FRIEDMAN INDUSTRIES INC
Form 10-Q
August 14, 2007

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007

OR

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

COMMISSION FILE NUMBER 1-7521

FRIEDMAN INDUSTRIES, INCORPORATED

(Exact name of registrant as specified in its charter)

TEXAS (State or other jurisdiction of incorporation or organization)	74-1504405 (I.R.S. Employer Identification Number)

4001 HOMESTEAD ROAD, HOUSTON, TEXAS 77028-5585
(Address of principal executive office) (zip code)
Registrant s telephone number, including area code (713) 672-9433

Former name, former address and former fiscal year, if changed since last report

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

Yes X No ____

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

Large accelerated filer ( ) Accelerated filer ( ) Non-accelerated filer (X)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ____ No X

At June 30, 2007, the number of shares outstanding of the issuer s only class of stock was 6,712,108 shares of Common Stock.

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Part I FINANCIAL INFORMATION

Item 1. Financial Statements

FRIEDMAN INDUSTRIES, INCORPORATED

CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	JUNE 30, 2007	MARCH 31, 2007
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 470,116	$ 1,039,030
Accounts receivable, net of allowances for bad debts and cash discounts of $37,276 at June 30 and March 31, 2007	16,905,139	17,261,553
Inventories	25,714,242	33,272,823
Other	144,724	157,963
TOTAL CURRENT ASSETS	43,234,221	51,731,369
PROPERTY, PLANT AND EQUIPMENT:		
Land	1,082,331	1,082,331
Construction in progress	5,976,327	5,004,550
Buildings and yard improvements	3,494,294	3,494,294
Machinery and equipment	21,523,952	21,236,184
Less accumulated depreciation	(17,624,121)	(17,344,822)
	14,452,783	13,472,537
OTHER ASSETS:		
Cash value of officers life insurance and other assets	679,600	667,800
TOTAL ASSETS	$ 58,366,604	$ 65,871,706
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	$ 12,613,009	$ 21,875,516
Current portion of long-term debt	54,028	
Dividends payable	536,969	536,969
Income taxes payable	662,344	46,742
Contribution to profit sharing plan	64,500	256,000
Employee compensation and related expenses	660,468	551,356
TOTAL CURRENT LIABILITIES	14,591,318	23,266,583
LONG-TERM DEBT LESS CURRENT PORTION	108,056	
DEFERRED INCOME TAXES	35,323	1,934
POSTRETIREMENT BENEFITS OTHER THAN PENSIONS	506,426	493,191
STOCKHOLDERS EQUITY:		
Common stock, par value $1:		
Authorized shares 10,000,000		
Issued shares 7,887,824 at June 30 and March 31, 2007	7,887,824	7,887,824
Additional paid-in capital	28,887,517	28,887,517
Treasury stock at cost (1,175,716 shares at June 30 and March 31, 2007)	(5,475,964)	(5,475,964)
Retained earnings	11,826,104	10,810,621

TOTAL STOCKHOLDERS EQUITY	43,125,481	42,109,998
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 58,366,604	$ 65,871,706

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FRIEDMAN INDUSTRIES, INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS UNAUDITED

	THREE MONTHS ENDED JUNE 30,	
	2007	**2006**
Net sales	$50,530,510	$52,623,730
Costs and expenses		
Costs of goods sold	46,760,892	47,747,054
General, selling and administrative costs	1,419,493	1,574,457
Interest expense	47,740	

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FRIEDMAN INDUSTRIES, INCORPORATED

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS UNAUDITED

	THREE MONTHS ENDED JUNE 30,	
	2007	**2006**
OPERATING ACTIVITIES		
Net earnings	$ 1,552,451	$ 2,145,141
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation	279,300	237,600
Provision (benefit) for deferred taxes	33,389	(52,831)
Change in post retirement benefits	13,235	11,862
Decrease (increase) in operating assets:		
Accounts receivable	356,414	(1,681,810)
Inventories	7,558,581	2,722,840
Other current assets	13,239	91,883
Increase (decrease) in operating liabilities:		
Accounts payable and accrued expenses	(9,262,507)	(3,673,496)
Contribution to profit-sharing plan payable	(191,500)	(188,500)
Employee compensation and related expenses	109,112	59,705
Federal income taxes payable	615,602	931,692
Deferred credit for LIFO replacement		125,275
NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	1,077,316	729,361
INVESTING ACTIVITIES		
Purchase of property, plant and equipment	(1,259,545)	(1,450,766)
Decrease (increase) in cash surrender value of officers life insurance	(11,800)	(12,394)
NET CASH USED IN INVESTING ACTIVITIES	(1,271,345)	(1,463,160)
FINANCING ACTIVITIES		
Cash dividends paid	(536,969)	(533,330)
Long-term debt	162,084	
NET CASH PROVIDED (USED) IN FINANCING ACTIVITIES	(374,885)	(533,330)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(568,914)	(1,267,129)
Cash and cash equivalents at beginning of period	1,039,030	1,982,526
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 470,116	$ 715,397

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FRIEDMAN INDUSTRIES, INCORPORATED

CONDENSED NOTES TO QUARTERLY REPORT UNAUDITED

NOTE A BASIS OF PRESENTATION

The accompanying unaudited condensed, consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. For further information, refer to the financial statements and footnotes included in the Company s annual report on Form 10-K for the year ended March 31, 2007.

NOTE B INVENTORIES

Inventories consist of prime coil, non-standard coil and tubular materials. Prime coil inventory consists primarily of raw materials, non-standard coil inventory consists primarily of finished goods and tubular inventory consists of both raw materials and finished goods. Inventories are valued at the lower of cost or replacement market. Cost for prime coil inventory is determined under the last-in, first-out (LIFO) method. Cost for non-standard coil inventory is determined using the specific identification method. Cost for tubular inventory is determined using the weighted average method.

During the quarter ended June 30, 2006, LIFO inventories were reduced but were replaced by March 31, 2007. A deferred credit of $125,275 was recorded at June 30, 2006 to reflect replacement costs in excess of LIFO cost.

