROWTH CAPITAL, INC.

CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)

March 31, 2010

(unaudited)

(dollars in thousands)

Portfolio Company	Industry	Type of Investment	Principal Amount	Cost(2)	Value(3)
BARRX Medical, Inc.	Therapeutic	Senior Debt Mature December 2011 Interest rate 11.00%	$ 4,861	$ 4,855	$ 4,855
		Revolving Line of Credit Matures May 2010 Interest rate 10.00%	$ 1,000	1,000	1,000
		Preferred Stock Warrants		76	86
		Preferred Stock		1,500	2,318
Total BARRX Medical, Inc.				7,431	8,259
EKOS Corporation	Therapeutic	Senior Debt Matures November 2010 Interest rate Prime + 2.00%	$ 1,959	1,932	1,932
		Preferred Stock Warrants		174	
		Preferred Stock Warrants		153	
Total EKOS Corporation				2,259	1,932
Gelesis, Inc. (8)	Therapeutic	Senior Debt Matures May 2012 Interest rate Prime + 7.5% or Floor rate of 10.75%	$ 2,847	2,820	
		Preferred Stock Warrants		58	
Total Gelesis, Inc.				2,878	
Gynesonics, Inc.	Therapeutic	Convertible Subordinated Debt Matures July 2010 Interest rate 8.00%	$ 51	51	51
		Preferred Stock Warrants		17	
		Preferred Stock		250	250
Total Gynesonics, Inc.				318	301
Light Science Oncology, Inc.	Therapeutic	Preferred Stock Warrants		99	26
Total Light Science Oncology, Inc.				99	26
Novasys Medical, Inc.	Therapeutic	Preferred Stock Warrants		71	

		Preferred Stock Warrants		54	
		Preferred Stock		1,000	1,170
Total Novasys Medical, Inc.				1,125	1,170
Pacific Child & Family Associates, LLC	Therapeutic	Senior Debt Matures January 2015 Interest rate 8.0%	$ 6,750	6,750	6,750
		Senior Debt Matures January 2015 Interest rate 10.50%	$ 5,900	5,928	5,928
Total Pacific Child & Family Associates, LLC				12,678	12,678
Total Therapeutic (6.65%)*				26,788	24,366

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(dollars in thousands)

Portfolio Company	Industry	Type of Investment	Principal Amount	Cost(2)	Value(3)
Cozi Group, Inc.	Internet Consumer & Business Services	Preferred Stock Warrants		$ 147	$
		Preferred Stock		177	7
Total Cozi Group, Inc.				324	7
Invoke Solutions, Inc.	Internet Consumer & Business Services	Preferred Stock Warrants		56	117
		Preferred Stock Warrants		26	26
Total Invoke Solutions, Inc.				82	143
Prism Education Group Inc.	Internet Consumer & Business Services	Senior Debt Matures December 2010 Interest rate 11.25%	$ 609	601	601
		Preferred Stock Warrants		43	98
Total Prism Education Group Inc.				644	699
RazorGator Interactive Group, Inc. (4)	Internet Consumer & Business Services	Revolving Line of Credit Matures October 2011 Interest rate Prime + 9.50% or Floor rate of 14.00%	$ 6,158	6,158	6,158
		Preferred Stock Warrants		13	582
		Preferred Stock Warrants		28	45
		Preferred Stock		1,000	452
Total RazorGator Interactive Group, Inc.				7,199	7,237
Spa Chakra Acquisition Corporation (7)	Internet Consumer & Business Services	Revolving Line of Credit Matures April 2011 Interest rate Prime + 9.00% or Floor rate of 12.50%	$ 2,314	2,314	2,314
		Preferred Stock		15,037	10,000
Total Spa Chakra Acquisition Corporation				17,351	12,314

Total Internet Consumer & Business Services (5.57%)*					25,600	20,400
Lilliputian Systems, Inc.	Energy	Preferred Stock Warrants			107	92
		Common Stock Warrants			48	
Total Lilliputian Systems, Inc.					155	92
Total Energy (0.03%)*					155	92
Box.net, Inc.	Information Services	Senior Debt Matures May 2011 Interest rate Prime + 1.50%	$	563	552	552
		Senior Debt Matures September 2011 Interest rate Prime + 0.50%	$	248	248	248
		Preferred Stock Warrants			73	195
Total Box.net, Inc.					873	995

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Portfolio Company	Industry	Type of Investment	Principal Amount	Cost(2)	Value(3)
Buzznet, Inc.	Information Services	Preferred Stock Warrants		$ 9	$ 1
		Preferred Stock		250	74
Total Buzznet, Inc.				259	75
XL Education Corp.	Information Services	Common Stock		880	880
Total XL Education Corp.				880	880
hi5 Networks, Inc.	Information Services	Senior Debt Matures December 2010 Interest rate Prime + 2.5%	$ 1,182	1,182	1,182
		Senior Debt Matures June 2011 Interest rate Prime + 0.5%	$ 2,856	2,825	2,825
		Preferred Stock Warrants		212	
Total hi5 Networks, Inc.				4,219	4,007
Jab Wireless, Inc.	Information Services	Senior Debt Matures November 2012 Interest rate Prime + 3.50% or Floor rate of 9.5%	$ 14,375	14,603	14,603
		Revolving Line of Credit Matures October 2010 Interest rate Prime + 3.50% or Floor rate of 9.5%	$ 2,500	2,517	2,517
		Preferred Stock Warrants		265	158
Total Jab Wireless, Inc.				17,385	17,278
Solutionary, Inc.	Information Services	Preferred Stock Warrants		94	
		Preferred Stock Warrants		2	
		Preferred Stock		250	50
Total Solutionary, Inc.				346	50
Ancestry.com, Inc.	Information Services	Common Stock		452	1,348
Total Ancestry.com				452	1,348

Intelligent Beauty, Inc.		Senior Debt Matures March 2013 Interest rate Prime + 8.0% or Floor rate of 11.25%	$ 6,000	6,000	6,000
Total Intelligent Beauty, Inc.				6,000	6,000
Good Technologies, Inc.	Information Services	Common Stock		603	603
Total Good Technologies, Inc.				603	603

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(dollars in thousands)

Portfolio Company	Industry	Type of Investment	Principal Amount	Cost[(2)]	Value[(3)]
Coveroo, Inc.	Information Services	Preferred Stock Warrants		$ 7	$
Total Coveroo, Inc.				7	
Zeta Interactive Corporation	Information Services	Senior Debt Matures November 2012 Interest rate 10.0%	$ 4,731	4,378	4,378
		Senior Debt Matures November 2012 Interest rate 12.0%	$ 6,025	6,261	6,261
		Preferred Stock Warrants		172	
		Preferred Stock		500	310
Total Zeta Interactive Corporation				11,311	10,949
Total Information Services (11.51%)*				42,335	42,185
Novadaq Technologies, Inc. [(5)]	Diagnostic	Common Stock		1,474	497
Total Novadaq Technologies, Inc.				1,474	497
Optiscan Biomedical, Corp.	Diagnostic	Senior Debt Matures June 2011 Interest rate 10.25%	$ 6,496	6,372	6,372
		Preferred Stock Warrants		761	168
		Preferred Stock		3,000	3,000
Total Optiscan Biomedical, Corp.				10,133	9,540
Total Diagnostic (2.74%)*				11,607	10,037
Kamada, LTD. [(5)]	Biotechnology Tools	Preferred Stock Warrants		159	310
		Common Stock		752	1,697
Total Kamada, LTD.				911	2,007
Labcyte, Inc.	Biotechnology Tools	Senior Debt Matures November 2012	$ 3,500	3,347	3,347

