

HEALTHCARE REALTY
TRUST

ANNUAL REPORT TO SHAREHOLDERS
1998

COMPANY PROFILE: Healthcare Realty Trust is a real estate investment trust that integrates owning, managing and developing income-producing real estate properties associated with the delivery of healthcare services throughout the United States. The Company's portfolio is comprised of nine facility types, located in 130 markets nationwide, and operated pursuant to contractual arrangements with 61 healthcare providers. Since commencing operations in June 1993, the Company has invested over \$1.7 billion in 280 properties, totaling over twelve million square feet. The Company currently provides property or asset management services for nine million square feet of real estate. The Company intends to maintain a portfolio of properties that is focused primarily on the outpatient services segment of the healthcare industry and is diversified by tenant, geographic location and facility type.

1998
*Letter
to*
SHAREHOLDERS

I am pleased to report that 1998 was an outstanding year for Healthcare Realty Trust, highlighted by a major acquisition and our 22nd consecutive profitable quarter. Our portfolio of quality healthcare properties, coupled with the achievements of our services group, generated solid revenue and earnings growth. Disappointingly, negative investor sentiment for all REITs depressed our share price, despite a record year for the Company.



DAVID R. EMERY
*Chairman of The Board &
Chief Executive Officer*

Revenues for 1998 totaled \$93.1 million, compared with \$59.8 million for 1997. Net income was \$40.5 million or \$1.63 per diluted common share, compared with \$31.2 million or \$1.68 per diluted common share for the prior year. Funds from operations, composed primarily of net income and depreciation of real estate, totaled \$59.7 million on a diluted basis or \$2.44 per diluted common share for the 12-month period. This compares with \$42.3 million or \$2.28 per diluted common share for the same period in 1997.

Since its formation in June 1993, the Company has increased the dividend paid to common shareholders every quarter. Total dividend payments for the calendar year 1998 were \$2.07 per common share, compared with \$1.99 per common share for the calendar year 1997, an increase of 4%. The common dividend payout, as a percentage of funds from operations, decreased to 85%.

October 15, 1998 marked a significant increase in the Company's investments with the acquisition of Capstone Capital Corporation, a real estate investment trust that owned or provided mortgage financing to 180 properties associated with the delivery of healthcare services. The Company is now one of the largest real estate investment trusts focused exclusively on healthcare-related properties, with investments totaling approximately \$1.7 billion. The enhanced asset base contributed to the subsequent assignment of an investment-grade credit rating by Moody's Investors Service and an upgrade of our existing Duff & Phelps investment-grade rating, further strengthening the Company's client relationships and access to capital.

We are proud of these accomplishments and believe they affirm our investment standards and reflect the quality of our portfolio. Based upon our operating strengths, low business-risk profile and dedication to shareholder return, we believe the Company is among the most strategically positioned real estate investment trusts in the country.

A VITAL INDUSTRY

The healthcare industry faced several challenges in 1998. Investigations into billing and cost reporting practices continued. In the wake of industry consolidation, nearly every publicly-traded and most not-for-profit providers pared ancillary assets in an effort to reduce overhead costs and renew their focus on core strategies. The implementation of Medicare reimbursement reductions under the 1997 Balanced Budget Agreement compressed acute care profit margins and introduced skilled nursing facilities to a prospective payment system.

Changes in reimbursement to skilled nursing facilities have also affected healthcare REIT share prices. While the Company acknowledges the challenge that some skilled nursing providers face, we do not foresee any material effect on the performance of the Company's investments in this sector. On average, the Company's skilled nursing facilities generate approximately \$2.40 of cash flow for every dollar of lease or mortgage expense. Furthermore, skilled nursing facilities comprise a minor portion of our investment portfolio.

In the latter part of 1998, it became evident that many investors' growth expectations for real estate investment were overzealous. The subsequent cooling of expectations caused momentum investors to reduce their holdings in REITs. Corresponding monetary outflows have continued to place downward pressure on all REIT stocks, negatively affecting the Company's share price, despite its achievements.

Even as REITs and the healthcare industry adapt, the fundamentals of healthcare and the related real estate remain firmly intact. The aging of the population, advances in technology and heightened focus on preventive medicine continue to increase demand for healthcare services. Expenditures for healthcare services and

products are now estimated to total more than \$1 trillion annually — 13% of the Gross Domestic Product. By 2007 these expenditures are projected to grow to \$2.2 trillion — 16.6% of GDP. Most hospital-based providers continue to post record profits on increasing revenues, with operating margins at an all-time high. Healthcare is a demographically need-driven industry with compelling fundamentals that support long-term real estate values.

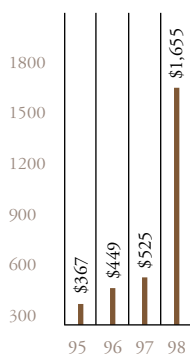
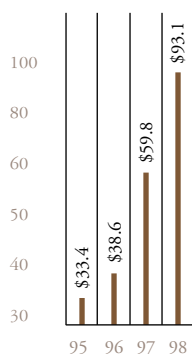
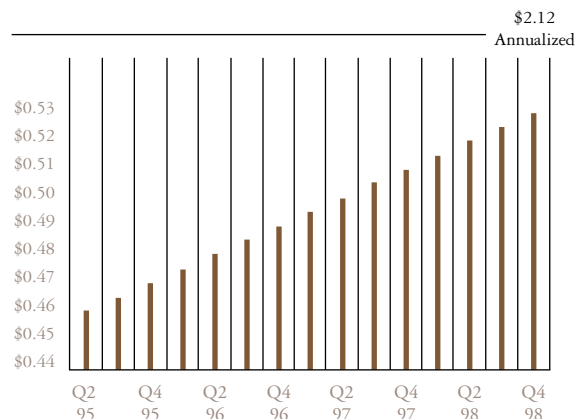
The value of real estate related to healthcare services is immense – estimated to exceed \$900 billion – yet to date, real estate investment trusts have funded only slightly more than 1% of these properties. These circumstances present the Company with considerable growth potential; still we continue to be selective by making investments that exhibit sound real estate fundamentals within the growth sectors of healthcare delivery.

Healthcare services delivery continues to shift toward outpatient settings. Outpatient revenues currently comprise approximately 43% of gross hospital revenues and are expected to exceed 50% in the near future. As outpatient services account for an increasingly larger portion of system revenues, providers are seeking to expand their network of affiliated clinics and ambulatory care centers. Of the estimated \$12 billion in new healthcare facilities developed annually, approximately 60% are outpatient facilities. Outpatient facilities currently comprise 56% of the Company's investment portfolio. As anticipated, transformations in the healthcare services industry continue to enhance investment and growth opportunities for Healthcare Realty Trust.

INTEGRATED REAL ESTATE SOLUTIONS

Healthcare industry developments, such as service delivery networks, ongoing enhancement of technology, and physician practice alliances, have presented healthcare providers with competing demands for capital. Providers are looking beyond traditional debt sources and recognize that the manner in which real estate needs are funded is crucial to their long-term financial capability. Forming strategic relationships with real estate equity sources and managers has enabled them to monetize their real estate assets and allocate internal funds to more compelling and mission-critical uses. Innovative equity co-investment and asset management strategies allow providers to preserve control of their real estate, while affording increased financial flexibility and enhanced capital formation.

As an integrated real estate company focused exclusively on the healthcare industry, Healthcare Realty Trust is functionally organized to be an attractive partner to address the increased demand for capital.

HEALTHCARE REALTY TRUST AT A GLANCE:**INVESTMENTS AND COMMITMENTS**
(\$ in millions)**REVENUES**
(\$ in millions)**DIVIDENDS PER SHARE**

The Company furnishes a continuum of client services, ranging from initial strategic market assessments and asset valuations to construction services and property and asset management. The Company's understanding of the healthcare industry and our ability to combine capital resources with management and construction expertise adds value for our clients and differentiates Healthcare Realty Trust from other real estate firms.

BUILDING RELATIONSHIPS

Healthcare Realty Trust continues to benefit from its integrated services approach, as healthcare providers seek real estate partners — not just sources of capital. Our strategy is to build relationships with leading healthcare providers that establish market presence, align financial incentives and ensure long-term engagements. Such relationships often foster additional investments and the opportunity to provide related services on the same campus or within the market area.

Healthcare Realty Trust's \$1 billion acquisition of Capstone Capital Corporation exemplifies our strategic intent. Encompassing over 180 properties located in 85 new markets, the acquisition enables the Company to further implement its comprehensive real estate services platform and provides a unique opportunity to expand its portfolio of high-quality properties. With this acquisition, the Company now has investment relationships with 61 healthcare providers nationwide.

The Company continues to be pleased with its exclusive, business-partner agreement with VHA Inc., the national alliance of 1,550 not-for-profit healthcare organizations. We are establishing mutually beneficial relationships that enhance the financial capabilities of our healthcare provider partners and expand the Company's ability to structure investments that align interests and create long-term value for our clients and our shareholders.

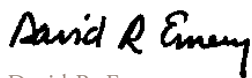
CONSERVATIVE FINANCIAL MANAGEMENT

We believe that Healthcare Realty Trust's conservative capital structure continues to provide sufficient resources necessary to readily take advantage of worthy investment opportunities. Utilizing the relationships, expertise and experience that we have developed over many years in the industry, the management team employs a disciplined real estate investment strategy. We believe quality growth is achieved by focusing only on investments that sustain long-term performance and add economic value.

The Company intends to maintain a low business-risk profile through conservative use of debt leverage. At year-end, the ratio of debt to total book capitalization was 35%. We feel that our new Moody's Investors Service investment-grade rating along with the upgrade from our existing Duff & Phelps' investment-grade rating validates the Company's conservative capital structure and prospects for growth.

The management team is pleased with Healthcare Realty Trust's progress and achievements during 1998 and is grateful to the Board of Directors and our employees for their energy and commitment. We are also appreciative of our shareholders, whose support and involvement provide the foundation for the continued growth of the Company. I look forward to keeping you informed of our progress during 1999.