A summary of inventory values follows:

	June 30, 2007	March 31, 2007
Prime Coil Inventory	$11,002,519	$11,034,422
Non-Standard Coil Inventory	618,979	665,234
Tubular Raw Material	3,237,476	5,854,255
Tubular Finished Goods	10,855,268	15,718,912
	$25,714,242	$33,272,823

NOTE C LONG-TERM DEBT

The Company has a $10 million revolving credit facility which expires April 1, 2010. There were no amounts outstanding pursuant to the facility at June 30, 2007 and March 31, 2007.

In June 2007, the Company incurred an interest free, long-term liability of $162,084 related to the purchase of pipe loading equipment which is payable in 36 equal monthly payments.

NOTE D STOCK BASED COMPENSATION

Under the Company s 1989 and 1996 Stock Option Plans, options were granted to certain officers and key employees to purchase common stock of the Company. Pursuant to the terms of the plans, no additional options may be granted. All options have ten-year terms and become fully exercisable at the end of six months of continued employment. The following is a summary of activity relative to options outstanding during each of the quarters ended June 30:

	2007		2006	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of quarter	88,836	$ 2.33	137,212	$ 2.35
Granted				
Exercised				
Canceled or expired			(2,894)	$ 3.13
Outstanding at end of quarter	88,836	$ 2.33	134,318	$ 2.33
Exercisable at the end of the quarter	88,836	$ 2.33	134,318	$ 2.33
Weighted average fair value of options granted during the quarter				

The aggregate intrinsic value of exercisable and outstanding options at June 30, 2007 was $650,280.

NOTE E SEGMENT INFORMATION

	THREE MONTHS ENDED JUNE 30,	
	2007	2006
	(in thousands)	
Net sales		
Coil	$21,076	$27,885
Tubular	29,455	24,739
Total net sales	$50,531	$52,624
Operating profit		
Coil	$ 936	$ 1,552
Tubular	2,257	2,786
Total operating profit	3,193	4,338
Corporate expenses	843	1,035
Interest expense	48	
Interest & other income	(42)	(57)
Total earnings before taxes	$ 2,344	$ 3,360

	June 30, 2007	March 31, 2007
Segment assets		
Coil	$27,067	$27,601

Tubular	30,085	36,491
	57,152	64,092
Corporate assets	1,215	1,780
	$58,367	$65,872

Corporate expenses reflect general and administrative expenses not directly associated with segment operations and consist primarily of corporate executive and accounting salaries, professional fees and services, bad debts, accrued profit sharing expense, corporate insurance expenses and office supplies. Corporate assets consist primarily of cash and cash equivalents and the cash value of officers life insurance.

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

Results of Operations

Three Months Ended June 30, 2007 Compared to Three Months Ended June 30, 2006

During the three months ended June 30, 2007, sales, costs of goods sold and gross profit decreased $2,093,220, $986,162 and $1,107,058, respectively, from the comparable amounts recorded during the three months ended June 30, 2006. The decrease in sales was related primarily to a decrease in tons sold. The Company recorded tons sold of approximately 79,000 tons in the 2007 quarter compared to approximately 81,000 tons in the 2006 quarter. In addition, average per ton selling prices in the 2007 quarter declined approximately $5 per ton from the level recorded in the 2006 quarter. While average per ton selling prices declined, the average per ton costs of goods increased approximately $7 per ton and adversely impacted gross profit. Gross profit as a percentage of sales decreased from approximately 9.3% in the 2006 quarter to approximately 7.5% in the 2007 quarter. During the 2006 quarter, the Company experienced strong market conditions for its products and recorded one of the most profitable quarters in Company history. Somewhat softer market conditions were experienced in the 2007 quarter which resulted in reduced margins.

Coil product segment sales decreased approximately $6,809,000 during the 2007 quarter. This decrease resulted primarily from a decrease in tons sold as coil tonnage shipped declined from approximately 41,000 tons in the 2006 quarter to approximately 31,000 tons in the 2007 quarter. The average per ton selling price was approximately the same for both quarters. Coil operating profit as a percentage of coil segment sales decreased from approximately 5.6% in the 2006 quarter to 4.4% in the 2007 quarter. The Company experienced strong market conditions for coil products during the 2006 quarter and softer market conditions during the 2007 quarter. As a result, the Company recorded a decrease in volume as well as reduced margins.

In the 2006 quarter, the Company s phased out the Lone Star coil facility (LSCF). The LSCF accounted for approximately 3% of total sales and generated a small profit in the 2006 quarter. Certain LSCF assets will be redeployed to the Company s new coil facility which will be located in Decatur, Alabama in close proximity to the Nucor Steel Company facility located there (NSC). The Company expects to have this new facility in operation in fiscal 2008.

The Company is primarily dependent on NSC for its supply of coil inventory. In the 2007 quarter, NSC continued to supply the Company with steel coils in amounts that were adequate for the Company s purposes. The Company does not currently anticipate any significant change in such supply from NSC.

Tubular product segment sales increased approximately $4,716,000 during the 2007 quarter. This increase primarily resulted from an increase in tons sold which increased from approximately 40,000 tons in the 2006 quarter to approximately 47,000 tons sold in the 2007 quarter. The average per ton selling price of pipe products was approximately the same in both quarters. Tubular product segment operating profits as a percentage of segment sales were approximately 11.3% and 7.7% in the 2006 and 2007 quarters, respectively. The Company experienced strong market conditions for its pipe products in the 2006 quarter and softer market conditions in the 2007 quarter. These softer market conditions had the effect of reducing average margins.

During the 2007 quarter, Lone Star Steel Company (LSS), the Company s primary supplier of tubular products and coil material used in pipe manufacturing, continued to supply such products in amounts that were adequate for the Company s purposes. On June 14, 2007, United States Steel Corporation consummated its purchase of LSS. While the potential impact of this purchase on the Company s business is uncertain, the Company does not currently anticipate any significant change in such supply from LSS.

During the 2007 quarter, general, selling and administrative costs decreased $154,964 from the amount recorded during the 2006 quarter. This decrease was related primarily to a decrease in bonuses associated with reduced earnings.

Interest expense in the 2007 quarter increased $47,740. For two months in the 2007 quarter, the Company borrowed funds under its line of credit facility to support cash flow.

Income taxes decreased $422,822 from the comparable amount recorded during the 2006 quarter. This decrease was primarily related to the decrease in earnings before taxes. Effective tax rates were 36.2% and 33.8% in the 2006 and 2007 quarters, respectively. In the 2007 quarter, the Company benefited from a reduction in state taxes due to changes in state law and from a federal deduction associated with domestic activities production.