		Interest rate Prime + 8.6% or Floor rate of 11.85%		
		Common Stock Warrants	192	
Total Labcyte, Inc.			3,539	3,347
NuGEN Technologies, Inc.	Biotechnology Tools	Preferred Stock Warrants	45	298
		Preferred Stock Warrants	33	24
		Preferred Stock	500	517
Total NuGEN Technologies, Inc.			578	839

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CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)

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(dollars in thousands)

Portfolio Company	Industry	Type of Investment	Principal Amount	Cost[2]	Value[3]
Solace Pharmaceuticals, Inc. [4]	Biotechnology Tools	Senior Debt Matures August 2012 Interest rate Prime + 4.25% or Floor rate of 9.85%	$ 2,386	$ 2,351	$ 2,351
		Senior Debt Matures August 2012 Interest rate 8.0%	$ 250	250	250
		Preferred Stock Warrants		42	
		Preferred Stock Warrants		54	
Total Solace Pharmaceuticals, Inc.				2,697	2,601
Total Biotechnology Tools (2.40%)*				7,725	8,794
Crux Biomedical, Inc.	Surgical Devices	Preferred Stock Warrants		37	
		Preferred Stock		250	26
Total Crux Biomedical, Inc.				287	26
Transmedics, Inc.	Surgical Devices	Senior Debt Matures February 2014 Interest rate Prime + 9.70% or Floor rate of 12.95%	$ 8,375	8,288	8,288
		Preferred Stock Warrants		225	
		Preferred Stock		1,100	1,100
Total Transmedics, Inc.				9,613	9,388
Total Surgical Devices (2.57%)*				9,900	9,414
Glam Media, Inc.	Media/Content/Info	Preferred Stock Warrants		483	283
Total Glam Media, Inc.				483	283
Everyday Health (Waterfront Media)	Media/Content/Info	Preferred Stock Warrants		60	588
		Preferred Stock		1,000	1,500

Total Everyday Health	1,060	2,088
Total Media/Content/Info (0.65%)*	1,543	2,371
Total Investments	389,904	379,973

* Value as a percent of net assets

(1) Preferred and common stock, warrants, and equity interests are generally non-income producing.

(2) Gross unrealized appreciation, gross unrealized depreciation, and net depreciation for federal income tax purposes totaled $14,747, $27,408 and $12,661, respectively. The tax cost of investments is $389,558.

(3) Except for warrants in seven publicly traded companies and common stock in five publicly traded companies, all investments are restricted at March 31, 2010. No unrestricted securities of the same issuer are outstanding. The Company uses the Standard Industrial Code for classifying the industry grouping of its portfolio companies.

(4) Debt investments of this portfolio company have been pledged as collateral under the Wells Facility.

(5) Non-U.S. company or the company s principal place of business is outside the United States.

(6) Affiliate investment that is defined under the Investment Company Act of 1940 as companies in which HTGC owns as least 5% but not more than 25% of the voting securities of the company.

(7) Control investment that is defined under the Investment Company Act of 1940 as companies in which HTGC owners as least 25% or more of the voting securities of such company or has greater than 50% representation on its board.

(8) Debt is on non-accrual status at March 31, 2010, and is therefore considered non-income producing.

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(dollars in thousands)

Portfolio Company	Industry	Type of Investment(1)	Principal Amount	Cost(2)	Value(3)
Acceleron Pharmaceuticals, Inc.	Drug Discovery	Preferred Stock Warrants		$ 69	$ 1,157
		Preferred Stock Warrants		35	215
		Preferred Stock		1,243	2,508
Total Acceleron Pharmaceuticals, Inc.				1,347	3,880
Aveo Pharmaceuticals, Inc.	Drug Discovery	Senior Debt Matures May 2012 Interest rate 11.13%	$ 14,564	14,509	14,509
		Preferred Stock Warrants		190	725
		Preferred Stock Warrants		104	219
		Preferred Stock Warrants		24	76
Total Aveo Pharmaceuticals, Inc.				14,827	15,529
Dicerna Pharmaceuticals, Inc.	Drug Discovery	Senior Debt Matures April 2012 Interest rate Prime + 9.20% or Floor rate of 12.95%	$ 6,603	6,434	6,434
		Preferred Stock Warrants		206	128
		Preferred Stock Warrants		31	22
Total Dicerna Pharmaceuticals, Inc.				6,671	6,584
Elixir Pharmaceuticals, Inc.	Drug Discovery	Senior Debt Matures October 2011 Interest rate Prime + 9.25% or Floor rate of 12.5%	$ 8,067	8,067	8,067
		Preferred Stock Warrants		217	
Total Elixir Pharmaceuticals, Inc.				8,284	8,067
EpiCept Corporation	Drug Discovery	Common Stock Warrants		8	38
		Common Stock Warrants		40	201
Total EpiCept Corporation				48	239
Horizon Therapeutics, Inc.	Drug Discovery	Senior Debt Matures July 2011 Interest rate Prime + 1.50%	$ 4,699	4,638	4,638
		Preferred Stock Warrants		231	
Total Horizon Therapeutics, Inc.				4,869	4,638
Inotek Pharmaceuticals Corp.	Drug Discovery	Preferred Stock		1,500	353

Total Inotek Pharmaceuticals Corp.			1,500	353
Merrimack Pharmaceuticals, Inc.	Drug Discovery	Preferred Stock Warrants	155	269
		Preferred Stock	2,000	1,699
Total Merrimack Pharmaceuticals, Inc.			2,155	1,968
Paratek Pharmaceuticals, Inc.	Drug Discovery	Preferred Stock Warrants	137	55
		Preferred Stock	1,000	1,000
Total Paratek Pharmaceuticals, Inc.			1,137	1,055

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(dollars in thousands)

Portfolio Company	Industry	Type of Investment[1]	Principal Amount	Cost[2]	Value[3]
Portola Pharmaceuticals, Inc.	Drug Discovery	Senior Debt Matures April 2011 Interest rate Prime + 2.16%	$ 6,666	$ 6,667	$ 6,671
		Preferred Stock Warrants		152	288
Total Portola Pharmaceuticals, Inc.				6,819	6,959
Recoly, N.V.[5]	Drug Discovery	Senior Debt Matures June 2012 Interest rate Prime + 4.25%	$ 2,576	2,576	2,576
Total Recoly, N.V.				2,576	2,576
Total Drug Discovery (14.15%)*				50,233	51,848
Affinity Videonet, Inc.[4]	Communications & Networking	Senior Debt Matures June 2012 Interest rate Prime + 8.75% or Floor rate of 12.00%	$ 2,318	2,326	2,326
		Senior Debt Matures June 2012 Interest rate Prime + 14.75% or Floor rate of 18.00%	$ 2,000	2,052	2,052
		Revolving Line of Credit Matures June 2012 Interest rate Prime + 9.75% or Floor rate of 13.00%	$ 500	500	500
		Preferred Stock Warrants		102	83
Total Affinity Videonet, Inc.				4,980	4,961
E-band Communications, Inc.[6]	Communications & Networking	Preferred Stock		2,880	2,274
Total E-Band Communications, Inc.				2,880	2,274
IKANO Communications, Inc.	Communications & Networking	Senior Debt Matures August 2011 Interest rate 12.00%	$ 6,472	6,472	6,472
		Preferred Stock Warrants		45	
		Preferred Stock Warrants		72	

Total IKANO Communications, Inc.			6,589	6,472
Neonova Holding Company	Communications & Networking	Preferred Stock Warrants	94	42
		Preferred Stock	250	247
Total Neonova Holding Company			344	289
Peerless Network, Inc.	Communications & Networking	Preferred Stock Warrants	95	
		Preferred Stock	1,000	800
Total Peerless Network, Inc.			1,095	800
Ping Identity Corporation	Communications & Networking	Preferred Stock Warrants	52	168
Total Ping Identity Corporation			52	168