Sincerely yours,



David R. Emery

Chairman of the Board and CEO

Selected
PROPERTIES



CANDLER REGIONAL HEART &
LUNG CENTER
Savannah, Georgia



RICHMOND MEDICAL BUILDING I
Richmond, Virginia



CORAL GABLES MEDICAL CENTER
Coral Gables, Florida



SUNRISE MOUNTAIN VIEW
MEDICAL CENTER
Las Vegas, Nevada



HUEBNER MEDICAL CENTER
San Antonio, Texas



KERLAN JOBE MEDICAL CENTER
Los Angeles, California



LEWIS-GALE CLINIC
Roanoke, Virginia



SARASOTA MEDICAL CENTER
Sarasota, Florida



KELSEY SEYBOLD CLINIC WEST
Houston, Texas



ST. ANDREW'S SURGERY CENTER
Venice, Florida

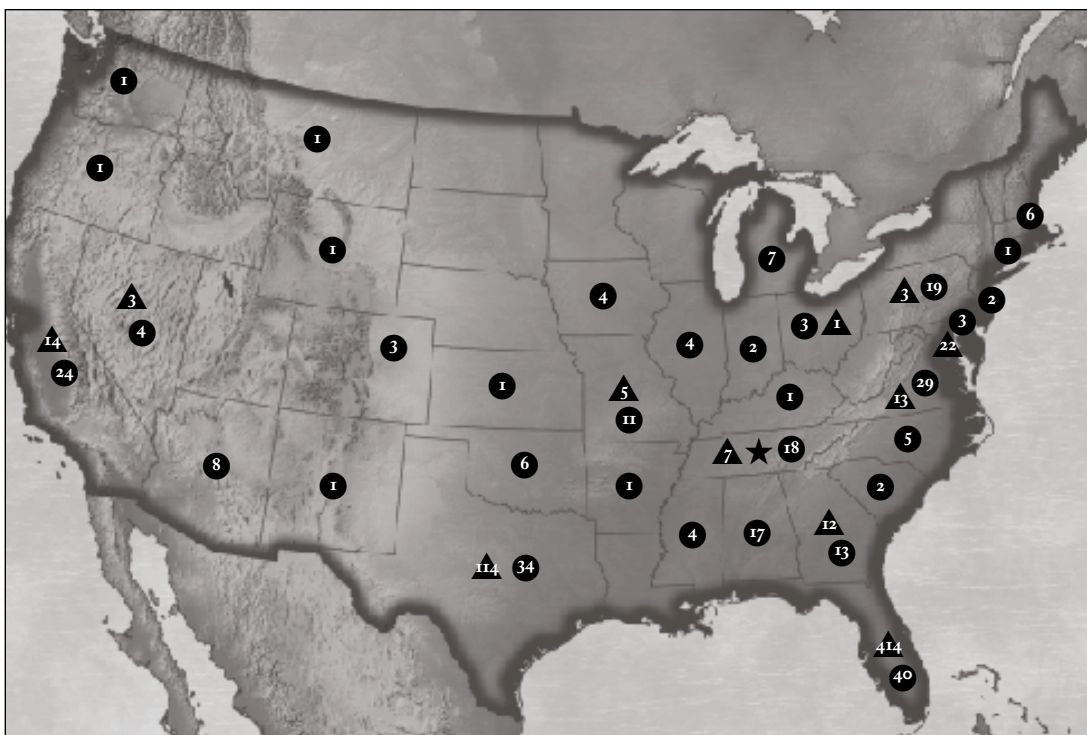


ORANGE COUNTY REGIONAL
CANCER CENTER
Fountain Valley, California



MARY WASHINGTON HOSPITAL
Fredericksburg, Virginia

Property
L O C A T I O N S



★ CORPORATE OFFICE ● INVESTMENTS ▲ MANAGED PROPERTIES

Alabama	17	Kansas	1	North Carolina	5
Arizona	8	Kentucky	1	Ohio	4
Arkansas	1	Maryland	3	Oklahoma	6
California	38	Massachusetts	6	Oregon	1
Colorado	3	Michigan	7	Pennsylvania	22
Connecticut	1	Mississippi	4	South Carolina	2
Florida	454	Missouri	16	Tennessee	25
Georgia	25	Montana	1	Texas	148
Illinois	4	Nevada	4	Virginia	42
Indiana	4	New Jersey	2	Washington	1
Iowa	4	New Mexico	1	Wyoming	1

1998
*Financial
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Selected Financial
I N F O R M A T I O N

The following table sets forth financial information for the Company which is derived from the Consolidated Financial Statements of the Company (Dollars in thousands, except per share data):

	Years Ended December 31,				
	1998 ⁽²⁾	1997	1996	1995	1994
Statement of Income Data:					
Total revenues	\$ 93,104	\$ 59,796	\$ 38,574	\$ 33,361	\$ 24,226
Interest expense	\$ 13,057	\$ 7,969	\$ 7,344	\$ 5,083	\$ 1,116
Net income	\$ 40,479	\$ 31,212	\$ 19,732	\$ 18,258	\$ 15,716
Net income per share - Basic	\$ 1.66	\$ 1.71	\$ 1.52	\$ 1.41	\$ 1.33
Net income per share - Diluted	\$ 1.63	\$ 1.68	\$ 1.49	\$ 1.41	\$ 1.33
Weighted average shares outstanding - Basic	24,043,942	18,222,243	13,014,286	12,931,082	11,806,864
Weighted average shares outstanding - Diluted	24,524,600	18,572,492	13,261,291	12,970,326	18,859,714
Balance Sheet Data (as of the end of the period):					
Real estate properties, net	\$ 1,337,439	\$ 466,273	\$ 416,034	\$ 318,480	\$ 280,767
Total Assets	\$ 1,615,423	\$ 488,514	\$ 427,505	\$ 336,778	\$ 283,190
Notes and bonds payable	\$ 559,924	\$ 101,300	\$ 168,618	\$ 92,970	\$ 40,375
Total stockholders' equity	\$ 1,017,704	\$ 376,472	\$ 245,964	\$ 234,448	\$ 236,340
Other Data:					
Funds from operations – Basic ⁽¹⁾	\$ 59,667	\$ 42,337	\$ 28,036	\$ 25,490	\$ 20,919
Funds from operations – Diluted ⁽¹⁾	\$ 59,731	\$ 42,337	\$ 28,036	\$ 25,490	\$ 20,919
Funds from operations per share - Basic ⁽¹⁾	\$ 2.48	\$ 2.32	\$ 2.15	\$ 1.97	\$ 1.77
Funds from operations per share - Diluted ⁽¹⁾	\$ 2.44	\$ 2.28	\$ 2.11	\$ 1.97	\$ 1.76
Dividends declared and paid per share	\$ 2.07	\$ 1.99	\$ 1.91	\$ 1.83	\$ 1.75

⁽¹⁾ See Note 12 to Consolidated Financial Statements.

⁽²⁾ See Note 2 to Consolidated Financial Statements.

Management's Discussion and Analysis of Financial Condition
AND RESULTS OF OPERATIONS

OVERVIEW

The Company operates under the Internal Revenue Code of 1986, as amended (the "Code"), as an indefinite life real estate investment trust ("REIT"). The Company, a self-managed and self-administered REIT, follows a general growth strategy that integrates owning, managing, and developing income-producing real estate properties and mortgages associated with the delivery of healthcare services throughout the United States. Management believes that by providing related real estate services, it can differentiate the Company's competitive market position, expand its asset base and increase revenue.

Substantially all of the Company's revenues are derived from rentals on its healthcare real estate property facilities, interest earned on mortgage loans and from the temporary investment of funds in short-term instruments and from management and development services. Leases and other financial support arrangements with respect to the Company's healthcare real estate facilities generally ensure that increased costs and expenses incurred with respect to the operation of the facilities will be borne by tenants and healthcare providers related to the facilities. The Company incurs operating and administrative expenses, principally compensation expense for its officers and other employees, office rental and related occupancy costs and various expenses incurred in the process of acquiring additional properties.

RESULTS OF OPERATIONS

1998 Compared to 1997

On October 15, 1998, the Company acquired by merger Capstone Capital Corporation ("Capstone"). The purchase price is summarized as follows (in thousands):

Common stock	\$ 532,554
Preferred stock	72,052
Cash and cash equivalents	8,330
Liabilities assumed	424,897
Total Purchase Price	<u>\$ 1,037,833</u>

The assets acquired in the Capstone merger are summarized as follows (in thousands):

Real estate properties	\$ 804,178
Mortgage notes receivable	211,590
Cash and cash equivalents	13,767
Other assets	8,298
Total Assets Acquired	<u>\$ 1,037,833</u>

The results of operations of the Company were significantly impacted by the Capstone merger. For the year ended December 31, 1998, net income increased \$12.3 million due to the Capstone merger. As a result of this transaction, the Company acquired 111 properties and 75 mortgages for a fair value of \$804.2 million and \$211.6 million, respectively. These investments resulted in additional master lease, straight line rent and property operating income, net of operating expenses, for the year of \$14.5 million, as well as, additional interest and other income of \$4.1 million, additional interest expense of \$2.0 million under the unsecured credit facility and depreciation and amortization expense of \$2.9 million. The Company also assumed Capstone's 6.55% and 10.5% convertible subordinated debentures and notes payable, with interest rates ranging from 7.625% to 9.0%, with a collective fair value of \$138.0 million which resulted in interest expense of \$1.4 million for the period October 15, 1998 through December 31, 1998.

For the year ended December 31, 1998, net income was \$40.5 million, or \$1.66 per basic share of common stock (\$1.63 per diluted share), on total revenues of \$93.1 million compared to net income of \$31.2 million, or \$1.71 per basic share of common stock

Management's Discussion and Analysis of Financial Condition
AND RESULTS OF OPERATIONS

(\$1.68 per diluted share), on total revenues of \$59.8 million, for the year ended December 31, 1997. Funds from operations ("FFO") was \$59.7 million, or \$2.48 per basic share (\$2.44 per diluted share), for the year ended December 31, 1998 compared to \$42.3 million, or \$2.32 per basic share (\$2.28 per diluted share), in 1997.

(Dollars in thousands)

	1998	1997
REVENUES		
Master lease rental income	\$ 48,777	\$ 40,298
Property operating income	35,269	14,631
Total rental income	84,046	54,929
Management fees	2,056	1,499
Interest and other income	7,002	3,368
	93,104	59,796
EXPENSES		
General and administrative	11,126	3,807
Property operating expenses	11,978	5,008
Interest	13,057	7,969
Depreciation	15,965	11,468
Amortization	499	332
	52,625	28,584
Net Income	\$ 40,479	\$ 31,212

Total revenues for the year ended December 31, 1998 compared to the year ended December 31, 1997, increased \$33.3 million or 55.7%. Excluding the impact of the Capstone merger, which is discussed above, total revenues for the year ended December 31, 1998 compared to the year ended December 31, 1997, increased \$13.5 million. This increase is primarily due to increases in master lease rental income and property operating income. During 1998, the Company acquired nine properties and two properties under construction were completed and began operations. Certain leases acquired from Capstone contain escalating rental rates over the life of the leases, however, rental income is recognized as earned on a straight line basis over the life of the lease. Therefore, \$1.3 million of accrued straight line rental income is included in master lease rental income.

Third party property management fees for the year ended December 31, 1998, compared to the year ended December 31, 1997, increased \$0.6 million or 37.2%, due primarily to the addition of over 60 buildings with approximately 2.6 million square feet under property management.

Interest and other income for the year ended December 31, 1998 was \$7.0 million compared to \$3.4 million for the year ended December 31, 1997. Excluding the effect of the Capstone merger, interest and other income decreased \$0.2 million from the year ending December 31, 1997 to the year ending December 31, 1998. During the first quarter of 1997, the Company completed a secondary offering and maintained a higher than normal average cash and short-term investment balance.

Total expenses for the year ended December 31, 1998 were \$52.6 million compared to \$28.6 million for the year ended December 31, 1997, an increase of \$24.0 million or 84.1%. General and administrative expenses increased \$7.3 million. \$6.3 million of this increase represents the write-off of certain capitalized software costs, leasehold improvements, organization and other deferred costs which were deemed to have no continuing value and incremental internal costs incurred in conjunction with the Capstone merger. The remaining \$1.0 million increase is primarily due to the increased number of employees for property management, development, and other service-based activities.

Property operating expenses for the year ended December 31, 1998 compared to the year ended December 31, 1997 increased \$7.0 million. Property operating expenses rose during 1998 for the same reasons property operating income increased.