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FINANCIAL POSITION, LIQUIDITY AND CAPITAL RESOURCES

The Company remained in a strong, liquid position at June 30, 2007. Current ratios were 3.0 and 2.2 at June 30, 2007 and March 31, 2007, respectively. Working capital was $28,642,903 at June 30, 2007 and $28,464,786 at March 31, 2007.

During the three months ended June 30, 2007, the Company maintained assets and liabilities at levels it believed were commensurate with operations. Changes in current assets and liabilities during the 2007 quarter were related primarily to the ordinary course of business of the Company. In March 2007, the Company planned substantial pipe production runs in March 2007 and April 2007 which required increased inventories and accounts payable. These runs were completed as planned and resulted in reduced inventories and accounts payable at June 30, 2007. The Company expects to continue to monitor, evaluate and manage balance sheet components depending on changes in market conditions and the Company s operations.

During the quarter ended June 30, 2007, the Company purchased approximately $1,260,000 in fixed assets. These assets were related primarily to equipment associated with the new coil operation to be located in Decatur, Alabama. In connection with this planned new operation, the Company phased out its coil processing facility in Lone Star, Texas in the 2006 quarter and will redeploy certain of these assets to this new coil facility. At the Decatur site, the Company is constructing a coil processing facility to include a steel temper mill and a steel cut-to-length line including a leveling line. The Company expects to commence operations at the Decatur site in fiscal 2008. In addition to the funds used to purchase the real property in Alabama, the Company s Board of Directors authorized up to an additional $16 million to be used for capital expenditures and operational cash requirements at this location. At June 30, 2007, the Company had invested approximately $7,500,000 at this location and expects to spend approximately $2,000,000 to complete this facility.

The Company has an arrangement with a bank which provides for a revolving line of credit facility (the revolving facility). Pursuant to the revolving facility, which expires April 1, 2010, the Company may borrow up to $10 million at the bank s prime rate or 1.5% over LIBOR. The Company uses the revolving facility to support cash flow and will borrow and repay the note as working capital is required. At June 30, 2007 and March 31, 2007, the Company had no borrowings outstanding under the revolving facility.

The Company has in the past and may in the future borrow funds on a term basis to build or improve facilities. The Company currently has no plans to borrow any significant amount of funds on a term basis.

Notwithstanding the current market conditions, the Company believes its cash flows from operations and borrowing capability under its revolving facility are adequate to fund its expected cash requirements for the next twenty-four months.

CRITICAL ACCOUNTING POLICIES

The preparation of consolidated financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. One such accounting policy which requires significant estimates and judgments is the valuation of LIFO inventories in the Company s quarterly reporting. The quarterly valuation of inventory requires estimates of the year end quantities which is inherently difficult. Historically, these estimates have been materially correct. In addition, the Company maintains an allowance for doubtful accounts receivable by providing for specifically identified accounts where collectibility is doubtful. On an ongoing basis, the Company evaluates estimates and judgments. The Company bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances.

FORWARD-LOOKING STATEMENTS

From time to time, the Company may make certain statements that contain forward-looking information (as defined in the Private Securities Litigation Reform Act of 1996) and that involve risk and uncertainty. These forward-looking statements may include, but are not limited to, future results of operations, future production capacity, product quality and proposed expansion plans. Forward-looking statements may be made by management orally or in writing including, but not limited to, this Management s Discussion and Analysis of Financial Condition and Results of Operations and other sections of the Company s filings with the Securities and Exchange Commission under the Securities Act of 1933 and the Securities Exchange Act of 1934. Actual results and trends in the future may differ materially depending on a variety of factors including but not limited to changes in the demand and prices of the Company products, changes in the demand for steel and steel products in general and the Company s success in executing its internal operating plans, including any proposed expansion plans.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

In the normal course of business the Company is exposed to market risks primarily from changes in the cost of steel in inventory and in interest rates. The Company closely monitors exposure to market risks and develops appropriate strategies to manage risk. With respect to steel purchases, there is no recognized market to purchase derivative financial instruments to reduce the inventory exposure risk on changing commodity prices. The exposure to market risk associated with interest rates relates primarily to debt. Recent debt balances are minimal and, as a result, direct exposure to interest rates changes is not significant.

Item 4. Controls and Procedures

The Company s management, with the participation of the Company s principal executive officer (CEO) and principal financial officer (CFO), evaluated the effectiveness of the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of the end of the fiscal quarter ended June 30, 2007. Based on this evaluation, the CEO and CFO have concluded that the Company s disclosure controls and procedures were effective as of the end of the fiscal quarter ended June 30, 2007 to ensure that information that is required to be disclosed by the Company in the reports it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported, within the time periods specified in the SEC s rules and forms and (ii) accumulated and communicated to the Company s management, including the CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure.

There were no changes in the Company s internal control over financial reporting that occurred during the fiscal quarter ended June 30, 2007 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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FRIEDMAN INDUSTRIES, INCORPORATED

Three Months Ended June 30, 2007

Part II OTHER INFORMATION

Item 1. Legal Proceedings

Not applicable

Item 1A. Risk Factors

Not applicable

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

a). Not applicable

b). Not applicable

c). Not applicable

Item 3. Defaults Upon Senior Securities

a). Not applicable

b). Not applicable

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

Not applicable

Item 6. Exhibits

Exhibits

31.1 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, signed by William E. Crow

31.2 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, signed by Ben Harper

32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by William E. Crow

32.2 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, signed by Ben Harper

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this r (1,158)

Cash and Cash Equivalents at Beginning of Period

1,704 2,364

Cash and Cash Equivalents at End of Period

$1,231 $ 1,206

Supplemental Disclosure of Cash Flow Information:

Cash Paid For:

Interest

$2,857 1,600

Income taxes

$413 1,806

Non-cash investing and financing activities:

Assets acquired under capital lease obligation

$34 $-

See notes to condensed consolidated financial statements.