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(dollars in thousands)

Portfolio Company	Industry	Type of Investment(1)	Principal Amount	Cost(2)	Value(3)
Purcell Systems, Inc.	Communications & Networking	Preferred Stock Warrants		$ 123	$ 386
Total Purcell Systems, Inc.				123	386
Rivulet Communications, Inc. (4)	Communications & Networking	Senior Debt Matures March 2010 Interest rate Prime + 8.00% or Floor rate of 12%	$ 1,063	1,060	1,060
		Preferred Stock Warrants		146	
		Common Stock		250	
Total Rivulet Communications, Inc.				1,456	1,060
Seven Networks, Inc.	Communications & Networking	Preferred Stock Warrants		174	11
Total Seven Networks, Inc.				174	11
Stoke, Inc.	Communications & Networking	Preferred Stock Warrants		53	81
Total Stoke, Inc.				53	81
Tectura Corporation	Communications & Networking	Senior Debt Matures September 2010 Interest rate Prime + 10.75% or Floor rate of 14.00%	$ 1,875	1,875	1,875
		Revolving Line of Credit Matures July 2011 Interest rate Prime + 10.75% or Floor rate of 14.00%	$ 9,908	10,238	10,238
		Revolving Line of Credit Matures July 2011 Interest rate Prime + 10.75% or Floor rate of 14.00%	$ 5,000	5,156	5,156
		Preferred Stock Warrants		51	
Total Tectura Corporation				17,320	17,269
Zayo Bandwidth, Inc.	Communications & Networking	Senior Debt Matures November 2013 Interest rate Libor + 5.25%	$ 24,750	24,750	24,317
Total Zayo Bandwith, Inc.				24,750	24,317

Total Communications & Networking (15.85%)*			59,816	58,088
Atrenta, Inc.	Software	Preferred Stock Warrants	102	99
		Preferred Stock Warrants	34	32
		Preferred Stock Warrants	95	159
		Preferred Stock	250	375
Total Atrenta, Inc.			481	665

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CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)

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(dollars in thousands)

Portfolio Company	Industry	Type of Investment[(1)]	Principal Amount	Cost[(2)]	Value[(3)]
Blurb, Inc.	Software	Senior Debt Matures June 2011 Interest rate Prime + 3.50% or Floor rate of 8.5%	$ 3,329	$ 3,234	$ 3,234
		Preferred Stock Warrants		25	128
		Preferred Stock Warrants		299	69
Total Blurb, Inc.				3,558	3,431
Braxton Technologies, LLC.	Software	Preferred Stock Warrants		188	116
Total Braxton Technologies, LLC.				188	116
Bullhorn, Inc.	Software	Preferred Stock Warrants		43	248
Total Bullhorn, Inc.				43	248
Clickfox, Inc.	Software	Senior Debt Matures September 2011 Interest rate Prime + 5.00% or Floor rate of 10.25%	$ 3,754	3,683	3,683
		Revolving Line of Credit Matures July 2010 Interest rate Prime + 8.50% or Floor rate of 13.5%	$ 2,000	2,003	2,003
		Preferred Stock Warrants		177	143
Total Clickfox, Inc.				5,863	5,829
Forescout Technologies, Inc.	Software	Preferred Stock Warrants		99	77
Total Forescout Technologies, Inc.				99	77
GameLogic, Inc.	Software	Preferred Stock Warrants		92	1
Total GameLogic, Inc.				92	1
HighJump Acquisition, LLC.	Software	Senior Debt Matures May 2013 Interest rate Libor + 8.75% or Floor rate of 12.00%	$ 15,000	15,000	15,000
Total HighJump Acquisition, LLC.				15,000	15,000
HighRoads, Inc.	Software	Preferred Stock Warrants		44	13
Total HighRoads, Inc.				44	13
Infologix, Inc.[(4)(7)]	Software	Senior Debt Matures November 2013	$ 5,500	5,500	5,500

		Interest rate 12.00%			
		Convertible Senior Debt Matures November 2014 Interest rate 12.00%	$ 5,000	5,004	10,060
		Revolving Line of Credit Matures May 2011 Interest rate 12.00%	$ 7,559	7,559	7,559
		Common Stock Warrants		760	1,494
		Common Stock		5,000	7,571
Total Infologix, Inc.				23,823	32,184
Intelliden, Inc.	Software	Preferred Stock Warrants		18	
Total Intelliden, Inc.				18	
PSS Systems, Inc.	Software	Preferred Stock Warrants		51	71
Total PSS Systems, Inc.				51	71
Rockyou, Inc.	Software	Preferred Stock Warrants		117	140
Total Rockyou, Inc.				117	140

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Portfolio Company	Industry	Type of Investment(1)	Principal Amount	Cost(2)	Value(3)
Savvion, Inc.(4)	Software	Senior Debt Matures February 2011 Interest rate Prime + 7.75% or Floor rate of 11.00%	$ 2,117	$ 2,065	$ 2,065
		Revolving Line of Credit Matures May 2010 Interest rate Prime + 6.75% or Floor rate of 10.00%	$ 1,500	1,500	1,500
		Preferred Stock Warrants		52	183
Total Savvion, Inc.				3,617	3,748
Sportvision, Inc.	Software	Preferred Stock Warrants		39	47
Total Sportvision, Inc.				39	47
WildTangent, Inc.	Software	Preferred Stock Warrants		238	77
Total WildTangent, Inc.				238	77
Total Software (16.82%)*				53,272	61,647
Luminus Devices, Inc.	Electronics & Computer Hardware	Senior Debt Matures December 2011 Interest rate 12.875%	$ 1,062	1,062	1,062
		Preferred Stock Warrants		183	
		Preferred Stock Warrants		84	
		Preferred Stock Warrants		334	
Total Luminus Devices, Inc.				1,663	1,062
Maxvision Holding, LLC.	Electronics & Computer Hardware	Senior Debt Matures October 2012 Interest rate Prime + 5.50%	$ 5,000	5,220	5,220
		Senior Debt Matures April 2012 Interest rate Prime + 2.25%	$ 4,409	4,409	4,409
		Revolving Line of Credit Matures April 2012 Interest rate Prime + 2.25%	$ 2,500	2,580	2,580
		Common Stock		81	170
Total Maxvision Holding, LLC				12,290	12,379
Shocking Technologies, Inc.	Electronics &	Senior Debt Matures December 2010 Interest rate Prime + 2.50%	$ 1,867	1,858	1,858

	Computer Hardware				
		Preferred Stock Warrants		63	119
Total Shocking Technologies, Inc.				1,921	1,977
Spatial Photonics, Inc.	Electronics & Computer Hardware	Senior Debt Matures April 2011 Interest rate 10.066%	$ 1,980	1,957	1,957
		Senior Debt Mature April 2011 Interest rate 9.217%	$ 197	197	197
		Preferred Stock Warrants		129	
		Preferred Stock		500	129
Total Spatial Photonics Inc.				2,783	2,283