Interest expense for the year ended December 31, 1998 compared to the year ended December 31, 1997 increased \$5.1 million. At the time of the Capstone merger, the Company repaid the outstanding balances under both Capstone's and the Company's own

Management's Discussion and Analysis of Financial Condition
AND RESULTS OF OPERATIONS - CONTINUED

unsecured credit facilities and entered into a \$265.0 million unsecured credit facility and a \$200.0 million unsecured term loan. During the year ended December 31, 1997, the Company had an average outstanding balance under its unsecured credit facility of \$18.1 million compared to an average outstanding balance under its unsecured credit facility and term loan during the year ended December 31, 1998 of \$82.3 million. In addition, Capstone's subordinated convertible debentures and notes payable were assumed by the Company in the merger and capitalized interest increased \$0.7 million from 1997 to 1998.

Depreciation expense increased \$4.5 million due to the significant increase during 1998 in depreciable properties. Excluding the effect of the Capstone merger, depreciation expense increased \$1.6 million. This increase primarily resulted from the acquisition of nine properties during 1998 and the completion in 1998 of two properties under construction at December 31, 1997.

1997 Compared to 1996

For the year ended December 31, 1997, net income was \$31.2 million, or \$1.71 per basic share of common stock (\$1.68 per diluted share), on total revenues of \$59.8 million compared to net income of \$19.7 million, or \$1.52 per basic share of common stock (\$1.49 per diluted share), on total revenues of \$38.6 million, for the year ended December 31, 1996. FFO was \$42.3 million, or \$2.32 per basic share (\$2.28 per diluted share), for the year ended December 31, 1997 compared to \$28.0 million, or \$2.15 per basic share (\$2.11 per diluted share), in 1996.

(Dollars in thousands)

	1997	1996
REVENUES		
Master lease rental income	\$ 40,298	\$ 35,329
Property operating income	14,631	1,338
Total rental income	54,929	36,667
Management fees	1,499	1,111
Interest and other income	3,368	796
	<u>59,796</u>	<u>38,574</u>
EXPENSES		
General and administrative	3,807	2,233
Property operating expenses	5,008	269
Interest	7,969	7,344
Depreciation	11,468	8,652
Amortization	332	344
	<u>28,584</u>	<u>18,842</u>
Net Income	<u>\$ 31,212</u>	<u>\$ 19,732</u>

Total revenues for the year ended December 31, 1997 compared to the year ended December 31, 1996, increased \$21.2 million or 55%. The increase is primarily due to master lease rental income and property operating income from 18 properties acquired and two developments completed during the latter part of the fourth quarter of 1996 and the year ended December 31, 1997, representing an investment of approximately \$102.3 million. Third party property management fees for the year ended December 31, 1997, compared to the year ended December 31, 1996, increased \$0.4 million or 35%, due to the net effect of adding third party management contracts in Florida and Virginia and converting six master leased properties (accounted for as third party management) to Company owned and managed properties. Interest and other income for the year ended December 31, 1997 was \$3.4 million compared to \$0.8 million for the year ended December 31, 1996. During the first quarter of 1997, the Company completed a secondary offering and maintained an average cash and short-term investment balance of \$26.1 million during the year ended December 31, 1997 compared to a \$2.2 million average cash balance during the year ended December 31, 1996.

Total expenses for the year ended December 31, 1997 were \$28.6 million compared to \$18.8 million for the year ended December 31, 1996, an increase of \$9.8 million or 52%. General and administrative expenses increased \$1.6 million, primarily due to an

Management's Discussion and Analysis of Financial Condition
AND RESULTS OF OPERATIONS - CONTINUED

increase in payroll associated with the large increase in property management and other service-based activities. Property operating expenses for the year ended December 31, 1997, compared to the year ended December 31, 1996 increased \$4.7 million due to the conversion from master leased or acquisition of 19 Company owned and managed properties during the latter part of the fourth quarter of 1996 and the year ended December 31, 1997. Interest expense for the year ended December 31, 1997, compared to the year ended December 31, 1996, increased \$0.6 million due to the net effect of a decrease in average outstanding debt balance and a decrease in average construction in progress, which reduced capitalized interest by approximately \$1.4 million. Depreciation expense increased \$2.8 million due to the acquisition of 18 properties and completion of two properties discussed in the preceding paragraph.

Liquidity and Capital Resources

On October 15, 1998, at the time of the Capstone merger, the Company repaid the outstanding balances under both Capstone's and the Company's own unsecured credit facilities and entered into a \$265.0 million unsecured credit facility (the "Unsecured Credit Facility") with ten commercial banks. The Unsecured Credit Facility bears interest at LIBOR plus 1.05%, payable quarterly, and matures on October 15, 2001. In addition, the Company will pay, quarterly, a commitment fee of 0.225 of 1% on the unused portion of funds available for borrowings. At December 31, 1998, the Company had available borrowing capacity of \$94.0 million under the Unsecured Credit Facility.

At the time of the Capstone merger, the Company entered into a \$200.0 million unsecured term loan (the "Term Loan Facility") with NationsBank. The Term Loan Facility bears interest at LIBOR plus 1.05%, payable quarterly, and matures on April 16, 1999. The Company intends to exercise the option to extend the maturity date for an additional six month period in consideration of an extension payment of .30 of 1%. Since the Capstone merger, the Company has received proceeds from the sale of assets and from mortgage prepayments of approximately \$29.0 million and reduced the unpaid balance of the Term Loan Facility to approximately \$171.0 million. The Company expects that the Term Loan Facility will be repaid by internally generated cash flow, proceeds from the sale of additional assets, and proceeds from additional prepayments of mortgage notes receivable. If such sources of funds are insufficient to repay the Term Loan Facility in full, any unpaid balance is expected to be refinanced.

In 1995, the Company privately placed \$90.0 million of unsecured notes (the "Unsecured Notes") bearing interest at 7.41%, payable semi-annually (\$5.0 million for 1999), and mature on September 1, 2002. The Company must repay \$18.0 million of principal annually. At December 31, 1998, \$72.0 million was outstanding under the Unsecured Notes.

The Company assumed in the Capstone merger 10.5% Convertible Subordinated Debentures and 6.55% Convertible Subordinated Debentures having an aggregate principal balance of \$78.3 million. In 1999 the Company will pay \$5.3 million of interest on these subordinated debentures.

In 1998, the Company sold an aggregate of 1.4 million shares of its common stock. The Company received an aggregate of \$37.1 million in net proceeds from these transactions. The proceeds were used to repay debt and were also used for acquisitions, developments and general corporate purposes.

As of March 1, 1999 the Company can issue an aggregate of approximately \$106.4 million of securities remaining under currently effective registration statements. Due to the current market price of the Company's stock, the Company does not presently plan to offer securities under such registration statements. The Company may, under certain circumstances, borrow additional amounts in connection with the renovation or expansion of its properties, the acquisition or development of additional properties or, as necessary, to meet distribution requirements for REITs under the Code. The Company may raise additional capital or make investments by issuing, in public or private transactions, its equity and debt securities, but the availability and terms of any such issuance will depend upon market and other conditions.

The Company generated net cash from operations in 1998 of \$23.5 million, a decrease of \$16.9 million from 1997 and \$5.9 million from 1996. The decrease from 1997 results primarily from the payment of accounts payable and accrued liabilities assumed in the Capstone merger. Other significant sources and uses of cash for investing and financing activities are set forth in the Statement of Cash Flows in the Consolidated Financial Statements.

In October 1998, the Company purchased an ancillary hospital facility in Lititz, Pennsylvania for approximately \$4.2 million from proceeds under the Unsecured Credit Facility.

Management's Discussion and Analysis of Financial Condition
AND RESULTS OF OPERATIONS - CONTINUED

As of December 31, 1998, the Company had an investment of approximately \$72.2 million in 13 build-to-suit developments in progress, which have a total remaining funding commitment of approximately \$34.7 million. The Company also had 21 mortgages under development at December 31, 1998, which have a total remaining funding commitment of approximately \$28.2 million. The Company intends to fund those commitments with funds available from operations and proceeds from the Unsecured Credit Facility.

At December 31, 1998, the Company had stockholders' equity of \$1.0 billion. The debt to total capitalization ratio was approximately .365 to 1 at March 1, 1999.

On January 26, 1999, the Company declared an increase in its quarterly common stock dividend from \$0.525 per share (\$2.10 annualized) to \$0.53 per share (\$2.12 annualized) payable to stockholders of record on February 5, 1999. This dividend was paid on February 16, 1999. The Company presently plans to continue to pay its quarterly common stock dividends, with increases consistent with its current practice. In the event that the Company cannot make additional investments in 1999 because of an inability to obtain new capital by issuing equity and debt securities, the Company will continue to be able to pay its common stock dividends in a manner consistent with its current practice. Should access to new capital not be available, the Company is uncertain of its ability to increase its quarterly common stock dividends.

During 1999, the Company will pay quarterly dividends on its 8 7/8% Series A Cumulative Preferred Stock in the annualized amount of \$2.22 per share.

Under the terms of the leases and other financial support agreements relating to most of the properties, tenants or healthcare providers are generally responsible for operating expenses and taxes relating to the properties. As a result of these arrangements, with limited exceptions not material to the performance of the Company, the Company does not believe that it will be responsible for any major expenses in connection with the properties during the respective terms of the agreements. The Company anticipates entering into similar arrangements with respect to additional properties it acquires or develops. After the term of the lease or financial support agreement, or in the event the financial obligations required by the agreement are not met, the Company anticipates that any expenditures it might become responsible for in maintaining the properties will be funded by cash from operations and, in the case of major expenditures, possibly by borrowings. To the extent that unanticipated expenditures or significant borrowings are required, the Company's cash available for distribution and liquidity may be adversely affected.

The Company plans to continue to meet its liquidity needs, including funding additional investments in 1999, paying its quarterly dividends (with increases consistent with its current practices) and funding the debt service on the 10.50% Convertible Subordinated Debentures, the 6.55% Convertible Subordinated Debentures, the Unsecured Credit Facility, the Term Loan Facility, and the Unsecured Notes from its operating revenues, the proceeds of mortgage loan repayments, sales of real estate investments and mortgage notes receivable, and debt market financings. The Company believes that its liquidity and sources of capital are adequate to satisfy its cash requirements. The Company, however, cannot be certain that these sources of funds will be available at a time and upon terms acceptable to the Company in sufficient amounts to meet its liquidity needs.

Impact of Inflation

Inflation has not significantly affected the earnings of the Company because of the moderate inflation rate and the fact that most of the Company's leases and financial support arrangements require tenants and sponsors to pay all or some portion of the increases in operating expenses, thereby reducing the risk of any adverse effects of inflation to the Company. In addition, inflation will have the effect of increasing the gross revenue the Company is to receive under the terms of the leases and financial support arrangements. Leases and financial support arrangements vary in the remaining terms of obligations from three to 20 years, further reducing the risk of any adverse effects of inflation to the Company. The Unsecured Credit Facility bears interest at a variable rate; therefore, the amount of interest payable under the Unsecured Credit Facility will be influenced by changes in short-term rates, which tend to be sensitive to inflation.