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SUNLINK HEALTH SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THREE AND SIX MONTH PERIODS ENDED DECEMBER 31, 2010

(all dollar amounts in thousands except per share amounts)

(unaudited)

Note 1. Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements as of and for the three and six month periods ended December 31, 2010 have been prepared in accordance with Rule 10-01 of Regulation S-X of the Securities and Exchange Commission (SEC) and, as such, do not include all information required by accounting principles generally accepted in the United States of America. These Condensed Consolidated Financial Statements should be read in conjunction with the audited consolidated financial statements included in the SunLink Health Systems, Inc. (SunLink , we , our , ours , us or the Company) Annual Report on Form 10-K for the fiscal year ended June 30, 2010, filed with the October 12, 2010. In the opinion of management, the Condensed Consolidated Financial Statements, which are unaudited, include all adjustments, consisting only of normal recurring adjustments, necessary to present fairly the financial position and results of operations for the periods indicated. The results of operations for the three month and six month periods ended December 31, 2010 are not necessarily indicative of the results that may be expected for the entire fiscal year or any other interim period.

Note 2. Business Operations and Corporate Strategy

Business Operations

SunLink Health Systems, Inc. is a provider of healthcare services in certain rural and exurban markets in the United States. SunLink s business is composed of two business segments:

Healthcare Facilities, which consist of

Our seven community hospitals, which have a total of 402 licensed beds;

Our three nursing homes, which have a total of 261 licensed beds, each of which is located adjacent to a corresponding SunLink community hospital; and

Our one home health agency, which operates in connection with a corresponding SunLink community hospital.

Specialty Pharmacy, which consists of

Specialty pharmacy services;

Durable medical equipment;

Institutional pharmacy services; and

Three retail pharmacies offering products and services, all of which are conducted in rural markets.

SunLink has conducted its healthcare facilities business since 2001 and its specialty pharmacy business since April 2008. Our Specialty Pharmacy segment currently is operated through Carmichael s Cashway Pharmacy, Inc. (Carmichael), a subsidiary of our ScriptsRx LLC subsidiary and consists of a specialty pharmacy business acquired in April 2008 with four service lines.

Strategy

SunLink s business strategy is to focus its efforts on internal growth of its existing healthcare facilities and its pharmacy business, supplemented by growth from selected rural and exurban healthcare acquisitions, including but not limited to hospitals, nursing homes, home care businesses, and pharmacy businesses. However, as was the case in 2004 with the sale of our

Mountainside Medical Center hospital and in September 2009 with the sale of three home health agencies, we consider dispositions of one or more of our facilities or operations. Dispositions may be considered based on a variety of factors including asset values, return on investment, competition from existing and potential facilities, capital improvement needs and other corporate objectives.

Operations

Our operational strategy is focused on efforts to improve operations and generate internal growth. Our primary operational strategy for our community hospitals is to improve the operations and profitability of such hospitals by reducing out-migration of patients, recruiting physicians, expanding services and implementing and maintaining effective cost controls. Our operational strategy for our nursing homes and home health agency is similar to that for our community hospitals and is focused on expanding services and implementing and maintaining effective cost controls. Our operational strategy for our Specialty Pharmacy segment is focused on continuing the integration of the Carmichael operations acquired in April 2008, increasing market share, expanding services and implementing and maintaining effective cost controls.

Acquisitions

Although the Company s situation could change, based on its current financial position as well as uncertainties in the healthcare industry, the Company is not actively seeking acquisitions for its Healthcare Facilities or Specialty Pharmacy segments. However, we continue to evaluate certain rural and exurban hospitals and healthcare businesses, which may be for sale, and monitor other selected rural and exurban healthcare acquisition targets which we believe might become available for sale.

Note 3. Sale of Home Health Businesses

In September 2009, we sold three of our home health businesses for approximately $3,300 resulting in a pre-tax gain of approximately $2,342 for the six months ended December 31, 2009. Included in the net assets of the three home health businesses sold was $429 of goodwill related to our Healthcare Facilities segment. The home health businesses were located in Adel, GA, Clanton, AL, and Fulton, MO.

Note 4. Discontinued Operations

All of the businesses discussed below are reported as discontinued operations and the condensed consolidated financial statements for all prior periods have been adjusted to reflect this presentation.

Results for all of the businesses included in discontinued operations are presented in the following table:

	Three Months Ended December 31, 2010	Three Months Ended December 31, 2009	Six Months Ended December 31, 2010	Six Months Ended December 31, 2009
Earnings (Loss) from discontinued operations:				
Housewares segment:				
Loss from operations	$ -	$ (139)	$ -	$ (174)
Income tax benefit	-	(42)	-	(59)
Loss from Housewares segment after taxes	-	(97)	-	(115)
Mountainside Medical				
Earnings from operations	525	(6)	347	(43)
Income tax expense	198	(2)	131	(15)
Earnings from Mountainside Medical Center after taxes	327	(4)	216	(28)
Life sciences and engineering segment:				
Loss from operations	(21)	(18)	(42)	(35)
Income tax benefit	(8)	(6)	(16)	(12)
Loss from life sciences and engineering segment after taxes	(13)	(12)	(26)	(23)
Earnings (Loss) from discontinued operations	$ 314	$ (113)	$ 190	$ (166)

Housewares Segment All claims in a liquidation proceeding with respect to SunLink s former Housewares segment were settled on April 13, 2010. In connection with the settlement of such claim SunLink paid approximately $1,400, of which $480 was covered under a directors and officers insurance policy. The Company cancelled all preferred stock of its SunLink subsidiary held by the former Housewares segment subsidiary. The pre-tax loss of $139 and $174 for the three and six months ended December 31, 2009, respectively, resulted from legal expenses incurred.

Mountainside Medical Center On June 1, 2004, SunLink sold its Mountainside Medical Center (Mountainside) hospital in Jasper, Georgia, for approximately $40,000 pursuant to the terms of an asset sale agreement. In connection with this sale, claims by the buyer and counter claims by SunLink were litigated which resulted in a judgment for SunLink. . The judgment, which included damages, prejudgment interest and certain losses, was collected by SunLink in the amount of $1,246 in May 2010 and $540 in December 2010, and the parties executed a mutual release.

Life Sciences and Engineering Segment SunLink retained a defined benefit retirement plan which covered substantially all of the employees of this segment when it was sold in fiscal 1998. Effective February 28, 1997, the plan was amended to freeze participant benefits and close the plan to new participants. Included in discontinued operations for the three and six month periods ended December 31, 2010 and 2009, respectively, were the following:

	Three Months Ended December 31, 2010	Three Months Ended December 31, 2009	Six Months Ended December 31, 2010	Six Months Ended December 31, 2009
Interest cost	$ 18	$ 18	$ 37	$ 36
Expected return on assets	(11)	(11)	(21)	(22)
Amortization of prior service cost	14	11	26	21
Net pension expense	$ 21	$ 18	$ 42	$ 35

SunLink did not contribute to the plan in the six months ended December 31, 2010. We expect to make no contribution to the plan through the end of the fiscal year ending June 30, 2011.