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Portfolio Company	**Industry**	**Type of Investment[1]**	**Principal Amount**	**Cost[2]**	**Value[3]**
VeriWave, Inc.	Electronics & Computer Hardware	Preferred Stock Warrants		$ 54	$
		Preferred Stock Warrants		46	
Total VeriWave, Inc.				100	
Total Electronics & Computer Hardware (4.83%)*				18,757	17,701
Aegerion Pharmaceuticals, Inc.[4]	Specialty Pharmaceuticals	Senior Debt Matures September 2011 Interest rate Prime + 2.50% or Floor rate of 11.00%	$ 5,481	5,482	5,482
		Convertible Senior Debt Matures December 2010	$ 279	279	279
		Preferred Stock Warrants		69	253
		Preferred Stock		1,000	1,019
Total Aegerion Pharmaceuticals, Inc.				6,830	7,033
QuatRx Pharmaceuticals Company	Specialty Pharmaceuticals	Senior Debt Matures October 2011 Interest rate Prime + 8.90% or Floor rate of 12.15%	$ 15,417	15,299	15,299
		Convertible Senior Debt Matures March 2010	$ 1,888	1,888	2,861
		Preferred Stock Warrants		220	
		Preferred Stock Warrants		307	
		Preferred Stock		750	
Total QuatRx Pharmaceuticals Company				18,464	18,160
Total Specialty Pharmaceuticals (6.87%)*				25,294	25,193
Annie s, Inc.	Consumer & Business Products	Senior Debt - Second Lien Matures April 2011 Interest rate LIBOR + 6.50% or Floor rate of 10.00%	$ 6,000	6,060	6,060
		Preferred Stock Warrants		321	113
Total Annie s, Inc.				6,381	6,173
IPA Holdings, LLC.[4]	Consumer & Business Products	Senior Debt Matures November 2012 Interest rate Prime + 8.25% or	$ 9,500	9,633	9,633

	Floor rate of 12.5%				
	Senior Debt Matures May 2013 Interest rate Prime + 11.25% or Floor rate of 15.5%	$	6,500	6,625	6,625
	Revolving Line of Credit Matures November 2012 Interest rate Prime + 7.75% or Floor rate of 12.00%	$	856	856	856
	Common Stock Warrants			275	
	Common Stock			500	120
Total IPA Holding, LLC.				17,889	17,234

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Portfolio Company	Industry	Type of Investment[(1)]	Principal Amount	Cost[(2)]	Value[(3)]
Market Force Information, Inc.	Consumer & Business Products	Preferred Stock Warrants		$ 24	$
		Preferred Stock		500	267
Total Market Force Information, Inc.				524	267
OnTech Operations, Inc.[(8)]	Consumer & Business Products	Senior Debt Matures June 2010 Interest rate 16.00%	$ 106	106	
		Preferred Stock Warrants		452	
		Preferred Stock Warrants		218	
		Preferred Stock		1,000	
Total OnTech Operations, Inc.				1,776	
Wageworks, Inc.	Consumer & Business Products	Preferred Stock Warrants		252	1,425
		Preferred Stock		250	368
Total Wageworks, Inc.				502	1,793
Total Consumer & Business Products (6.95%)*				27,072	25,467
Custom One Design, Inc.[(8)]	Semiconductors	Senior Debt Matures September 2010 Interest rate 11.50%	$ 426	422	122
		Common Stock Warrants		18	
Total Custom One Design, Inc.				440	122
Enpirion, Inc.	Semiconductors	Senior Debt Matures August 2011 Interest rate Prime + 2.00% or Floor rate of 7.625%	$ 5,094	5,055	5,053
		Preferred Stock Warrants		157	2
Total Enpirion, Inc.				5,212	5,055
iWatt Inc.	Semiconductors	Preferred Stock Warrants		628	
		Preferred Stock		490	950
Total iWatt Inc.				1,118	950
NEXX Systems, Inc.[(4)]	Semiconductors	Senior Debt Matures March 2010 Interest rate Prime + 3.50% or Floor rate of 11.25%	$ 565	423	423
		Revolving Line of Credit Matures June 2010	$ 3,000	3,000	

	Interest rate Prime + 8.00% or Floor rate of 13.25%			3,000
	Revolving Line of Credit Matures June 2010 Interest rate Prime + 8.00% or Floor rate of 14.00%	$ 500	500	500
	Preferred Stock Warrants		562	784
	Preferred Stock		6	332
Total NEXX Systems, Inc.			4,491	5,039

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HERCULES TECHNOLOGY GROWTH CAPITAL, INC.

CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)

December 31, 2009

(dollars in thousands)

Portfolio Company	Industry	Type of Investment(1)	Principal Amount	Cost(2)	Value(3)
Quartics, Inc.	Semiconductors	Senior Debt Matures May 2010 Interest rate 10.00%	$ 139	$ 134	$ 134
		Preferred Stock Warrants		53	
Total Quartics, Inc.				187	134
Solarflare Communications, Inc.	Semiconductors	Senior Debt Matures August 2010 Interest rate 11.75%	$ 197	181	181
		Preferred Stock Warrants		83	
		Common Stock		641	
Total Solarflare Communications, Inc.				905	181
Total Semiconductors (3.13%)*				12,353	11,481
Labopharm USA, Inc.(5)	Drug Delivery	Senior Debt Matures June 2012 Interest rate 10.95%	$ 20,000	19,718	19,718
		Common Stock Warrants		687	1,307
Total Labopharm USA, Inc.				20,405	21,025
Transcept Pharmaceuticals, Inc.	Drug Delivery	Common Stock Warrants		36	94
		Common Stock Warrants		51	91
		Common Stock		500	283
Total Transcept Pharmaceuticals, Inc.				587	468
Total Drug Delivery (5.86%)*				20,992	21,493
BARRX Medical, Inc.	Therapeutic	Senior Debt Mature December 2011 Interest rate 11.00%	$ 5,481	5,473	5,473
		Revolving Line of Credit Matures May 2010 Interest rate 10.00%	$ 1,000	1,000	1,000
		Preferred Stock Warrants		76	111
		Preferred Stock		1,500	2,303
Total BARRX Medical, Inc.				8,050	8,887
EKOS Corporation	Therapeutic	Senior Debt Matures November 2010	$ 2,677	2,629	2,630

		Interest rate Prime + 2.00%			
		Preferred Stock Warrants		175	
		Preferred Stock Warrants		153	
Total EKOS Corporation				2,957	2,630
Gelesis, Inc.[8]	Therapeutic	Senior Debt Matures May 2012 Interest rate Prime + 7.5% or Floor rate of 10.75%	$ 2,847	2,814	
		Preferred Stock Warrants		58	
Total Gelesis, Inc.				2,872	
Gynesonics, Inc.	Therapeutic	Preferred Stock Warrants		18	5
		Preferred Stock		250	627
Total Gynesonics, Inc.				268	632

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HERCULES TECHNOLOGY GROWTH CAPITAL, INC.

CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)

December 31, 2009

(dollars in thousands)

Portfolio Company	Industry	Type of Investment[1]	Principal Amount	Cost[2]	Value[3]
Light Science Oncology, Inc.	Therapeutic	Preferred Stock Warrants		$ 99	$ 26
Total Light Science Oncology, Inc.				99	26
Novasys Medical, Inc.[4]	Therapeutic	Senior Debt Matures January 2010 Interest rate 9.70%	$ 295	295	295
		Preferred Stock Warrants		71	
		Preferred Stock Warrants		54	
		Preferred Stock		1,000	1,000
Total Novasys Medical, Inc.				1,420	1,295
Total Therapeutic (3.68%)*				15,665	13,470
Cozi Group, Inc.	Internet Consumer & Business Services	Preferred Stock Warrants		148	
		Preferred Stock		177	7
Total Cozi Group, Inc.				325	7
Invoke Solutions, Inc.	Internet Consumer & Business Services	Preferred Stock Warrants		56	129
		Preferred Stock Warrants		26	29
Total Invoke Solutions, Inc.				82	158
Prism Education Group Inc.	Internet Consumer & Business Services	Senior Debt Matures December 2010 Interest rate 11.25%	$ 801	789	790
		Preferred Stock Warrants		43	104
Total Prism Education Group Inc.				832	894
RazorGator Interactive Group, Inc. [4]	Internet Consumer & Business Services	Revolving Line of Credit Matures May 2010 Interest rate Prime + 6.00% or Floor rate of 12.00%	$ 10,000	10,000	10,000
		Preferred Stock Warrants		14	223
		Preferred Stock Warrants		28	33
		Preferred Stock		1,000	1,037

Total RazorGator Interactive Group, Inc.				11,042	11,293
Spa Chakra, Inc.[8]	Internet Consumer & Business Services	Senior Debt Matures from December 2009 to October 2011 Interest rate from 16.45% to 17%	$ 12,482	12,778	8,000
		Preferred Stock Warrants		1	
Total Spa Chakra, Inc.				12,779	8,000
Total Internet Consumer & Business Services (5.55%)*				25,060	20,352
Lilliputian Systems, Inc.	Energy	Preferred Stock Warrants		107	104
		Common Stock Warrants		48	
Total Lilliputian Systems, Inc.				155	104
Total Energy (0.03%)*				155	104

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HERCULES TECHNOLOGY GROWTH CAPITAL, INC.

CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)

December 31, 2009

(dollars in thousands)

Portfolio Company	Industry	Type of Investment(1)	Principal Amount	Cost(2)	Value(3)
Box.net, Inc.	Information Services	Senior Debt Matures May 2011 Interest rate Prime + 1.50%	$ 676	$ 658	$ 658
		Senior Debt Matures September 2011 Interest rate Prime + 0.50%	$ 287	287	287
		Preferred Stock Warrants		73	53
Total Box.net, Inc.				1,018	998
Buzznet, Inc.	Information Services	Preferred Stock Warrants		9	
		Preferred Stock		250	74
Total Buzznet, Inc.				259	74
XL Education Corp.	Information Services	Common Stock		880	880
Total XL Education Corp.				880	880
hi5 Networkss, Inc.	Information Services	Senior Debt Matures December 2010 Interest rate Prime + 2.5%	$ 1,559	1,559	1,559
		Senior Debt Matures June 2011 Interest rate Prime + 0.5%	$ 3,401	3,356	3,356
		Preferred Stock Warrants		213	
Total hi5 Networks, Inc.				5,128	4,915
Jab Wireless, Inc.	Information Services	Senior Debt Matures November 2012 Interest rate Prime + 3.50% or Floor rate of 9.5%	$ 14,750	14,891	14,892
		Revolving Line of Credit Matures October 2010 Interest rate Prime + 3.50% or Floor rate of 9.5%	$ 2,500	2,504	2,504
		Preferred Stock Warrants		265	151
Total Jab Wireless, Inc.				17,660	17,547
Solutionary, Inc.	Information Services	Preferred Stock Warrants		94	
		Preferred Stock Warrants		2	
		Preferred Stock		250	83
Total Solutionary, Inc.				346	83
Ancestry.com, Inc.	Information Services	Common Stock		452	880
Total Ancestry.com, Inc.				452	880

Good Technologies, Inc.		Common Stock	603	603
Total Good Technologies Inc.			603	603
Coveroo, Inc.	Information Services	Preferred Stock Warrants	7	
Total Coveroo, Inc.			7	

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HERCULES TECHNOLOGY GROWTH CAPITAL, INC.

CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)

December 31, 2009

(dollars in thousands)

Portfolio Company	Industry	Type of Investment(1)	Principal Amount	Cost(2)	Value(3)
Zeta Interactive Corporation	Information Services	Senior Debt Matures November 2012 Interest rate 9.50%	$ 4,731	$ 4,732	$ 4,731
		Senior Debt Matures November 2012 Interest rate 10.50%	$ 6,484	6,719	6,719
		Preferred Stock Warrants		172	
		Preferred Stock		500	310
Total Zeta Interactive Corporation				12,123	11,760
Total Information Services (10.30%)*				38,476	37,740
Novadaq Technologies, Inc.(5)	Diagnostic	Common Stock		1,567	542
Total Novadaq Technologies, Inc.				1,567	542
Optiscan Biomedical, Corp.	Diagnostic	Senior Debt Matures June 2011 Interest rate 10.25%	$ 7,696	7,516	7,515
		Preferred Stock Warrants		760	342
		Preferred Stock		3,000	3,000
Total Optiscan Biomedical, Corp.				11,276	10,857
Total Diagnostic (3.11%)*				12,843	11,399
Kamada, LTD. (5)	Biotechnology Tools	Common Stock Warrants		159	149
		Common Stock		794	1,161
Total Kamada, LTD.				953	1,310
Labcyte, Inc.	Biotechnology Tools	Senior Debt Matures November 2012 Interest rate Prime + 8.6% or Floor rate of 11.85%	$ 3,500	3,323	3,323
		Common Stock Warrants		192	235
Total Labcyte, Inc.				3,515	3,558
NuGEN Technologies, Inc.	Biotechnology Tools	Senior Debt Matures November 2010 Interest rate Prime + 3.45% or Floor rate of 6.75%	$ 785	780	780
		Senior Debt Matures November 2010 Interest rate Prime + 1.70% or	$ 442	442	442

		Floor rate of 6.75%			
		Preferred Stock Warrants		45	391
		Preferred Stock Warrants		33	41
		Preferred Stock		500	587
Total NuGEN Technologies, Inc.				1,800	2,241
Solace Pharmaceuticals, Inc.[4]	Biotechnology Tools	Senior Debt Matures August 2012 Interest rate Prime + 4.25% or Floor rate of 9.85%	$ 2,617	2,560	2,560
		Preferred Stock Warrants		42	
		Preferred Stock Warrants		54	
Total Solace Pharmaceuticals, Inc.				2,656	2,560
Total Biotechnology Tools (2.64%)*				8,924	9,669
Crux Biomedical, Inc.	Surgical Devices	Preferred Stock Warrants		37	
		Preferred Stock		250	26
Total Crux Biomedical, Inc.				287	26

See Notes to Consolidated Financial Statements

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HERCULES TECHNOLOGY GROWTH CAPITAL, INC.

CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)

December 31, 2009

(dollars in thousands)

Portfolio Company	Industry	Type of Investment[(1)]	Principal Amount	Cost[(2)]	Value[(3)]
Transmedics, Inc.[(4)(8)]	Surgical Devices	Senior Debt Matures December 2011 Interest rate Prime + 5.25% or Floor rate of 10.50%	$ 9,475	$ 9,384	$ 2,384
		Preferred Stock Warrants		225	
Total Transmedics, Inc.				9,609	2,384
Total Surgical Devices (0.66%)*				9,896	2,410
Glam Media, Inc.	Media/Content/Info	Preferred Stock Warrants		482	283
Total Glam Media, Inc.				482	283
Waterfront Media Inc.	Media/Content/Info	Preferred Stock Warrants		60	592
		Preferred Stock		1,000	1,500
Total Waterfront Media Inc.				1,060	2,092
Total Media/Content/Info (0.65%)*				1,542	2,375
Total Investments				$ 380,351	$ 370,437

* Value as a percent of net assets

(1) Preferred and common stock, warrants, and equity interests are generally non-income producing.

(2) Gross unrealized appreciation, gross unrealized depreciation, and net depreciation for federal income tax purposes totaled $17,409, $30,495 and $13,086, respectively. The tax cost of investments is $379,600.

(3) Except for warrants in five publicly traded companies and common stock in five publicly traded companies, all investments are restricted at December 31, 2009. No unrestricted securities of the same issuer are outstanding. The Company uses the Standard Industrial Code for classifying the industry grouping of its portfolio companies.

(4) Debt investments of this portfolio company have been pledged as collateral under the Wells Facility.

(5) Non-U.S. company or the company s principal place of business is outside the United States.

(6) Affiliate investment that is defined under the Investment Company Act of 1940 as companies in which HTGC owns as least 5% but not more than 25% of the voting securities of the company.