Real Estate Investment Trust Tax Proposals

The Clinton Administration's Fiscal Year 2000 Budget proposal includes three provisions of interest to REITs in general, two of which potentially affect the Company. These provisions (i) modify the structure of businesses which are indirectly conducted by the Company and could limit or negatively affect the Company's future ability to engage indirectly in certain business activities that cannot be conducted directly by the Company; and (ii) repeal tax-free conversion of large C corporations to S corporations, which would

Management's Discussion and Analysis of Financial Condition
AND RESULTS OF OPERATIONS - CONTINUED

effectively tax the built-in gains of C corporations prospectively electing tax-free reorganizations, thus affecting an acquisition format employed by the Company in the past. The President's Budget proposal includes numerous other revenue provisions, none of which would materially impact the Company in the event of their adoption. The last action on the President's Year 2000 Budget proposal was the release by the Joint Committee on Taxation's "Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal" on February 22, 1999. Congress has yet to debate the broader implications of the President's Year 2000 Budget proposals, so there is no way to predict the outcome of these proposals or the eventual economic effect of these proposals on the Company if these proposals are enacted.

Year 2000 Issue

The Year 2000 ("Y2K") issue is the result of computer programs being written using two digits rather than four to define the applicable year. Computer programs or hardware that have date-sensitive software or embedded chips may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in a system failure or miscalculations causing disruptions of operations, including, among other things, a temporary inability to process transactions or engage in normal business activities. The Y2K issue relating to the Company's corporate information technology systems, including applications employed with respect to the real estate investments of the Company, could have a material impact on the operations of the Company if compliance is not completed in a timely manner. The Company's plan to resolve the Y2K issue involves four phases: assessment, remediation, testing, and implementation.

Status of Y2K Issue Relating to the Company's Information Technology Systems

Based on the Company's completed assessment of its own software and hardware relating to the Company's corporate information technology systems, the Company determined that it is necessary to modify or replace certain portions of its software and hardware so that those systems will properly utilize dates beyond December 31, 1999. The Company presently believes that, with actual and planned modifications or replacements of existing software and certain hardware, material damage to the Company resulting from the Y2K issue relating to the Company's corporate information technology systems will be fully mitigated by March 31, 1999. The Y2K issue could have a material impact on the operations of the Company if such modifications and replacements are not properly made or are not completed timely. The Company does not expect to incur costs of more than \$50,000 in this effort.

In the ordinary course of events, the Company has purchased new file servers and replaced many older desktop microcomputers with new equipment, all of which are certified to be Y2K compliant by the manufacturers. Additionally, "patches" are available from the manufacturers that will bring certain equipment into compliance, and will be installed in desktop systems as necessary. Two non-compliant file servers currently used for data storage are scheduled to be replaced by March 31, 1999.

The Company's assessment of computer operating systems and software indicated that the Company's significant information systems programs should not require remediation. Accordingly, the Company does not believe that the Y2K presents a material exposure as it relates to the Company's services. The Company requested, and has subsequently received, certification from all of its significant software and operating systems vendors that the versions of their products currently installed are fully Y2K compliant.

The Company has yet to complete Y2K testing of its information systems, operating systems and other software. However, the Company expects that it will be completed in 1999. While the Company does not anticipate that testing will disprove its vendors' certifications of compliance, remediation of any systems or software that signal potential Y2K problems will begin immediately upon discovery. The Company will utilize both internal and external resources to reprogram or replace, test, and implement the software and operating equipment for Y2K modifications.

Y2K Issue Compliance of Vendors and Clients

The Company has questioned its significant suppliers and clients as to their respective responses to the Y2K issue. To date, the Company is not aware of any suppliers or clients with a Y2K issue that would materially impact the Company's results of operations, liquidity, or capital resources; however, the Company has no means of ensuring that those parties will in fact be Y2K compliant. The Company has not received responses from all of its inquiries and has renewed its solicitation for written disclosures in compliance with the Year 2000 Information and Readiness Disclosure Act. The inability of suppliers and clients to complete their Y2K resolution

Management's Discussion and Analysis of Financial Condition
AND RESULTS OF OPERATIONS - CONTINUED

process in a timely fashion could materially impact the Company. The Company cannot presently determine the effect of non-compliance by the Company's suppliers and clients.

While the Company does have ongoing relationships with third-party payors, suppliers, vendors, and others, it has no systems that interface directly with third party vendors other than its accounts with financial institutions and the Company's payroll system interfaces directly with a vendor. The Company is in the process of working with these institutions and its payroll vendor to ensure that the Company's systems that interface directly with them are Y2K compliant by December 31, 1999.

The Company will also have Y2K issue exposure in non-information technology applications with respect to its real estate investments. Computer technology employed in elevators, security systems, electrical systems and similar applications involved in the operations of real estate properties may cause interruptions of services with respect to those properties on and after January 1, 2000. The terms of agreements in place with respect to the bulk of the real estate investments held by the Company impose the economic cost of compliance upon third party lessees and mortgagees; consequently, the costs to the Company for Y2K remediation should not be material. The Company is in the process of inquiring and assessing responses of those third parties as to their respective Y2K issue readiness and will require that those third parties undertake the necessary actions to ensure Y2K compliance of the properties.

Finally, the Y2K issue may affect the greater business environment in which the Company operates. Due to the general uncertainty surrounding the Y2K readiness of third parties, including federal and state governments, the effect of the Y2K issue on the Company's lessees and mortgagees, as well as the Company itself cannot be gauged. For example, the General Accounting Office has reported that the systems employed in managing Medicare reimbursements is not likely to be Y2K compliant in time to ensure the delivery of uninterrupted benefits and services. Delay in reimbursements could negatively affect the Company's lessees and mortgagees, resulting in a delay in receipt of payments owed to the Company's clients, with the further possibility of delay in payments due by those clients to the Company. Similar consequences could result from the failure of other parties having such an indirect relationship with the Company.

Management of the Company believes it has an effective program in place to resolve the Y2K issue in a timely manner. As noted above, the Company has not yet completed all necessary phases of the Y2K program. In the event that the Company does not complete any additional phases, the Company may be unable to collect receipts in a timely manner. In addition, disruptions in the economy generally resulting from Y2K issues could also materially adversely affect the Company. The Company could be subject to litigation for computer systems failure, for example, equipment shutdown or failure to properly date business records. The Company cannot reasonably estimate the amount of potential liability and lost revenue at this time. The most reasonable likely worst case Y2K scenario is that business disruption could occur with respect to third-party payors, suppliers, or vendors who fail to become Y2K compliant, and disruptions in the economy generally resulting from Y2K issues could adversely impact the Company.

The Company has contingency plans for certain critical applications and is working on such plans for other non-critical applications. These contingency plans involve, among other actions, manual workarounds, increasing inventories, and adjusting staffing strategies. The Company plans to maintain an ongoing evaluation of its Y2K compliance readiness and contingent plans throughout 1999.

Market Risk

The Company is exposed to market risk, in the form of changing interest rates, on its debt and mortgage notes receivable. The Company has no market risk with respect to derivatives and foreign currency fluctuations. Management uses daily monitoring of market conditions and analytical techniques to manage this risk.

At December 31, 1998, the fair value of the Company's fixed rate debt approximates its carrying value of \$209.7 million. At December 31, 1998, the fixed rate debt assumed in the Capstone merger totaled \$137.7 million. This debt was recorded at fair value at the acquisition date of October 15, 1998. Market risk, expressed as the hypothetical increase in fair value resulting from a one percentage point decrease in interest rates, is \$7.2 million for aggregate fixed rate debt.

At December 31, 1998, the fair value of the Company's variable rate debt approximates its carrying value of \$350.2 million. By definition, because the interest rate is variable, the carrying amount of variable rate debt will always approximate its fair value. Assuming the \$350.2 million carrying value is held constant, the hypothetical increase in interest expense resulting from a one per-

Management's Discussion and Analysis of Financial Condition
AND RESULTS OF OPERATIONS - CONTINUED

centage point increase in interest rates, would be \$3.5 million. The interest rate on variable rate debt is based on and variable with European interbank interest rates (LIBOR).

At December 31, 1998, the fair value of the Company's mortgage notes receivable approximates its carrying value of \$228.5 million. These assets, acquired in the Capstone merger, were recorded at fair value at the acquisition date of October 15, 1998. Market risk, expressed as the hypothetical decrease in fair value resulting from a one percentage point increase in interest rates, is \$10.7 million on the aggregate portfolio of mortgage notes receivable.

Cautionary Language Regarding Forward Looking Statements

Statements in this Annual Report on Form 10-K that are not historical factual statements are "forward looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. The statements include, among other things, statements regarding the intent, belief or expectations of the Company and its officers and can be identified by the use of terminology such as "may", "will", "expect", "believe", "intend", "plan", "estimate", "should" and other comparable terms. In addition, the Company, through its senior management, from time to time makes forward looking oral and written public statements concerning the Company's expected future operations and other developments. Shareholders and investors are cautioned that, while forward looking statements reflect the Company's good faith beliefs and best judgment based upon current information, they are not guarantees of future performance and are subject to known and unknown risks and uncertainties. Actual results may differ materially from the expectations contained in the forward looking statements as a result of various factors. For a more detailed discussion of these, and other factors, see pages 25 through 29 of Item 1 of the Company's Form 10-K for the fiscal year ended December 31, 1998.

Report of
I N D E P E N D E N T A U D I T O R S

**The Board of Directors and Stockholders
Healthcare Realty Trust Incorporated**

We have audited the accompanying consolidated balance sheets of Healthcare Realty Trust Incorporated as of December 31, 1998 and 1997, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Healthcare Realty Trust Incorporated at December 31, 1998 and 1997, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1998 in conformity with generally accepted accounting principles.

Nashville, Tennessee
January 29, 1999,
except for Note 14,
as to which the date is February 17, 1999.

Consolidated
BALANCE SHEETS

<i>(Dollars in thousands)</i>	December 31,	
	1998	1997
ASSETS		
Real estate properties:		
Land	\$ 140,617	\$ 58,424
Buildings and improvements	1,169,941	423,618
Personal property	4,825	4,492
Construction in progress	72,172	14,457
	1,387,555	500,991
Less accumulated depreciation	(50,116)	(34,718)
Total real estate properties, net	1,337,439	466,273
Cash and cash equivalents	14,411	5,325
Mortgage notes receivable	228,542	4,708
Other assets, net	35,031	12,208
Total assets	\$ 1,615,423	\$ 488,514
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Notes and bonds payable	\$ 559,924	\$ 101,300
Accounts payable and accrued liabilities	25,824	6,879
Other liabilities	11,971	3,863
Total liabilities	597,719	112,042
Commitments	-	-
Stockholders' equity:		
Preferred stock, \$.01 par value; 50,000,000 shares authorized; issued and outstanding, 1998 - 3,000,000; 1997 - none	30	-
Common stock, \$.01 par value; 150,000,000 shares authorized; issued and outstanding, 1998 - 39,792,775; 1997 - 19,285,927	398	193
Additional paid-in capital	1,049,039	402,607
Deferred compensation	(10,662)	(7,689)
Cumulative net income	129,346	88,867
Cumulative dividends	(150,447)	(107,506)
Total stockholders' equity	1,017,704	376,472
Total liabilities and stockholders' equity	\$ 1,615,423	\$ 488,514