Discontinued Operations Reserves Over the past 21 years, SunLink has discontinued operations carried on by its former Mountainside Medical Center and SunLink s former industrial, life sciences and engineering segments, U.K. leisure and housewares segment and European child safety segments, as well as the U.K. housewares segment. SunLink s reserves relating to discontinued operations of these segments represent management s best estimate of SunLink s possible liability for property, product liability and other claims for which SunLink may incur liability. These estimates are based on management s judgments, using currently available information, as well as, in certain instances, consultation with its insurance carriers, third party advisors and legal counsel. While estimates have been based on the evaluation of available information, it is not possible to predict with certainty the ultimate outcome of many contingencies relating to discontinued operations. SunLink intends to continue to adjust its estimates of the reserves as additional information is developed and evaluated. However, management believes that the final resolution of these contingencies will not have a material adverse impact on the financial position, cash flows or results of operations of SunLink.

Note 5. Stock-Based Compensation

For the three months ended December 31, 2010 and 2009, the Company recognized $2 and $10, respectively, in salaries, wages and benefit expense for share options issued to employees and directors of the Company and for the six months ended December 31, 2010 and 2009, the Company recognized $5 and $23, respectively, in salaries, wages and benefit expense for share options issued to employees and directors of the Company. The fair value of the share options granted was estimated using the Black-Scholes option pricing model. There were no share options granted during the six months ended December 31, 2010 and 28,000 share options granted during the six months ended December 31, 2009.

Note 6. Receivables- net

Summary information for receivables is as follows:

	December 31, 2010	June 30, 2010
Accounts receceivable (net of contractual allowances)	33,781	$ 33,741
Less allowance for doubtful accounts	(15,101)	(16,508)
Receivables - net	$ 18,680	$ 17,233

Net revenues included increases of $847 and $559 for the three months ended December 31, 2010 and 2009, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports. Net revenues included increases of $856 and $459 for the six months ended December 31, 2010 and 2009, respectively, for the settlements of prior year Medicare and Medicaid cost reports.

Note 7. Goodwill And Intangible Assets

SunLink has goodwill and intangible assets related to its Healthcare Facilities and Specialty Pharmacy segments.

Intangibles consist of the following, net of amortization:

	December 31, 2010	June 30, 2010
Healthcare Facilities Segment		
Certificates of Need	$ 630	$ 630
Noncompetition Agreements	83	83
	713	713
Accumulated Amortization	(253)	(226)
	$ 460	$ 487
Specialty Pharmacy Segment		
Trade Name	5,400	5,400
Customer Relationships	6,400	6,400
Medicare License	769	769
	12,569	12,569
Accumulated Amortization	(1,572)	(1,280)
	10,997	11,289
Total	$ 11,457	$ 11,776

Amortization expense was $159 and $211 for the quarters ended December 31, 2010 and 2009, respectively. Amortization expense was $319 and $422 for the six months ended December 31, 2010 and 2009, respectively.

Goodwill consists of the following:

	December 31, 2010	June 30, 2010
Healthcare Facilities Segment	$ 2,515	$ 2,515
Specialty Pharmacy Segment	6,509	6,509
	$ 9,024	$ 9,024

In September 2009, we sold three of our home health businesses for approximately $3,300. Included in the net assets of the three home health businesses sold was $429 of goodwill related to our Healthcare Facilities segment.

Note 8. Long-Term Debt

Long-term debt consisted of the following:

	December 31, 2010	June 30, 2010
Term Loan	$ 29,961	$ 30,836
Capital lease obligations	57	51
Total	30,018	30,887
Less current maturities	(30,000)	(1,797)
	$ 18	$ 29,090

SunLink Credit Facilities On April 23, 2008, SunLink entered into a $47,000 seven-year senior secured credit facility (2008 Credit Facility). The 2008 Credit Facility includes a revolving line of credit of up to $12,000 (the Revolving Loan) and a $35,000 term loan (the Term Loan). Interest under the 2008 Credit Facility is LIBOR (defined as the thirty-day published rate) plus the applicable margin. Pursuant to a waiver agreement (the Credit

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Agreement Waiver) discussed below, the termination date of the 2008 Credit Facility was changed from April 22, 2015 to September 30, 2011 and the interest rate for the Revolving Loan is LIBOR plus 6.50% from the waiver date through November 14, 2010, LIBOR plus 7.50% from November 15, 2010 to February 15, 2011, LIBOR plus 8.50% from February 16, 2011 to May 14, 2011 and LIBOR plus 9.50% from May 15, 2011 to the September 30, 2011 termination date. The interest rate for the Term Loan is LIBOR plus 8.07% from the waiver date through November 14, 2010, LIBOR plus 9.07% from November 15, 2010 to February 15, 2011, LIBOR plus 10.07% from February 16, 2011 to May 14, 2011 and LIBOR plus 11.07% from May 15, 2011 to August 14, 2011. At December 31, 2010, the interest rate for the Term Loan was 11.82% and the interest rate for the Revolving Loan was 10.25%. We also agreed to a reduction in the revolving line of credit facility commitment from $12,000 to $9,000, which we believe is adequate for our current level of operations. The total availability of credit under all components of the 2008 Credit Facility is keyed to the level of SunLink s earnings, which, based upon the Company s estimates, provided for current borrowing capacity, before any draws, of approximately $38,746 at December 31, 2010. The 2008 Credit Facility is secured by a first priority security interest in substantially all real and personal property of the Company and its consolidated domestic subsidiaries, including a pledge of all of the equity interests in such subsidiaries.