(7) Control investment that is defined under the Investment Company Act of 1940 as companies in which HTGC owners as least 25% or more of the voting securities of such company or has greater than 50% representation on its board.

(8) Debt is on non-accrual status at December 31, 2009, and is therefore considered non-income producing.

See Notes to Consolidated Financial Statements

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HERCULES TECHNOLOGY GROWTH CAPITAL, INC.

CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands, except per share data)

	Three Months Ended March 31, 2010	2009
Investment income:		
Interest income		
Non Control/Non Affiliate investments	$ 10,430	$ 17,823
Affiliate investments		153
Control investments	805	
Total interest Income	11,235	17,976
Fees		
Non Control/Non Affiliate investments	1,113	2,455
Affiliate investments		19
Control investments	172	
Total fees	1,285	2,474
Total investment income	12,520	20,450
Operating expenses:		
Interest	2,026	3,159
Loan fees	298	946
General and administrative	1,889	1,471
Employee Compensation:		
Compensation and benefits	2,238	2,884
Stock-based compensation	457	432
Total employee compensation	2,695	3,316
Total operating expenses	6,908	8,892
Net investment income	5,612	11,558
Net realized gain (loss) on investments	362	(1,146)
Net increase (decrease) in unrealized appreciation on investments	(260)	(5,930)
Net realized and unrealized gain (loss)	102	(7,076)
Net increase in net assets resulting from operations	$ 5,714	$ 4,482
Net investment income before investment gains and losses per common share:		
Basic	$ 0.16	$ 0.35
Diluted	$ 0.16	$ 0.35
Change in net assets per common share:		
Basic	$ 0.16	$ 0.14

Diluted	$ 0.16	$ 0.14
Weighted average shares outstanding		
Basic	35,181	32,775
Diluted	35,813	32,798

See notes to Consolidated Financial Statements (unaudited).

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HERCULES TECHNOLOGY GROWTH CAPITAL, INC.

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

(unaudited)

(dollars in thousands)

	Common Stock					Distributions		
	Shares	Par Value	Capital in Excess of Par Value	Unrealized Accumulated (Depreciation) on Investments	Accumulated Realized Gains (Losses) on Investments	in Excess of Investment Income	Provision for Income Taxes on Investment Gains	Net Assets
Balance at December 31, 2008	33,096	$ 33	$ 395,760	$ (11,297)	$ 3,906	$ (5,602)	$ (342)	$ 382,458
Net increase in net assets resulting from operations				(5,930)	(1,146)	11,558		4,482
Issuance of common stock	2		13					13
Issuance of common stock under restricted stock plan	306							
Issuance of common stock as stock dividend	1,921	2	9,530					9,532
Dividends declared						(10,591)		(10,591)
Stock-based compensation			452					452
Balance at March 31, 2009	35,325	$ 35	$ 405,755	$ (17,227)	$ 2,760	$ (4,635)	$ (342)	$ 386,346
Balance at December 31, 2009	35,634	$ 35	$ 409,036	$ (10,028)	$ (28,129)	$ (4,057)	$ (342)	$ 366,515
Net increase (decrease) in net assets resulting from operations				(260)	362	5,612		5,714
Issuance of common stock	81		446					446
Issuance of common stock under restricted stock plan	491							
Acquisition of common stock under stock repurchase plan	(25)		(234)					(234)
Issuance of common stock under dividend reinvestment plan	67		620					620
Dividends declared						(7,130)		(7,130)
Stock-based compensation			481					481
Balance at March 31, 2010	36,248	$ 35	$ 410,349	$ (10,288)	$ (27,767)	$ (5,575)	$ (342)	$ 366,412

See notes to Consolidated Financial Statements (unaudited)

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HERCULES TECHNOLOGY GROWTH CAPITAL, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS

(unaudited)

(dollars in thousands)

	Three Months Ended March 31, 2010	2009
Cash flows from operating activities:		
Net increase in net assets resulting from operations	$ 5,714	$ 4,482
Adjustments to reconcile net increase in net assets resulting from operations to net cash used in and provided by operating activities:		
Purchase of investments	(88,108)	(48,648)
Principal payments received on investments	77,983	91,690
Proceeds from sale of investments	2,090	1,239
Net unrealized appreciation (depreciation) on investments	260	5,930
Net realized gain on investments	(362)	1,146
Accretion of paid-in-kind principal	(568)	(411)
Accretion of loan discounts	(588)	(2,445)
Accretion of loan exit fees	(568)	(225)
Depreciation	95	91
Stock-based compensation	176	452
Amortization of restricted stock grants	305	
Common stock issued in lieu of Director compensation		13
Amortization of deferred loan origination revenue	(639)	(1,647)
Change in operating assets and liabilities:		
Interest receivable	(614)	1,081
Prepaid expenses and other assets	(788)	1,036
Accounts payable	(112)	(330)
Income tax payable	8	(192)
Accrued liabilities	(7,764)	(4,915)
Deferred loan origination revenue	1,424	172
Net cash (used in) provided by operating activities	(12,056)	48,519
Cash flows from investing activities:		
Purchases of capital equipment	(50)	(13)
Other long-term assets	153	25
Net cash provided by (used in) investing activities	103	12
Cash flows from financing activities:		
Proceeds from issuance of common stock, net	383	
Stock repurchase program	(234)	
Dividends paid	(6,510)	(1,060)
Borrowings of credit facilities		53,858
Repayments of credit facilities		(110,687)
Fees paid for credit facilities and debentures	(376)	
Net cash provided by (used in) financing activities	(6,737)	(57,889)
Net increase (decrease) in cash	(18,690)	(9,358)
Cash and cash equivalents at beginning of period	124,828	17,242

Cash and cash equivalents at end of period	$ 106,138	$ 7,884

See Notes to Consolidated Financial Statements (unaudited).

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HERCULES TECHNOLOGY GROWTH CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Description of Business and Unaudited Interim Consolidated Financial Statements Basis of Presentation

Hercules Technology Growth Capital, Inc. (the Company) is a specialty finance company that provides debt and equity growth capital to technology-related companies at various stages of development, from seed and emerging growth to expansion and established, which include select publicly listed companies and lower middle market companies. The Company sources its investments through its principal office located in Silicon Valley, as well as through its additional offices in the Boston, Massachusetts and Boulder, Colorado. The Company was incorporated under the General Corporation Law of the State of Maryland in December 2003.

The Company is an internally managed, non-diversified closed-end investment company that has elected to be regulated as a business development company (BDC) under the Investment Company Act of 1940, as amended (the 1940 Act). From incorporation through December 31, 2005, the Company was taxed as a corporation under Subchapter C of the Internal Revenue Code of 1986, (the Code). Effective January 1, 2006, the Company has elected to be treated for tax purposes as a regulated investment company, or RIC, under the Code (see Note 4).

The Company formed Hercules Technology II, L.P. (HT II), which was licensed on September 27, 2006, to operate as a Small Business Investment Company (SBIC) under the authority of the Small Business Administration (SBA). As an SBIC, HT II is subject to a variety of regulations concerning, among other things, the size and nature of the companies in which it may invest and the structure of those investments. The Company also formed Hercules Technology SBIC Management, LLC (HTM), a limited liability company. HTM is a wholly-owned subsidiary of the Company. The Company is the sole limited partner of HT II and HTM is the general partner (see Note 4).

The Company also established wholly owned subsidiaries, all of which are structured as Delaware corporations and limited liability companies, to hold portfolio companies organized as limited liability companies, or LLCs (or other forms of pass-through entities). We currently qualify as a RIC for federal income tax purposes, which allows us to avoid paying corporate income taxes on any income or gains that we distribute to our stockholders. The purpose of establishing these entities is to satisfy the RIC tax requirement that at least 90% of our gross income for income tax purposes is investment income.