Consolidated
STATEMENTS OF INCOME

	Year Ended December 31,		
	1998	1997	1996
<i>(Dollars in thousands, except per share data)</i>			
REVENUES			
Master lease rental income	\$ 48,777	\$ 40,298	\$ 35,329
Property operating income	35,269	14,631	1,338
Management fees	2,056	1,499	1,111
Interest and other income	7,002	3,368	796
	<u>93,104</u>	<u>59,796</u>	<u>38,574</u>
EXPENSES			
General and administrative	11,126	3,807	2,233
Property operating expenses	11,978	5,008	269
Interest	13,057	7,969	7,344
Depreciation	15,965	11,468	8,652
Amortization	499	332	344
	<u>52,625</u>	<u>28,584</u>	<u>18,842</u>
Net income	<u>\$ 40,479</u>	<u>\$ 31,212</u>	<u>\$ 19,732</u>
Net income per share - Basic	<u>\$ 1.66</u>	<u>\$ 1.71</u>	<u>\$ 1.52</u>
Net income per share - Diluted	<u>\$ 1.63</u>	<u>\$ 1.68</u>	<u>\$ 1.49</u>
Shares outstanding - Basic	<u>24,043,942</u>	<u>18,222,243</u>	<u>13,014,286</u>
Shares outstanding - Diluted	<u>24,524,600</u>	<u>18,572,492</u>	<u>13,261,291</u>

Consolidated
STATEMENTS OF STOCKHOLDERS' EQUITY

<i>(Dollars in thousands, except per share data)</i>	Preferred Stock	Common Stock	Additional Paid-In Capital	Deferred Compensation	Cumulative Net Income	Cumulative Dividends	Total Stockholder's Equity
Balance at December 31, 1995	-	\$ 130	\$ 243,419	\$ (478)	\$ 37,923	\$ (46,546)	\$ 234,448
Issuance of stock	-	7	16,584	-	-	-	16,591
Shares awarded as deferred stock compensation	-	2	4,611	(4,613)	-	-	-
Deferred stock compensation amortization	-	-	-	389	-	-	389
Net income	-	-	-	-	19,732	-	19,732
Dividends (\$1.91 per share)	-	-	-	-	-	(25,196)	(25,196)
Balance at December 31, 1996	-	139	264,614	(4,702)	57,655	(71,742)	245,964
Issuance of stock	-	52	134,113	-	-	-	134,165
Shares awarded as deferred stock compensation	-	2	3,880	(3,882)	-	-	-
Deferred stock compensation amortization	-	-	-	895	-	-	895
Net income	-	-	-	-	31,212	-	31,212
Dividends (\$1.99 per share)	-	-	-	-	-	(35,764)	(35,764)
Balance at December 31, 1997	-	193	402,607	(7,689)	88,867	(107,506)	376,472
Issuance of common stock	-	202	567,734	-	-	-	567,936
Issuance of preferred stock	\$ 30	-	71,956	-	-	-	71,986
Shares awarded as deferred stock compensation	-	2	4,331	(4,274)	-	-	59
Shares issued from warrants	-	1	2,411	-	-	-	2,412
Deferred stock compensation amortization	-	-	-	1,301	-	-	1,301
Net income	-	-	-	-	40,479	-	40,479
Dividends – common (\$2.07 per share)	-	-	-	-	-	(42,386)	(42,386)
Dividends – preferred (\$0.46224 per share)	-	-	-	-	-	(555)	(555)
Balance at December 31, 1998	\$ 30	\$ 398	\$1,049,039	\$(10,662)	\$129,346	\$ (150,447)	\$ 1,017,704

See accompanying notes.

Consolidated Statements of
CASH FLOWS

<i>(In thousands)</i>	Year Ended December 31,		
	1998	1997	1996
OPERATING ACTIVITIES			
Net income	\$ 40,479	\$ 31,212	\$ 19,732
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation and amortization	17,122	12,073	9,017
Deferred compensation	1,247	672	377
Increase (decrease) in deferred income	(907)	114	(29)
Increase in other assets	(7,957)	(2,346)	(933)
Increase (decrease) in accounts payable and accrued liabilities	(27,906)	(1,340)	1,222
Increase in straight line rent	(1,265)	-	-
One time charge to operations	3,373	-	-
Gain on sales of real estate	(675)	-	-
Net cash provided by operating activities	23,511	40,385	29,386
INVESTING ACTIVITIES			
Acquisition and development of real estate properties	(94,066)	(61,813)	(63,069)
Acquisition and development of mortgages	(12,439)	(4,708)	-
Proceeds from sale of real estate	11,895	-	-
Receipt (disbursement) of security deposits	134	(976)	(390)
Purchase of Capstone, net of cash acquired	5,437	-	-
Net cash used in investing activities	(89,039)	(67,497)	(63,459)
FINANCING ACTIVITIES			
Borrowings on notes and bonds payable	425,000	35,300	101,899
Repayments on notes and bonds payable	(338,689)	(102,618)	(50,903)
Increase in notes receivable	(6,439)	-	-
Dividends paid	(42,941)	(35,764)	(25,196)
Proceeds from issuance of common stock	37,683	134,165	484
Net cash provided by financing activities	74,614	31,083	26,284
Increase (decrease) in cash and cash equivalents	9,086	3,971	(7,789)
Cash and cash equivalents, beginning of period	5,325	1,354	9,143
Cash and cash equivalents, end of period	\$ 14,411	\$ 5,325	\$ 1,354

See accompanying notes.

Notes to
CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

The Company invests in healthcare-related properties and mortgages located throughout the United States, including ancillary hospital facilities, physician clinics, ambulatory surgery centers, medical office buildings, inpatient rehab facilities, assisted living facilities, skilled nursing facilities, comprehensive ambulatory care centers, and other facilities. The Company provides management, leasing and build-to-suit development, and capital for the construction of new facilities as well as for the acquisition of existing properties. As of December 31, 1998, the Company had invested or committed to invest in 280 properties (the "Properties") located in 130 markets nationwide, affiliated with 61 healthcare-related entities.

Basis of Presentation

The financial statements include the accounts of the Company, its wholly owned subsidiaries and certain other affiliated corporations with respect to which the Company controls the operating activities and receives substantially all economic benefits. Significant intercompany accounts and transactions have been eliminated.

Use of Estimates in Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Actual results may differ from those estimates.

Real Estate Properties

Real estate properties are recorded at cost. Transaction fees and acquisition costs are netted with the purchase price as appropriate. The cost of real properties acquired is allocated between land, buildings, and personal property based upon estimated market values at the time of acquisition. Depreciation is provided for on a straight-line basis over the following estimated useful lives:

Buildings and improvements	31.5 or 39.0 years
Personal property	3.0 to 7.0 years

Mortgage Notes Receivable

Mortgage notes receivable, substantially all of which were acquired in the Capstone merger (see Note 2), were recorded at their fair value at the date of acquisition. The mortgage portfolio has a weighted average maturity of approximately 7 years. Interest rates, which range from 8.1% to 12.5%, are generally adjustable each year to reflect actual increases in the Consumer Price Index subject to a minimum increase of 4%. Substantially all of the mortgages are subject to a prepayment penalty.

Cash and Cash Equivalents

Short-term investments with maturities of three months or less at date of purchase are classified as cash equivalents.

Federal Income Taxes

No provision has been made for federal income taxes. The Company intends at all times to qualify as a real estate investment trust under Sections 856 through 860 of the Internal Revenue Code of 1986, as amended. The Company must distribute at least 95% of its real estate investment trust taxable income to its stockholders and meet other requirements to continue to qualify as a real estate investment trust.

Other Assets

Other assets consist primarily of receivables, deferred costs and intangible assets. Deferred financing costs are amortized over the term of the related credit facility using the interest method. Intangible assets are amortized straight-line over the applicable lives of the assets, which range from four to forty years. Accumulated amortization was \$2.5 million and \$1.5 million at December 31, 1998 and 1997, respectively.

Revenue Recognition

Rental income related to noncancelable operating leases is recognized as earned over the life of the lease agreements on a straight-line basis. Any additional rent, as defined in each lease agreement, is recognized as earned.

Notes to
CONSOLIDATED FINANCIAL STATEMENTS

Stock Issued to Employees

The Company has elected to follow Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations in accounting for its stock issued to employees.

Net Income Per Share

Earnings per share have been restated for Financial Accounting Standards Board Statement No. 128, "Earnings per Share".

Basic earnings per share is calculated using weighted average shares outstanding less issued and outstanding but unvested restricted shares of Common Stock.

Diluted earnings per share is calculated using weighted average shares outstanding plus the dilutive effect of convertible debt and restricted shares of Common Stock and outstanding stock options, using the treasury stock method and the average stock price during the period.

Significant Accounting Pronouncements

In June 1997, the Financial Accounting Standards Board ("FASB") issued Financial Accounting Standards Board Statement No. 130, "Reporting Comprehensive Income" ("FAS 130"), which establishes standards for reporting and displaying comprehensive income and its components in a full set of general purpose financial statements. The Company adopted FAS 130 effective for its fiscal year ended December 31, 1998. Comprehensive income is the same as net income for the Company.

In June 1997, the FASB issued Financial Accounting Standards Board Statement No. 131, "Disclosures about Segments of an Enterprise and Related Information" ("FAS 131"). The Company adopted FAS 131 effective for its fiscal year ended December 31, 1998. The adoption of FAS 131 had no impact on the Company, as the Company operates in only one business segment, consisting of investments in healthcare related-related properties and mortgages throughout the United States.

Reclassification

Certain reclassifications have been made in the financial statements for the years ended 1997 and 1996 to conform to the 1998 presentation. These reclassifications had no effect on the results of operations as previously reported.

2. CAPSTONE MERGER

On June 8, 1998, the Company announced a definitive agreement to acquire Capstone Capital Corporation ("Capstone"). The merger was consummated on October 15, 1998. Pursuant to the merger agreement, the Company acquired Capstone in a stock-for-stock merger in which the stockholders of Capstone received a fixed ratio of .8518 shares of the Company's common stock and the holders of Capstone preferred stock received one share of the Company's voting preferred stock in exchange for each share of Capstone preferred stock. The Company issued 18,906,909 shares of common stock (See Note 11) and 3,000,000 shares of preferred stock. The transaction was accounted for as a purchase and resulted in no goodwill.

The purchase price is summarized as follows (in thousands):

Common stock	\$ 532,554
Preferred stock	72,052
Cash and cash equivalents	8,330
Liabilities assumed	424,897
Total Purchase Price	<u>\$ 1,037,833</u>

The assets acquired in the Capstone merger are summarized as follows (in thousands):

Real estate properties	\$ 804,178
Mortgage notes receivable	211,590
Cash and cash equivalents	13,767
Other assets	8,298
Total Assets Acquired	<u>\$ 1,037,833</u>

Notes to
C O N S O L I D A T E D F I N A N C I A L S T A T E M E N T S

The unaudited proforma results of operations for the two years ended December 31, 1998 and 1997, assuming that the Capstone merger had occurred as of the beginning of each of those periods are (dollars in thousands, except for per share data):

	1998	1997
Revenues	\$ 168,721	\$ 116,974
Net income	\$ 73,186	\$ 54,234
Net income per share - Basic	\$ 1.74	\$ 1.39
Net income per share - Diluted	\$ 1.72	\$ 1.38

3. REAL ESTATE PROPERTY LEASES

The Company's properties are generally leased or supported pursuant to noncancelable, fixed-term operating leases and other financial support arrangements with expiration dates from 1999 to 2018. Some leases and financial arrangements provide for fixed rent renewal terms of five years, or multiples thereof, in addition to market rent renewal terms. The leases generally provide the lessee, during the term of the lease and for a short period thereafter, with an option and a right of first refusal to purchase the leased property. Each lease generally requires the lessee to pay minimum rent, additional rent based upon increases in the Consumer Price Index or increases in net patient revenues (as defined in the lease agreements), and all taxes (including property tax), insurance, maintenance and other operating costs associated with the leased property.