The 2008 Credit Facility contains various terms and conditions, including operational and financial restrictions and limitations, and affirmative and negative covenants. If we fail to remain in compliance with the 2008 Credit Facility, we would cease to have a right to draw on the Revolving Loan and the lenders would, among other things, be entitled to declare a default under the 2008 Credit Facility and demand repayment of the indebtedness outstanding under the Revolving Loan and the Term Loan. If SunLink or its applicable subsidiaries experience a material adverse change in their business, assets, financial condition, management or operations, or if the value of the collateral securing the 2008 Credit Facility decreases, we may be unable to draw on the Revolving Loan. The covenants include financial covenants measured on a quarterly basis which require SunLink to comply with maximum leverage and minimum fixed charge ratios, maximum capital expenditure amounts, collateral value to loan amount and liquidity and cash flow measures, all as defined in the 2008 Credit Facility. At June 30, 2010, SunLink was in non-compliance with certain financial covenants of the 2008 Credit Facility. On October 8, 2010 (the Waiver Date), the Company received, pursuant to the Credit Agreement Waiver, a waiver from its lenders of these financial covenants for the fiscal quarter ended June 30, 2010, and subject to certain conditions, also for the fiscal quarters ended September 30, 2010, December 31, 2010 and March 31, 2011.

Under the terms of the Credit Agreement Waiver, the conditions for waivers of the non-compliance with financial covenants for the quarters ended September 30, 2010, December 31, 2010 and March 31, 2011 include, among other things, compliance by SunLink with minimum consolidated adjusted earnings before interest, taxes depreciation and amortization but at a level reduced from that formerly applicable. The Company was in compliance with the terms of the 2008 Credit Agreement, including the revised levels of financial covenants for the December 31, 2010 financial statements. A waiver fee of 2% of the current 2008 Credit Facility commitment totaling approximately $788 was paid to the Lenders by SunLink at the Waiver Date, which was expensed in the quarter ending December 31, 2010. An additional waiver fee of 0.5% of the total 2008 Credit Facility commitment totaling approximately $196 was paid at November 15, 2010 and additional waiver fees of 0.5% of the commitment will be paid at both February 15, 2011 and May 15, 2011. The waiver includes other conditions related to a February 2011 $11,000 term loan reduction covenant which may increase the interest rate for both the Term Loan and the Revolving Loan by an additional 2% over the prescribed interest rate for the remainder of the 2008 Credit Facility. The Company does not currently anticipate having sufficient funds to make the payment to effect the required $11,000 reduction in principal and is in discussions with the lender seeking a waiver. Should such a waiver not be obtained, the increase in interest rates of an additional 2% will become effective February 15, 2011. Amortization of the fees and expenses recorded in interest expense were approximately $995 and $95 for the three months ended December 31, 2010 and 2009, respectively. Amortization of the fees and expenses recorded in interest expense were approximately $1,102 and $192 for the six months ended December 31, 2010 and 2009, respectively.

As a result of the new termination date of September 30, 2011 for the 2008 Credit Facility, SunLink will be required to refinance or otherwise source funds to repay the existing indebtedness outstanding thereunder prior to the termination date. SunLink is currently pursuing various alternatives, which may include refinancing some or all of such indebtedness or the sale of certain operating assets, the proceeds of which would be used to repay, in whole or in part, such indebtedness. To the extent available, borrowings under any replacement credit facility, excess proceeds from the sale of operating assets, or both also may be used to finance certain capital improvements at SunLink s s healthcare facilities. There can be no assurance that it will be able to effect any such refinancing or the sale of any operating assets before by the 2008 Credit Facility s schedule September 30, 2011 termination date.

Note 9. Subordinated Long-Term Debt

Subordinated long-term debt consisted of the following:

	December 31, 2010	June 30, 2010
Carmichael	$ 2,400	$ 2,550
Less current maturities	(300)	(300)
	$ 2,100	$ 2,250

Carmichael Loan On April 22, 2008, SunLink Scripts Rx, LLC (formerly known as SunLink Homecare Services LLC) entered into a $3,000 promissory note agreement with an interest rate of 8% with the former owners of Carmichael as part of the acquisition purchase price (the Carmichael Loan). The Carmichael Loan is payable in semi-annual installments of $150 beginning on April 22, 2009 with the remaining balance of $1,200 due April 22, 2015. Interest is payable in arrears semi-annually on the six-month anniversary of the issuance of the note. The Carmichael Loan is guaranteed by SunLink Health Systems, Inc. The note and the guarantee are subordinate to the 2008 Credit Facility.

Under the terms of the 2008 Credit Facility (see Note 8), if SunLink is in violation of certain terms and conditions of such facility, the Company cannot make principal payments due under the Carmichael Loan without permission of the 2008 Credit Facility lender. At June 30, 2010, SunLink was in violation of certain financial covenants of the 2008 Credit Facility, but has received a waiver on the restriction of paying the principal and interest due under the Carmichael Loan as long as SunLink is not in violation of the terms of the Credit Agreement Waiver.

Note 10. Income Taxes

Income tax benefit of $978 ($983 federal tax benefit and $5 state tax expense) and income tax benefit of $365 ($308 federal tax benefit and $57 state tax benefit) was recorded for the three months ended December 31, 2010 and 2009, respectively. Income tax benefit of $1,788 ($2,000 federal tax benefit and $212 state tax expense) and income tax benefit of $218 ($218 federal tax benefit and $0 state tax benefit) was recorded for the six months ended December 31, 2010 and 2009, respectively. The high effective income tax rate of 61.0% for the six months ended December 31, 2009 resulted from the tax non-deductibility of $429 of goodwill included in the net assets of the home health businesses sold during in September 2009.

We had an estimated net operating loss carry-forward for federal income tax purposes of approximately $6,150 at December 31, 2010. Use of this net operating loss carry-forward is subject to the limitations of the provisions of Internal Revenue Code Section 382. As a result, not all of the net operating loss carry-forward is available to offset federal taxable income in the current year. At December 31, 2010, we have provided a partial valuation allowance against the domestic deferred tax asset so that the net domestic tax asset was $4,048. Based upon management s assessment that it was more likely than not that a portion of its domestic deferred tax asset (primarily its domestic net operating losses subject to limitation) would not be recovered, the Company established a valuation allowance for the portion of the domestic tax asset which may not be utilized. The Company has provided a valuation allowance for the entire amount of the foreign tax asset as it is more likely than not that none of the foreign deferred tax assets will be realized through future taxable income or implementation of tax planning strategies.