The consolidated financial statements include the accounts of the Company and its subsidiaries. All inter-company accounts and transactions have been eliminated in consolidation. In accordance with Article 6 of Regulation S-X under Securities Act of 1933 and the Securities and Exchange Act of 1934, the Company does not consolidate portfolio company investments. The accompanying consolidated interim financial statements are presented in conformity with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information, and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X under the Securities Act of 1933 and the Securities Exchange Act of 1934. Accordingly, certain disclosures accompanying annual consolidated financial statements prepared in accordance with U.S. GAAP are omitted. In the opinion of management, all adjustments consisting solely of normal recurring accruals considered necessary for the fair presentation of consolidated financial statements for the interim periods, have been included. The current period s results of operations are not necessarily indicative of results that ultimately may be achieved for the year. Therefore, the interim unaudited consolidated financial statements and notes should be read in conjunction with the audited consolidated financial statements and notes thereto for the period ended December 31, 2009. Financial statements prepared on a U.S. GAAP basis require management to make estimates and assumptions that affect the amounts and disclosures reported in the consolidated financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed herein.

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2. Valuation of Investments

Our investments are carried at fair value in accordance with the Investment Act of 1948, (the 1948 Act) Act and Accounting Standards Codification (ASC) topic 820 *Fair Value Measurements and Disclosures*. At March 31, 2010, approximately 76% of the Company s total assets represented investments in portfolio companies that are valued at fair value by the Board of Directors. Value, as defined in Section 2(a)(41) of the 1940 Act, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors in accordance with valuation procedures and the recommendation of the Valuation Committee of the Board of Directors. Since there is typically no readily available market value for the investments in the Company s portfolio, it values substantially all of its investments at fair value as determined in good faith by its Board of Directors pursuant to a consistent valuation policy and a consistent valuation process in accordance with the provisions of ASC 820 and the 1940 Act. Due to the inherent uncertainty in determining the fair value of investments that do not have a readily available market value, the fair value of the Company s investments determined in good faith by its Board of Directors may differ significantly from the value that would have been used had a ready market existed for such investments, and the differences could be material.

Our Board of Directors has engaged an independent valuation firm to provide us with valuation assistance with respect to certain of our portfolio investments on a quarterly basis. We intend to continue to engage an independent valuation firm to provide us with assistance regarding our determination of the fair value of selected portfolio investments each quarter unless directed by the Board of Directors to cancel such valuation services. However, our Board of Directors is ultimately and solely responsible for determining the fair value of our investments in good faith.

We adopted ASC 820 on January 1, 2008. ASC 820 establishes a framework for measuring the fair value of the assets and liabilities and outlines a fair value hierarchy which prioritizes the inputs used to measure fair value and the effect of fair value measures on earnings. ASC 820 also enhances disclosure requirements for fair value measurements based on the level within the hierarchy of the information used in the valuation. ASC 820 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but doesn t expand the use of fair value in any new circumstances. ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

In October 2008, the Financial Accounting Standards Board, or the FASB, issued ASC 820-10-35, formerly known as FSP SFAS No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* , which clarifies the application of ASC 820 in a market that is not active. More specifically, this standard states that significant judgment should be applied to determine if observable data in a dislocated market represents forced liquidations or distressed sales and are not representative of fair value in an orderly transaction. The standard also provides further guidance that the use of a reporting entity s own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available. In addition, the standard provides guidance on the level of reliance of broker quotes or pricing services when measuring fair value in a non active market stating that less reliance should be placed on a quote that does not reflect actual market transactions and a quote that is not a binding offer.

Consistent with ASC 820, the Company determines fair value to be the amount for which an investment could be exchanged in a current sale, which assumes an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The Company s valuation policy considers the fact that no ready market exists for substantially all of the securities in which it invests.

In accordance with ASC 820, the Company has considered the principal market, or the market in which it exits its portfolio investments with the greatest volume and level of activity. ASC 820 requires that the portfolio investment is assumed to be sold in the principal market to market participants, or in the absence of a principal market, the most advantageous market. Market participants are defined as buyers and sellers in the principal or most advantageous market that are independent, knowledgeable, and willing and able to transact. The Company believes that the market participants for its investments are primarily other technology-related companies. Such participants acquire the Company s investments in order to gain access to the underlying assets of the portfolio company. As such, the Company believes the estimated value of the collateral of the portfolio company, up to the cost value of the investment, represents the fair value of the investment.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment. Unlike banks, the Company is not permitted to provide a general reserve for anticipated loan losses. Instead, the Company must determine the fair value of each individual investment on a quarterly basis. The Company records unrealized depreciation on investments when it believes that an investment has decreased in value, including where collection of a loan or realization of an equity security is doubtful. Conversely, where appropriate, the Company records unrealized appreciation if it believes that the underlying portfolio company has appreciated in value and, therefore, that its investment has also appreciated in value.

As a business development company, the Company invests primarily in illiquid securities including debt and equity-related securities of private companies. The Company s investments are generally subject to some restrictions on resale and generally have no established trading market. Because of the type of investments that the Company makes and the nature of its business, its valuation process requires an analysis of various factors that might be considered in a hypothetical secondary market. The Company s valuation methodology includes the examination of, among other things, the underlying investment performance, the current portfolio company s financial condition and market changing events that impact valuation, estimated remaining life, and interest rate spreads of similar securities as of the measurement date. If there is a significant deterioration of the credit quality of a debt investment, we may consider other factors that a hypothetical market participant would use to estimate fair value, including the proceeds that would be received in a liquidation analysis.

When originating a debt instrument, the Company generally receives warrants or other equity-related securities from the borrower. The Company determines the cost basis of the warrants or other equity-related securities received based upon their respective fair values on the date of receipt in proportion to the total fair value of the debt and warrants or other equity-related securities received. Any resulting discount on the loan from recordation of the warrant or other equity instruments is accreted into interest income over the life of the loan.

At each reporting date, privately held debt and equity securities are valued based on an analysis of various factors including, but not limited to, the portfolio company s operating performance and financial condition and general market conditions that could impact the valuation. When an external event occurs, such as a purchase transaction, public offering, or subsequent equity sale, the pricing indicated by that external event is utilized to corroborate the Company s valuation of the debt and equity securities. The Company periodically reviews the valuation of its portfolio companies that have not been involved in a qualifying external event to determine if the enterprise value of the portfolio company may have increased or decreased since the last valuation measurement date. The Company may consider, but is not limited to, industry valuation methods such as price to enterprise value or price to equity ratios, discounted cash flow, valuation comparisons to comparable public companies or other industry benchmarks in its evaluation of the fair value of its investment. We have a limited number of equity securities in public companies. In accordance with the 1940 Act, unrestricted minority-owned publicly traded securities for which market quotations are readily available are valued at the closing market quote on the valuation date.

An unrealized loss is recorded when an investment has decreased in value, including: where collection of a loan is doubtful, there is an adverse change in the underlying collateral or operational performance, there is a change in the borrower s ability to pay, or there are other factors that lead to a determination of a lower valuation for the debt or equity security. Conversely, unrealized appreciation is recorded when the investment has

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appreciated in value. Securities that are traded in the over-the-counter markets or on a stock exchange will be valued at the prevailing bid price at period end. The Board of Directors estimates the fair value of warrants and other equity-related securities in good faith using a Black-Scholes pricing model and consideration of the issuer s earnings, sales to third parties of similar securities, the comparison to publicly traded securities, and other factors.

The Company has categorized all investments recorded at fair value in accordance with ASC 820 based upon the level of judgment associated with the inputs used to measure their fair value. Hierarchical levels, defined by ASC 820 and directly related to the amount of subjectivity associated with the inputs to fair valuation of these assets and liabilities, are as follows:

Level 1 Inputs are unadjusted, quoted prices in active markets for identical assets at the measurement date. The types of assets carried at Level 1 fair value generally are equities listed in active markets.