Amounts of rental income received from lessees who accounted for more than 10% of the Company's rental income for the three years in the period ended December 31, 1998 were (in thousands):

	1998	1997	1996
Tenet Healthcare	\$ 13,713	\$ 13,297	\$ 11,539
Columbia/HCA Healthcare Corporation	17,125	13,899	8,761
Phycor	8,899	8,218	2,160

Future minimum lease and guaranty payments under the noncancelable operating leases and financial support arrangements as of December 31, 1998 are as follows (in thousands):

1999	\$ 133,651
2000	134,104
2001	133,359
2002	132,682
2003	133,175
2004 and thereafter	796,270
	\$ 1,463,241

Notes to
CONSOLIDATED FINANCIAL STATEMENTS

4. REAL ESTATE PROPERTIES

The following table summarizes the Company's real estate properties by type of facility and by state as of December 31, 1998 (dollars in thousands).

	Number of Facilities ⁽¹⁾	Land	Buildings and Improvements and CIP	Personal Property	Total	Accumulated Depreciation
<i>Ancillary hospital facilities:</i>						
California	10	20,560	74,944	40	95,543	4,667
Florida	12	5,843	88,016	114	93,973	4,885
Texas	13	9,472	71,894	259	81,625	7,407
Virginia	7	11,718	54,225	87	66,031	3,870
Other states	18	12,265	146,488	59	158,811	5,811
	60	59,858	435,567	559	495,983	26,640
<i>Assisted Living Facilities:</i>						
New Jersey	2	0	13,527	0	13,527	0
Pennsylvania	7	1,017	27,654	0	28,671	90
Texas	8	0	71,153	0	71,153	301
Virginia	3	888	15,815	0	16,703	67
Other states	14	765	42,507	0	43,271	99
	34	2,670	170,656	0	173,325	557
<i>Ambulatory surgery centers:</i>						
Florida	2	0	16,179	0	16,179	69
Missouri	2	2,958	12,555	0	15,513	59
Nevada	1	940	2,861	0	3,801	327
Texas	1	510	1,514	15	2,040	278
Other states	3	541	3,370	9	3,919	165
	9	4,949	36,479	24	41,452	898
<i>Comprehensive ambulatory care:</i>						
California	1	2,571	19,281	0	21,853	82
Florida	6	5,866	36,367	0	42,233	764
Illinois	1	198	10,935	0	11,133	47
Texas	2	1,643	20,005	69	21,717	2,761
Other states	6	687	28,655	0	29,342	66
	16	10,965	115,243	69	126,278	3,720
<i>Inpatient rehabilitation facilities:</i>						
Alabama	1	0	17,388	0	17,388	108
Florida	1	0	11,483	0	11,483	72
Pennsylvania	6	4,675	105,461	0	110,136	521
Texas	1	1,095	11,578	0	12,673	49
Virginia	1	364	2,575	0	2,939	11
	10	6,134	148,485	0	154,619	761
<i>Medical office buildings:</i>						
Tennessee	1	3,212	5,518	0	8,730	58
Texas	1	166	1,810	0	1,976	202
Virginia	4	1,927	11,774	129	13,830	959
	6	5,305	19,102	129	24,536	1,219
<i>Physician clinics:</i>						
Alabama	2	2,382	8,419	0	10,801	37
Florida	9	12,097	41,844	51	53,991	2,424
Massachusetts	5	4,204	26,003	0	30,207	111
Texas	3	6,550	22,184	461	29,195	1,932
Other states	16	5,956	23,512	0	29,467	624
	35	31,189	121,962	512	153,661	5,128
<i>Skilled nursing facilities:</i>						
Colorado	3	2,885	23,522	0	26,408	1,059
Pennsylvania	3	478	20,098	0	20,576	86
Texas	2	1,795	17,670	0	19,466	887
Virginia	7	1,870	40,773	0	42,643	174
Other states	14	6,568	62,263	215	69,047	5,382
	29	13,596	164,326	215	178,140	7,588
<i>Other:</i>						
Alabama	1	182	8,569	8	8,759	1,520
Arizona	2	0	2,518	0	2,518	0
Michigan	1	4,692	9,751	0	14,443	42
Mississippi	1	538	3,718	30	4,285	519
Texas	1	539	5,737	0	6,277	26
	6	5,951	30,293	38	36,282	2,107
Corporate property	0	0	0	3,279	3,279	1,498
Total property	205	140,617	1,242,113	4,825	1,387,555	50,116

⁽¹⁾ Includes thirteen lessee developments.

Notes to
C O N S O L I D A T E D F I N A N C I A L S T A T E M E N T S

5. NOTES AND BONDS PAYABLE

Notes and bonds payable at December 31, 1998 and 1997 consisted of the following (in thousands):

	December 31,	
	1998	1997
Unsecured credit facility	\$ 171,000	\$ 11,300
Term loan facility	179,200	–
Unsecured notes	72,000	90,000
6.55% Convertible subordinated debentures, net	73,219	–
10.50% Convertible subordinated debentures, net	3,823	–
Mortgage notes	60,682	–
	\$ 559,924	\$ 101,300

Unsecured Credit Facility

On October 15, 1998, concurrent with the Capstone merger, the Company repaid the outstanding balances under both Capstone and its own unsecured credit facilities and entered into a \$265.0 million unsecured credit facility (the “Unsecured Credit Facility”) with ten commercial banks. The Unsecured Credit Facility bears interest at LIBOR plus 1.05%, payable quarterly, and matures on October 15, 2001. In addition, the Company will pay, quarterly, a commitment fee of 0.225 of 1% on the unused portion of funds available for borrowings. The Unsecured Credit Facility contains certain representations, warranties, and financial and other covenants customary in such loan agreements. At December 31, 1998, the Company had available borrowing capacity of \$94.0 million under the Unsecured Credit Facility.

Term Loan Facility

On October 15, 1998, concurrent with the Capstone merger, the Company entered into a \$200.0 million unsecured term loan (the “Term Loan Facility”) with NationsBank. The Term Loan Facility bears interest at LIBOR plus 1.05%, payable quarterly, and matures on April 16, 1999. The Company intends to exercise the option to extend the maturity date for an additional six month period in consideration of an extension payment of .30 of 1%. The Term Loan Facility contains certain representations, warranties and financial and other covenants customary in such loan agreements, as well as restrictions on dividend payments if minimum tangible capital requirements are not met. At December 31, 1998, the Company had no additional available borrowing capacity under the Term Loan Facility.

Unsecured Notes

On September 18, 1995, the Company privately placed \$90.0 million of unsecured notes (the “Unsecured Notes”) with 16 institutions. The Unsecured Notes bear interest at 7.41%, payable semi-annually, and mature on September 1, 2002. Beginning on September 1, 1998 and on each September 1 through 2002, the Company must repay \$18.0 million of principal. The note agreements pursuant to which the Unsecured Notes were purchased contain certain representations, warranties and financial and other covenants customary in such loan agreements.

Convertible Subordinated Debentures

As part of the Capstone merger, the Company assumed and recorded at fair value \$74.7 million aggregate face amount of 6.55% Convertible Subordinated Debentures (the “6.55% Debentures”) of Capstone. At December 31, 1998, the Company had approximately \$73.2 million aggregate principal amount of 6.55% Debentures outstanding with a face amount of \$74.7 million and unaccreted discount of \$1.5 million. Such rate of interest and accretion of discount represents a yield to maturity of 7.5% per annum (computed on a semiannual bond equivalent basis). The 6.55% Debentures are due on March 14, 2002, unless redeemed earlier by the Company or converted by the holder, and are callable on March 16, 2000. Interest on the 6.55% Debentures is payable on March 14 and September 14 in each year. The 6.55% Debentures are convertible into shares of common stock of the Company at the option of the holder at any time prior to redemption or stated maturity, at a conversion price rate of 33.6251 shares per \$1 thousand bond.

As part of the Capstone merger, the Company assumed and recorded at fair value \$3.75 million aggregate face amount of 10.5% Convertible Subordinated Debentures (the “10.5% Debentures”) of Capstone. At December 31, 1998, the Company had approximately \$3.8 million aggregate principal amount of 10.5% Debentures outstanding with a face amount of \$3.6 million and unamortized premium of \$0.2 million. Such rate of interest and amortization of premium represents a yield to maturity of 7.5% per annum (computed on a semiannual bond equivalent basis). The 10.5% Debentures are due on April 1, 2002, unless redeemed earlier by the Company or converted by the holder, and are callable on April 5, 2000. Interest on the 10.5% Debentures is payable on April 1 and October 1 in each year. The 10.5% Debentures are convertible into shares of common stock of the Company at the option of the holder at any time prior to redemption or stated maturity, at a conversion price rate of 52.8248 shares per \$1 thousand bond.

Notes to
CONSOLIDATED FINANCIAL STATEMENTS

Mortgage Notes

As part of the Capstone merger, the Company assumed six non-recourse mortgage notes payable, and the related collateral, as follows (*Dollars in millions*):

Mortgagor	Original Balance	Interest Rate	Collateral	Book Value	
				Of Collateral at December 31, 1998	Balance at December 31, 1998
Life Insurance Co.	\$ 23.3	8.500%	Ancillary hospital facility	\$ 40.1	\$ 22.9
Life Insurance Co.	4.7	7.625%	Ancillary hospital facility	10.2	4.5
Life Insurance Co.	17.1	8.125%	Two Ambulatory surgery centers & one ancillary hospital facility	35.0	16.8
Bank	17.0	8.250%	Six skilled nursing facilities	29.6	16.5
	<u>\$ 62.1</u>			<u>\$ 114.9</u>	<u>\$ 60.7</u>

The \$23.3 million note is payable in monthly installments of principal and interest based on a 30 year amortization with the final payment due in July 2026. The \$4.7 million note is payable in monthly installments of principal and interest based on a 20 year amortization with the final payment due in January 2017. The three notes totaling \$17.1 million are payable in monthly installments of principal and interest based on a 25 year amortization with a balloon payment of the unpaid balance in September 2004. The \$17.0 million note bears interest at 50 basis points in excess of the prime rate, and is payable in monthly installments of principal and interest based on a 25 year amortization with a balloon payment of the unpaid balance in June 2000.

Other Long-Term Debt Information

Future maturities of long-term debt are as follows (in thousands):

1999	\$ 197,644
2000	112,289
2001	189,684
2002	18,742
2003	805
2004 and thereafter	40,760
	<u>\$ 559,924</u>

During the years ended December 31, 1998, 1997 and the 1996, interest paid totaled \$11.1 million, \$9.0 million and \$8.4 million, and capitalized interest totaled \$1.4 million, \$0.7 million and \$2.2 million, respectively.

6. NON-CASH ACQUISITIONS OF REAL ESTATE

During November 1996, the Company acquired ten properties, in exchange for an aggregate of 687,692 shares of the Company's common stock (valued at \$16.1 million) and the assumption of \$20.6 million of notes payable, \$4.1 million of bonds payable and \$3.0 million of accounts payable and accrued liabilities, and incurred \$0.5 million in acquisition costs. In addition to the properties, representing an aggregate investment of \$44.1 million, the Company acquired \$0.2 million of other assets. The Company has repaid the notes and bonds payable assumed in the acquisition.