The Company accounts for uncertainty in income taxes for a change in judgment related to prior years tax positions in the quarter of such change. Activity in the unrecognized tax benefit liability account is as follows from July 1, 2008 through December 31, 2010:

Balance at July 1, 2008	$	58
Additions based on tax positions related to current year		31
Reduction for tax positions of prior years		(23)
Balance at June 30, 2009		66
Additions based on tax positions related to current year		35
Reduction for tax positions of prior years		(30)
Balance at June 30, 2010		71
Additions based on tax positions related to current year		26
Reduction for tax positions of prior years		(16)
Balance at December 31, 2010	$	81

SunLink or one or more of our subsidiaries files income tax returns with the United States, various states in the United States and in certain foreign jurisdictions. We are not currently subject to U.S. federal, state or local, or non-U.S. income tax examinations by tax authorities for any tax years. We therefore believe that there is no tax jurisdiction in which the outcome of unresolved issues or claims is likely to be material to our financial position, cash flows or results of operations. We further believe that we have made adequate provision for all income tax uncertainties.

At July 1, 2010, our unrecognized tax benefits, the aggregate tax effect of differences between tax return positions and the benefits recognized in our financial statements as shown above, amounted to $71. If recognized, all of our unrecognized tax benefits would not reduce our income tax expense or effective tax rate except as such recognition related to the removal of the liability associated with interest classified as income tax expense. No portion of any such reduction might be reported as discontinued operations. During fiscal year 2011, certain factors could potentially reduce our unrecognized

tax benefits, either because of the expiration of open statutes of limitation or modifications to our intercompany accounting policies and procedures. Of these tax positions, none relate to positions that would affect our total tax provision or effective tax rate (except as such recognition related to the removal of the liability associated with interest classified as income tax expense).

We classify interest accrued on tax deficiencies as tax expense and classify income tax penalties as tax expense. At December 31, 2010, before any tax benefits, our accrued interest on unrecognized tax benefits amounted to $18 and we had recorded no related accrued penalties.

Note 11. Noncontrolling Interest

On February 1, 2008, SunLink sold 17% of the Chilton Medical Center in Clanton, Alabama, to individual physicians, most of whom practice at that facility. The noncontrolling interest reported reflects these physicians ownership interests at September 30, 2010. The results of operations for the period from February 1, 2008 to December 31, 2010 were a loss and did not impact the ownership interests of the physicians or the corporation. On July 1, 2009, SunLink sold 49% of the pharmacy operations subsidiary in Ellijay, Georgia, to an unaffiliated buyer. In December 2007, the FASB issued new guidance relating to accounting for noncontrolling interests in consolidated financial statements and requires that noncontrolling interests in subsidiaries be reported in the equity section of the controlling company s balance sheet. The Company adopted this guidance on July 1, 2009.

Note 12. Comprehensive Earnings

Our comprehensive earnings include foreign currency translation adjustments and change in minimum pension liability. The foreign currency translation adjustment resulted primarily from the effect of changes in the exchange rates of the UK pound on our reserve for in connection with our discontinued Housewares segment (See Note 4. *Discontinued Operations*).

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Total comprehensive earnings for the following periods were as follows:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Net loss	$ (1,765)	$ (524)	$ (4,534)	$ (28)
Other comprehensive income net of tax:				
Change in equity due to:				
Foreign currency translation adjustments	-	(9)	-	15
Comprehensive earnings	$ (1,765)	$ (533)	$ (4,534)	$ (13)

Note 13. Commitments and Contingencies

Legal Proceedings

On December 7, 2007, Southern Health Corporation of Ellijay, Inc. (SHC-Ellijay), a SunLink subsidiary, filed a Complaint against James P. Garrett and Roberta Mundy, both individually and as Fiduciary of the Estate of Randy Mundy (collectively, Defendants), seeking specific performance of an Option Agreement (the Option Agreement) dated April 17, 2007, between SHC-Ellijay, Mr. Garrett, and Ms. Mundy as Executrix of the Estate of Randy Mundy for the sale of approximately 24.74 acres of real property located in Gilmer County, Georgia, and recovery of SHC-Ellijay s damages suffered as a result of Defendants failure to close the transaction in accordance with the Option Agreement. SHC-Ellijay also stated alternative claims for breach of the Option Agreement and fraud, along with claims to recover attorney s fees and punitive damages.

In January 2008, the Mundys filed a motion to strike, motion to dismiss, answer, affirmative defenses, and a counterclaim against SHC-Ellijay. On March 3, 2009, SHC-Ellijay filed a First Amended and Restated Complaint for Damages, which effectively dropped the cause of action for specific performance of the Option Agreement. On May 7, 2009, Mr. Garrett and Ms. Mundy served a motion for summary judgment on all counts and causes of action stated in the First Amended Complaint. The court has postponed consideration of the defendants motion for summary judgment and SHC-Ellijay s response thereto until after a discovery dispute between the parties has been resolved.

SunLink denies that it has any liability to the Mundys and intends to vigorously defend the claims asserted against SunLink by the Mundys complaint and to vigorously pursue its claims against the Mundys. While the ultimate outcome and materiality of the litigation cannot be determined, in management s opinion the litigation will not have a material adverse effect on SunLink s financial condition or results of operations.

SunLink is a party to claims and litigation incidental to its business, for which it is not currently possible to determine the ultimate liability, if any. Based on an evaluation of information currently available and consultation with legal counsel, management believes that resolution of such claims and litigation is not likely to have a material effect on the financial position, cash flows, or results of operations of the Company. The Company expenses legal costs as they are incurred.

Contractual Obligations, Commitments and Contingencies

Contractual obligations, commitments and contingencies related to long-term debt, non-cancelable operating leases, physician guarantees, and interest (including 2008 Credit Agreement waiver fees and scheduled increases in interest rates) on outstanding debt from continuing operations at December 31, 2010 were as follows:

Payments due in:	Long-Term Debt	Subordinated Long-Term Debt	Operating Leases	Interest On Outstanding Debt	Interest On Subordinated Outstanding Debt
1 year (2011)	$ 30,000	$ 300	$ 3,068	$ 3,528	$ 180
2 years (2012)	18	300	1,364	1	156
3 years (2013)	-	300	846	-	132
4 years (2014)	-	300	609	-	108
5 years (2015)	-	1,200	351	-	96
5 years +	-	-	820	-	-
	$ 30,018	$ 2,400	$ 7,058	$ 3,529	$ 672

At December 31, 2010, SunLink had guarantee agreements with four physicians. A physician with whom a guarantee agreement is made generally agrees to maintain his/her practice within a hospital geographic area for a specific period (normally three years) or be liable to repay all or a portion of the guarantee received. The physician s liability for any guarantee repayment due to non-compliance with the provisions of a guarantee agreement generally is collateralized by the physician s patient accounts receivable and/or a promissory note from the physician. All potential payments payable under the four guarantees have been paid as of December 31, 2010. SunLink expensed $130 and $207 on physician guarantees and recruiting for the three months ended December 31, 2010 and 2009, respectively and expensed $219 and $434 on physician guarantees and recruiting for the six months ended December 31, 2010 and 2009, respectively. There were no remaining non-cancelable commitments under guarantee agreements with physicians as of December 31, 2010.