Level 2 Inputs (other than quoted prices included in Level 1) are either directly or indirectly observable for the asset in connection with market data at the measurement date and for the extent of the instrument s anticipated life. Fair valued assets that are generally included in this category are warrants held in a public company.

Level 3 Inputs reflect management s best estimate of what market participants would use in pricing the asset at the measurement date. It includes prices or valuations that require inputs that are both significant to the fair value measurement and unobservable. Generally, assets carried at fair value and included in this category are the debt investments and warrants and equities held in a private company.

Investments measured at fair value on a recurring basis are categorized in the tables below based upon the lowest level of significant input to the valuations as of March 31, 2010 and as of December 31, 2009:

		Investments at Fair Value as of March 31, 2010		
(in thousands) **Description**	**March 31, 2010**	**Quoted Prices In Active Markets For Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Senior secured debt	$ 315,523	$	$	$ 315,523
Senior debt-second lien	6,119			6,119
Preferred stock	34,102			34,102
Common stock	11,061	2,526	6,762	1,773
Warrants	13,168		3,159	10,009
	$ 379,973	$ 2,526	$ 9,921	$ 367,526

		Investments at Fair Value as of December 31, 2009		
(in thousands) **Description**	**December 31, 2009**	**Quoted Prices In Active Markets For Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Senior secured debt	$ 314,842	$	$	$ 314,842
Senior debt-second lien	6,060			6,060
Preferred stock	22,875			22,875
Common stock	12,210	1,986	8,451	1,773
Warrants	14,450		3,374	11,076

$ 370,437	$ 1,986	$ 11,825	$ 356,626

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The table below presents a reconciliation for all financial assets measured at fair value on a recurring basis, excluding accrued interest components, using significant unobservable inputs (Level 3) for the three months ended March 31, 2010 and as of December 31, 2009:

(in thousands)	Balance, January 1, 2010	Net Realized Gains (losses)[1]	Net change in unrealized appreciation or depreciation[2]	Purchases, sales, repayments, and exit, net	Transfer in & out of Level 3	Balances, March 31, 2010
Senior Debt	$ 314,842	$ 579	$ 6,974	$ (6,872)	$	$ 315,523
Senior Debt-Second Lien	6,060			59		6,119
Preferred Stock	22,875		(5,180)	16,407		34,102
Common Stock	1,773			0		1,773
Warrants	11,076	(514)	466	0	(1,019)	10,009
Total	$ 356,626	$ 65	$ 2,260	$ 9,594	$ (1,019)	$ 367,526

(in thousands)	Balance, January 1, 2009	Net Realized Gains (losses)[1]	Net change in unrealized appreciation or depreciation[2]	Purchases, sales, repayments, and exit, net	Transfer in & out of Level 3	Balances, December 31, 2009
Senior Debt	$ 534,230	$ (27,192)	$ 4,698	$ (196,894)	$	$ 314,842
Senior Debt-Second Lien	5,824			236		6,060
Preferred Stock	21,249	(3,000)	4,373	661	(408)	22,875
Common Stock	1,894	(105)	(749)	1,204	(471)	1,773
Warrants	14,952	(1,150)	(4,116)	1,390		11,076
Total	$ 578,149	$ (31,447)	$ 4,206	$ (193,403)	$ (879)	$ 356,626

(1) Includes net realized gains (losses) recorded as realized gains or losses in the accompanying consolidated statements of operations.
(2) Included in change in net unrealized appreciation or depreciation in the accompanying consolidated statements of operations.

As required by the 1940 Act, the Company classifies its investments by level of control. Control Investments are defined in the 1940 Act as investments in those companies that the Company is deemed to Control . Generally, under 1940 Act, the Company is deemed to Control a company in which it has invested if it owns 25% or more of the voting securities of such company or has greater than 50% representation on its board. Affiliate Investments are investments in those companies that are Affiliated Companies of the Company, as defined in the 1940 Act, which are not Control Investments. The Company is deemed to be an Affiliate of a company in which it has invested if it owns 5% or more but less than 25% of the voting securities of such company. Non-Control/Non-Affiliate Investments are investments that are neither Control Investments nor Affiliate Investments.

At March 31, 2010, the Company had investments in two portfolio companies deemed to be Control Investments. Approximately $821,000 and $156,000 in investment income was derived from our debt investments in these Software and Internet Consumer and Business Services portfolio companies, respectively. Approximately $1,000 of realized losses related to Control Investments was recognized during the quarter ended March 31, 2010. The Company recognized net unrealized depreciation of approximately $3.4 million on control investments during the quarter ended March 31, 2010. As of March 31, 2009, no portfolio companies were deemed to be Control Investments.

At March 31, 2010, the Company had an investment in one portfolio company deemed to be an Affiliate. No income was derived from this investment as this is a non-income producing equity investment. At March 31, 2009,

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the Company had three portfolio companies deemed to be Affiliates. For the quarter ended March 31, 2009, income derived from these investments was approximately $153,000. One company that was an Affiliate as of March 31, 2009 performed a capital raise in 2009 which resulted in our ownership percentage decreasing to less than 5% of the voting securities in the portfolio company. As a result, this portfolio company is no longer considered an Affiliate for reporting purposes. We recognized a realized loss of approximately $4.0 million in the second quarter of 2009 in a portfolio company that was an Affiliate prior to the disposal of the investment. During the quarters ended March 31, 2010 and 2009, we recognized net unrealized depreciation of approximately $52,000 and $867,000, respectively, related to Affiliates.

A summary of the composition of the Company s investment portfolio as of March 31, 2010 and December 31, 2009 at fair value is shown as follows:

	March 31, 2010		December 31, 2009	
(in thousands)	Investments at Fair Value	Percentage of Total Portfolio	Investments at Fair Value	Percentage of Total Portfolio
Senior secured debt with warrants	$ 250,459	65.9%	$ 229,454	61.9%
Senior secured debt	78,147	20.6%	99,725	26.9%
Preferred stock	34,102	9.0%	22,875	6.2%
Senior debt-second lien with warrants	6,204	1.6%	6,173	1.7%
Common Stock	11,061	2.9%	12,210	3.3%
	$ 379,973	100.0%	$ 370,437	100%

A summary of the Company s investment portfolio, at value, by geographic location is as follows:

	March 31, 2010		December 31, 2009	
	Investments at Fair Value	Percentage of Total Portfolio	Investments at Fair Value	Percentage of Total Portfolio
(in thousands)				
United States	$ 356,994	94.0%	$ 344,984	93.1%
Canada	20,972	5.5%	21,567	5.8%
Israel	2,007	0.5%	1,310	0.4%
Netherlands		%	2,576	0.7%
	$ 379,973	100.0%	$ 370,437	100%

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The following table shows the fair value of our portfolio by industry sector at March 31, 2010 and December 31, 2009 (excluding unearned income):

	March 31, 2010		December 31, 2009	
	Investments at Fair Value	**Percentage of Total Portfolio**	**Investments at Fair Value**	**Percentage of Total Portfolio**
(in thousands)				
Software	$ 58,147	15.3%	$ 61,647	16.6%
Consumer & Business Products	51,118	13.5%	25,467	6.9%
Drug Discovery	49,348	13.0%	51,848	14.0%
Information Services	42,185	11.1%	37,740	10.2%
Communications & Networking	30,790	8.1%	58,088	15.7%
Therapeutic	24,366	6.4%	13,470	3.6%
Specialty Pharma	23,028	6.1%	25,193	6.8%
Drug Delivery	20,903	5.5%		