Notes to
C O N S O L I D A T E D F I N A N C I A L S T A T E M E N T S

7. STOCKHOLDERS' EQUITY

The Company had common and preferred shares outstanding as of the three years ended December 31, 1998 as follows:

	Year Ended December 31,		
	1998	1997	1996
Common Shares			
Balance, beginning of period	19,285,927	13,898,777	12,976,796
Issuance of stock	20,226,981	5,235,761	718,084
Shares awarded as deferred stock compensation	148,357	143,716	203,897
Shares issued from warrants	131,510	7,673	-
Balance, end of period	<u>39,792,775</u>	<u>19,285,927</u>	<u>13,898,777</u>
Preferred Shares			
Balance, beginning of period	-	-	-
Issuance of stock	3,000,000	-	-
Balance, end of period	<u>3,000,000</u>	<u>-</u>	<u>-</u>

On October 15, 1998, the Company issued 18,906,909 shares of Common stock and 3,000,000 shares of 8 7/8% Series A Voting Cumulative Preferred stock in a stock-for-stock merger with Capstone Capital Corporation (see Note 2).

In July 1998, warrants for 128,149 shares of common stock were exercised. The Company has no other warrants outstanding. During April and May 1998, the Company sold an aggregate of 49,953 shares of common stock to a single institutional investor. In February 1998, the Company participated in two unit investment trust offerings and sold an aggregate of 1,224,026 shares of its common stock. The Company received an aggregate of \$37.1 million in proceeds for these transactions. The proceeds were used to repay outstanding borrowings under the Unsecured Credit Facility, acquisitions, developments and for general corporate purposes.

Effective February 14, 1997, the Company sold 5,175,000 shares of its common stock in a secondary offering (the "Secondary Offering") under its currently effective registration statement pertaining to \$250.0 million of equity securities, debt securities and warrants. The Company received \$133.4 million in net proceeds. Promptly thereafter, the net proceeds were used, in part, to extinguish all \$71.9 million of indebtedness outstanding under the Unsecured Credit Facility, and to repay or defease secured indebtedness in the total amount of \$6.7 million. Remaining proceeds of the Secondary Offering of approximately \$57.2 million have been invested in additional property acquisitions, build-to-suit property development and for general corporate purposes.

8. BENEFIT PLANS

Executive Retirement Plan

The Company has an Executive Retirement Plan, under which an executive designated by the Compensation Committee of the Board of Directors may receive upon normal retirement (defined to be when the executive reaches age 65 and has completed five years of service with the Company) 60% of the executive's final average earnings (defined as the average of the executive's highest three years' earnings) plus 6% of final average earnings times years of service after age 60 (but not more than five years), less 100% of certain other retirement benefits received by the executive.

Retirement Plan for Outside Directors

The Company has a retirement plan for outside directors which upon retirement will pay annually, for a period not to exceed 15 years, an amount equal to the director's pay immediately preceding retirement from the Board.

Notes to
CONSOLIDATED FINANCIAL STATEMENTS

Retirement Plan Information

Net expense for both the Executive Retirement Plan and the Retirement Plan for Outside Directors (the "Plans") for the two years in the period ended December 31, 1998 is comprised of the following (in thousands):

	1998	1997
Service cost	\$ 775	\$ 218
Interest cost	103	73
Other	10	(10)
	\$ 888	\$ 281

The Plans are unfunded and benefits will be paid from earnings of the Company. The following table sets forth the benefit obligations at December 31, 1998 and 1997 (in thousands).

	1998	1997
Benefit obligation at beginning of year	\$ 1,213	\$ 744
Service cost	775	218
Interest cost	103	73
Other	10	(10)
Actuarial gain	452	188
Benefit obligation at end of year	2,553	1,213
Unrecognized net actuarial (gain) loss	(362)	90
Net pension liability in accrued liabilities	\$ 2,191	\$ 1,303

Accounting for the Executive Retirement Plan for the years ended December 31, 1998 and 1997 assumes discount rates of 7.04% and 7.6%, respectively, and compensation increase rates of 2.7% and 2.7%, respectively. Accounting for the Retirement Plan for Outside Directors assumes discount rates of 7.04% and 7.6%, respectively.

9. STOCK PLANS AND WARRANTS

1993 Employees Stock Incentive Plan

The Company is authorized to issue stock representing up to 7.5% of its outstanding shares of common stock, (the "Employee Plan Shares") under the 1993 Employees Stock Incentive Plan (the "Employee Plan"). As of December 31, 1998 and 1997, the Company had a total of 2,470,080 and 1,073,735 Employee Plan Shares authorized, respectively, that had not been issued. Unless terminated earlier, the Employee Plan will terminate on January 1, 2003. As of December 31, 1998 and 1997, the Company had issued a total of 514,378 and 372,710, and had specifically reserved, but not issued, a total of 445,000 and 141,668 Employee Plan Shares (the "Reserved Stock"), respectively, for performance-based awards to employees under the Employee Plan. The issuance of Reserved Stock to eligible employees is contingent upon the achievement of specific performance criteria. The Reserved Stock awards are subject to fixed vesting periods varying from four to twelve years beginning on the date of issue. If an employee voluntarily terminates employment with the Company before the end of the vesting period, the shares are forfeited, at no cost to the Company. Once the Reserved Stock has been issued, the employee has the right to receive dividends and the right to vote the shares. For 1998 and 1997, compensation expense resulting from the amortization of the value of these shares was \$1.2 million and \$0.6 million, respectively.

Non-Employee Directors' Stock Plans

Prior to May 1995, the Company was authorized to issue stock options for up to 2% of its outstanding shares of common stock under the 1993 Outside Directors Stock Incentive Plan (the "1993 Director Plan"). During 1996 the Company canceled all unexercised options granted pursuant to the 1993 Director Plan. Effective May 1995, the Company enacted the 1995 Restricted Stock Plan for Non-Employee Directors (the "1995 Directors' Plan"). The Directors' stock vests in each Director upon the date three years from the date of issue and is subject to forfeiture prior to such date upon termination of the Director's service, at no cost to the Company. As of December 31, 1998 and 1997, the Company had a total of 95,800 and 96,850 shares under the 1995 Directors' Plan authorized, respectively, that had not been issued. As of December 31, 1998 and 1997, the Company had issued a total of 13,473 and 12,423 shares, respectively, pursuant to the Non-Employee Directors' Stock Plans. For 1998 and 1997, compensation expense resulting from the amortization of the value of these shares was \$89,792 and \$79,354 respectively.

Notes to
CONSOLIDATED FINANCIAL STATEMENTS

1995 Employee Stock Purchase Plan

Effective May 1995, the Company adopted an Employee Stock Purchase Plan (the "Employee Purchase Plan") pursuant to which the Company is authorized to issue shares of common stock (the "Employee Purchase Plan Shares"). As of December 31, 1998 and 1997, the Company had a total of 851,232 and 883,664 shares authorized under the Employee Purchase Plan, respectively, that had not been issued or optioned. Under the Employee Purchase Plan, each eligible employee as of May 1995 and each subsequent January 1 has been or shall be granted an option to purchase up to \$25,000 of common stock at the lesser of 85% of the market price on the date of grant or 85% of the market price on the date of exercise of such option (the "Exercise Date"), but at not less than book value per share as of the December 31 immediately preceding the date of grant. The number of shares subject to each year's option becomes fixed on the date of grant. Eligible employees include those employees who were employed by the Company or a subsidiary on a full-time basis as of May 1995 and those employees with six months of service who are so employed by the Company or subsidiary as of each subsequent January 1. Options granted under the Employee Purchase Plan expire if not exercised 27 months after each such option's date of grant.

A summary of Employee Purchase Plan activity and related information for the years ended December 31 is as follows:

	All Options		
	1998	1997	1996
Outstanding, beginning of year	65,573	71,073	47,268
Granted	74,472	69,930	47,564
Exercised	(12,289)	(40,631)	(10,132)
Forfeited	(31,799)	(23,723)	(13,627)
Expired	(10,241)	(11,076)	-
Outstanding and exercisable at end of year	85,716	65,573	71,073
Weighted-average fair value of options granted during the year (calculated as of the grant date)	\$ 5.94	\$ 3.12	\$ 2.70
Weighted-average exercise price of options exercised during the year	\$ 20.69	\$ 19.48	\$ 18.59
Weighted-average exercise price of options outstanding (calculated as of December 31)	\$ 19.10	\$ 21.58	\$ 19.09
Range of exercise prices of options outstanding (calculated as of December 31)	\$18.43- \$19.52	\$19.71-\$22.47	\$18.46-\$19.71
Weighted-average contractual life of outstanding options (calculated as of December 31, in years)	0.9	0.9	0.9

The fair value for these options was estimated at the date of grant using a Black-Scholes options pricing model with the following assumptions for 1998, 1997 and 1996; risk-free interest rates of 5.00%, 6.00% and 6.30%; a dividend yield of 7.13%, 8.02% and 8.60%; a volatility factor of the expected market price of the Company's Common Stock of .139, .096 and .121; and an expected life of the option of 1.13 years, respectively. The Company has determined that the pro forma effect on net income and earnings per share for the three years in the period ended December 31, 1998 of adopting Statement of Financial Accounting Standards No. 123 "Accounting for Stock-Based Compensation" is not material.

Other

In 1993, the Company issued warrants to purchase up to 188,712 shares of common stock (the "Warrants"). The Warrants were exercisable for a period of four years commencing July 1, 1994 at a price of \$19.50 per share, the then current fair market value, subject to adjustment under applicable antidilution provisions. The holders of the Warrants had the right to require the Company to include the common stock underlying such Warrants in any registration statement filed by the Company at the Company's expense. At December 31, 1998 and 1997, the Company had a total of zero and 162,712 shares, respectively, eligible for purchase pursuant to the Warrants. During the twelve months ended December 31, 1998 and 1997, the Company had issued a total of 131,510 and 7,673 shares, respectively, and had cancelled 13,000 and 18,327 shares, respectively, pursuant to the Warrants. As of December 31, 1998, the Company has no warrants outstanding.

At December 31, 1998 and 1997, the Company had reserved 3,430,112 and 2,216,961 shares, respectively, for future issuance under stock plans.

Notes to
CONSOLIDATED FINANCIAL STATEMENTS

10. NET INCOME PER SHARE

The table below sets forth the computation of basic and diluted earnings per share as required by FASB Statement No. 128 for the three years in the period ended December 31, 1998.

	Year Ended Dec. 31, 1998	Year Ended Dec. 31, 1997	Year Ended Dec. 31, 1996
Basic EPS			
Average Shares Outstanding	24,573,885	18,605,876	13,254,233
Actual Restricted Stock Shares	(529,943)	(383,633)	(239,947)
Denominator – Basic	24,043,942	18,222,243	13,014,286
Net income	\$ 40,478,407	\$ 31,212,289	\$ 19,731,623
Preferred Stock Dividend	(554,688)	0	0
Numerator – Basic	\$ 39,923,719	\$ 31,212,289	\$ 19,731,623
Per share amount	\$ 1.66	\$ 1.71	\$ 1.52
Diluted EPS			
Average Shares Outstanding	24,573,885	18,605,876	13,254,233
Actual Restricted Stock Shares	(529,943)	(383,633)	(239,947)
Dilution for Convertible Debentures	40,017	0	0
Restricted Shares – Treasury	405,235	276,890	205,097
Dilution For Employee Stock Purchase Plan	15,597	25,032	13,981
Dilution For Warrants	19,809	48,327	27,927
Denominator – Diluted	24,524,600	18,572,492	13,261,291
Numerator – Basic	\$ 39,923,719	\$ 31,212,289	\$ 19,731,623
Convertible Subordinated Debenture Interest	63,638	0	0
Numerator – Diluted	\$ 39,987,357	\$ 31,212,289	\$ 19,731,623
Per share amount	\$ 1.63	\$ 1.68	\$ 1.49

11. COMMITMENTS

As of December 31, 1998, the Company had a net investment of approximately \$72.2 million in thirteen build-to-suit developments in progress, which have a total remaining funding commitment of approximately \$34.7 million. The Company also has 21 mortgages under development at December 31, 1998, which have a total remaining funding commitment of approximately \$28.2 million.

As a part of the Capstone merger, agreements were entered into with three individuals affiliated with Capstone that restrict competitive practices and which the Company believes will protect and enhance the value of the real estate properties acquired from Capstone. These agreements provide for the issuance of 150,000 shares per year of common stock of the Company to the individuals on October 15 of the years 1999, 2000, 2001, and 2002, provided all terms of the agreement are met.

Notes to
CONSOLIDATED FINANCIAL STATEMENTS

12. OTHER DATA

Funds From Operations (Unaudited)

Funds from operations, as defined by the National Association of Real Estate Investment Trusts, Inc. ("NAREIT") 1995 White Paper, means net income (computed in accordance with generally accepted accounting principles), excluding gains (or losses) from debt restructuring and sales of property, plus depreciation from real estate assets. Funds from operations does not represent cash generated from operating activities in accordance with generally accepted accounting principles, is not necessarily indicative of cash available to fund cash needs, and should not be considered as an alternative to net income as an indicator of the Company's operating performance or as an alternative to cash flow as a measure of liquidity.

<i>(Dollars in thousands)</i>	Year Ended Dec. 31, (Unaudited)	
	1998	1997
Net Income ⁽¹⁾	\$ 40,479	\$ 31,212
Non-recurring items ⁽²⁾	6,308	112
Gain or loss on dispositions ⁽³⁾	(675)	–
Straight line rents	(1,264)	–
Preferred stock dividend	(555)	–
Depreciation		
Real estate	15,374	11,013
Office F,F&E	0	0
Leasehold improvements	0	0
Other non-revenue producing assets	0	0
	15,374	11,013
Amortization		
Acquired property contracts	0	0
Other non-revenue producing assets	0	0
Organization costs	0	0
	0	0
Deferred financing costs	0	0
Total Adjustments	19,189	11,125
Funds From Operations – Basic	\$ 59,667	\$ 42,337
Convertible Subordinated Debenture Interest	64	0
Funds From Operations – Diluted	\$ 59,731	\$ 42,337
Shares Outstanding – Basic	24,043,942	18,222,243
Shares Outstanding – Diluted	24,524,600	18,572,492
Funds From Operations Per Share – Basic	\$ 2.48	\$ 2.32
Funds From Operations Per Share – Diluted	\$ 2.44	\$ 2.28

⁽¹⁾ 1998 and 1997 amounts include \$1.4 million and \$0.7 million, respectively, of stock-based, long-term, incentive compensation expense, a non-cash expense.

⁽²⁾ Represents charges primarily to write off certain capitalized costs, leasehold improvements, organization and other deferred costs in 1998 and a loss from a debt restructuring in 1997.

⁽³⁾ Represents gains from sales of a real estate property and a tract of land.

Return of Capital

Distributions in excess of earnings and profits generally constitute a return of capital. For the years ended December 31, 1998, 1997 and 1996, dividends paid per share of common stock were \$2.07, \$1.99 and \$1.91, respectively, which consisted of ordinary income per share of \$2.07, \$1.72 and \$1.65 and return of capital per share of \$0.00, \$0.27 and \$0.26, respectively. For the year ended December 31, 1998, dividends paid per share of preferred stock were \$0.46, all of which was ordinary income.

Notes to
CONSOLIDATED FINANCIAL STATEMENTS

13. FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts of cash, receivables and payables are a reasonable estimate of their fair value due to their short-term nature. The fair value of notes and bonds payable is estimated using discounted cash flow analyses, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements. The difference between the carrying amount and the fair value of the Company's notes and bonds payable is not significant. At December 31, 1998, the carrying value of mortgage notes receivable approximates fair value based on the present value of future cash flows using current market interest rates.

14. SUBSEQUENT EVENTS

On January 26, 1999, the Company declared an increase in its quarterly dividend from \$.525 per share (\$2.10 annualized) to \$.53 per share (\$2.12 annualized) payable on February 16, 1999 to shareholders of record on February 5, 1999. On February 17, 1999, the Company received proceeds of approximately \$8.1 million from the sale of an ancillary hospital facility in Savannah, Georgia.

15. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

Quarterly financial information for the years ended December 31, 1998 and 1997 is summarized below:

<i>(In thousands, except per share data)</i>	Quarter Ended			
	March 31	June 30	September 30	December 31
1998				
Total revenue	\$ 17,333	\$ 17,730	\$ 18,325	\$ 39,716
Net income	\$ 8,606	\$ 9,381	\$ 3,050	\$ 19,442
Funds from operations - Basic	\$ 11,604	\$ 12,316	\$ 12,368	\$ 23,379
Funds from operations - Diluted	\$ 11,604	\$ 12,316	\$ 12,368	\$ 23,443
Net income per share - Basic	\$ 0.44	\$ 0.46	\$ 0.15	\$ 0.52
Net income per share - Diluted	\$ 0.43	\$ 0.45	\$ 0.15	\$ 0.51
Funds from operations per share - Basic	\$ 0.60	\$ 0.61	\$ 0.61	\$ 0.65
Funds from operations per share - Diluted	\$ 0.59	\$ 0.60	\$ 0.60	\$ 0.64
1997				
Total revenue	\$ 12,842	\$ 14,265	\$ 15,865	\$ 16,824
Net income	\$ 6,339	\$ 8,170	\$ 8,328	\$ 8,375
Funds from operations - Basic	\$ 9,056	\$ 10,873	\$ 11,122	\$ 11,286
Funds from operations - Diluted	\$ 9,056	\$ 10,873	\$ 11,122	\$ 11,286
Net income per share - Basic	\$ 0.39	\$ 0.43	\$ 0.44	\$ 0.44
Net income per share - Diluted	\$ 0.38	\$ 0.42	\$ 0.43	\$ 0.44
Funds from operations per share - Basic	\$ 0.56	\$ 0.58	\$ 0.59	\$ 0.60
Funds from operations per share - Diluted	\$ 0.55	\$ 0.57	\$ 0.58	\$ 0.59

Management
 BOARD OF DIRECTORS & CORPORATE OFFICERS



Board of Directors (L-R)

David R. Emery

Chairman of the Board and Chief Executive Officer

Edwin B. Morris III

Managing Director, Morris & Morse Company Inc.

C. Raymond Fernandez M.D.

Medical Director, Nalle Clinic

Errol L. Biggs, Ph.D.

Director, Center for Health Administration, University of Colorado

Thompson S. Dent

Executive Vice President and Chief Operating Officer, PhyCor, Inc.

Marliese E. Mooney

Consultant, Hospital Operations

Batey M. Gresham, Jr. AIA

Founder, Gresham Smith & Partners

J. Knox Singleton

President and Chief Executive Officer, INOVA Health Systems



Timothy G. Wallace

Executive Vice President and Chief Financial Officer

David R. Emery

Chairman of the Board and Chief Executive Officer

Roger O. West

Executive Vice President and General Counsel



J. D. Carter Steele

Vice President, Real Estate Investments

Keith A. Harville

Vice President, Real Estate Investments

Eric W. Fischer

Vice President, Real Estate Investments



Fredrick M. Langreck

Senior Vice President, Treasurer

Leigh Ann Stach

Vice President, Controller

Michael W. Crisler

Vice President, Financial Planning

Rita H. Todd

Corporate Secretary

Scott W. Holmes

Senior Vice President, Financial Reporting



Thomas M. Carnell AIA

Vice President, Design and Construction

Roland H. Hart

President, Healthcare Realty Services

Anne C. Sanborn

Director, Tenant Services

B. Bart Starr

Chairman, Healthcare Realty Services

James P. Tainter

Vice President, Asset and Real Estate Management Services

Corporate
I N F O R M A T I O N

CORPORATE ADDRESS

Healthcare Realty Trust Incorporated
3310 West End Avenue, Suite 700
Nashville, Tennessee 37203
Phone: (615) 269-8175
Fax: (615) 269-8461

Web Site: www.healthcarerealty.com
Email Address: hrinfo@healthcarerealty.com

INDEPENDENT PUBLIC AUDITORS

Ernst & Young LLP
NationsBank Plaza
414 Union Street
Nashville, Tennessee 37219-1779

TRANSFER AGENT

Transfer of Shares
BankBoston
c/o EquiServe, L.P.
Investor Services
P.O. Box 8040
Boston, Massachusetts 02266-8040
Phone: (781) 575-3400
Common CUSIP #: 421946104
Preferred CUSIP #: 421946203

Web Site: www.equiserve.com

Street Address for Courier Service
Boston EquiServe, L.P.
Blue Hills Office Park
Attn: Investor Services
150 Royall Street
Canton, Massachusetts 02021-1031

DIVIDEND REINVESTMENT PLAN

A Dividend Reinvestment Plan is offered as a convenience to stockholders who wish to increase their holdings in the Company. Additional shares may be purchased, without a service or sales charge, through automatic reinvestment of quarterly cash dividends. For information write Investor Relations, Boston EquiServe, L.P., 150 Royall Street, Canton, Massachusetts 02021 or call (781) 575-3400.

FORM 10-K

The Company has filed an Annual Report on Form 10-K for the year ended December 31, 1998 with the Securities and Exchange Commission. Shareholders may obtain a copy of this report, without charge, by writing: Investor Relations, Healthcare Realty Trust Inc., 3310 West End Avenue, Suite 700, Nashville, Tennessee 37203. Or, via e-mail: hrinfo@healthcarerealty.com

COMMON STOCK

Healthcare Realty Trust Incorporated common stock is traded on The New York Stock Exchange under the symbol HR. As of March 25, 1999, there were approximately 1,697 shareholders of record. The following table shows, for the fiscal periods indicated, the quarterly range of high and low closing share prices of the common stock.

	High	Low
1998		
First Quarter	\$ 29.938	\$ 27.375
Second Quarter	28.625	26.938
Third Quarter	28.563	21.688
Fourth Quarter	25.313	21.250
1997		
First Quarter	29.125	26.000
Second Quarter	27.875	25.500
Third Quarter	29.000	27.375
Fourth Quarter	29.875	27.813
1996		
First Quarter	23.125	20.875
Second Quarter	23.750	21.500
Third Quarter	24.125	21.500
Fourth Quarter	26.875	23.000
1995		
First Quarter	29.000	19.000
Second Quarter	20.500	18.500
Third Quarter	20.750	19.375
Fourth Quarter	23.000	20.000

ANNUAL SHAREHOLDERS MEETING

The annual meeting of shareholders will be held on May 11, 1999, at 10:00 a.m. at 3310 West End Avenue, 7th Floor, Nashville, Tennessee.