Note 14. Related Party Transactions

A director of the Company and our company secretary (who was a director of SunLink until November 2003 and is now a director emeritus) are members of two different law firms, each of which provides services to SunLink. The Company has paid an aggregate of $166 and $68 for legal services to these law firms in the three months ended December 31, 2010 and 2009, respectively, and $433 and $252 for the six months ended December 31, 2010 and 2009, respectively.

Note 15. Financial Information By Segments

Under ASC Topic No. 280, Segment Reporting, operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision-making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision-making group is composed of the chief executive officer and members of senior management. Our two reportable operating segments are Healthcare Facilities and Specialty Pharmacy.

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We evaluate performance of our operating segments based on revenue and operating income (loss). Segment information for the quarters and six months ended December 31, 2010 and 2009 is as follows:

Three months ended December 31, 2010	**Healthcare Facilities**	**Specialty Pharmacy**	**Corporate And Other**	**Total**
Net Revenues from external customers	$ 37,267	$ 11,484	$ -	$ 48,751
Operating profit (loss)	(565)	(7)	743	171
Depreciation and amortization	1,041	393	113	1,547
Assets	58,829	25,957	11,631	96,417
Expenditures for property, plant and equipment	201	84	19	304
Six months ended December 31, 2010				
Net Revenues from external customers	$ 72,569	$ 20,386	$ -	$ 92,955
Operating loss	(1,697)	(212)	(528)	(2,437)
Depreciation and amortization	2,131	781	228	3,140
Assets	58,829	25,957	11,631	96,417
Expenditures for property, plant and equipment	523	255	91	869

Three months ended December 31, 2009	**Healthcare Facilities**	**Specialty Pharmacy**	**Corporate And Other**	**Total**
Net Revenues from external customers	$ 38,160	$ 12,235	$ -	$ 50,395
Operating profit (loss)	1,310	(109)	(1,124)	77
Depreciation and amortization	1,164	417	114	1,695
Assets	63,619	27,319	10,861	101,799
Expenditures for property, plant and equipment	229	131	105	465
Six months ended December 31, 2009				
Net Revenues from external customers	$ 76,201	$ 22,261	$ -	$ 98,462
Operating profit (loss)	4,348	182	(2,405)	2,125
Depreciation and amortization	2,321	814	222	3,357
Assets	63,619	27,319	10,861	101,799
Expenditures for property, plant and equipment	835	396	106	1,337

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (dollars in thousands, except per share and admissions data)

Forward-Looking Statements

This Quarterly Report and the documents that are incorporated by reference in this Quarterly Report contain certain forward-looking statements within the meaning of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Forward-looking statements include all statements that do not relate solely to historical or current facts and may be identified by the use of words such as may, believe, will, expect, project, estimate, anticipate, plan or continue. These forward-looking statements are plans and expectations and are subject to a number of risks, uncertainties and other factors which could significantly affect current plans and expectations and our future financial condition and results. These factors, which could cause actual results, performance and achievements to differ materially from those anticipated, include, but are not limited to:

General Business Conditions

general economic and business conditions in the U.S., both nationwide and in the states in which we operate;
the competitive nature of the U.S. community hospital, nursing home, homecare, and specialty pharmacy businesses;
demographic changes in areas where we operate;
the availability, cost, and terms of new long-term financing to replace our current credit agreement lender;
the availability and terms of capital to fund working capital, renovations, replacements, expansions, and capital improvements at existing hospital facilities and replacement hospital facilities;
changes in accounting principles generally accepted in the U.S.; and,
fluctuations in the market value of equity securities including SunLink common shares;

Operational Factors

inability to operate profitably in one or more segments of the healthcare business;
the availability of, and our ability to attract and retain, sufficient qualified staff physicians, management, nurses, pharmacists and staff personnel for our operations;
timeliness and amount of reimbursement payments received under government programs;
restrictions imposed by debt agreements;
the cost and availability of insurance coverage including professional liability (e.g., medical malpractice) and general liability insurance;
the efforts of insurers, healthcare providers, and others to contain healthcare costs;
the impact on hospital services of the treatment of patients in lower acuity healthcare settings, whether with drug therapy or via alternative healthcare services, such as surgery centers or urgent care centers;
changes in medical and other technology;
risks of changes in estimates of self insurance claims and reserves;
increases in prices of materials and services utilized in our Healthcare Facilities and Specialty Pharmacy segments;
increases in wages as a result of inflation or competition for management, physician, nursing, pharmacy and staff positions;
increases in the amount and risk of collectability of accounts receivable, including deductibles and co-pay amounts; and,
the functionality or costs with respect to our management information system for our Healthcare Facilities and Specialty Pharmacy segments, including both software and hardware;
the availability and competition from alternative drugs or treatments provided by our Specialty Pharmacy segment;

Liabilities, Claims, Obligations and Other Matters

- claims under leases, guarantees and other obligations relating to discontinued operations, including sold facilities, retained or acquired subsidiaries and former subsidiaries;
- potential adverse consequences of known and unknown government investigations;
- claims for product and environmental liabilities from continuing and discontinued operations;
- professional, general and other claims which may be asserted against us; and
- weather-related events such as flooding, wind damage and population evacuations affecting areas in which we operate, including Louisiana and South Georgia.

Regulation and Governmental Activity

- existing and proposed governmental budgetary constraints;
- the regulatory environment for our businesses, including state certificate of need laws and regulations, rules and judicial cases relating thereto;
- anticipated adverse changes in the levels and terms of government (including Medicare, Medicaid and other programs) and private reimbursement for SunLink s healthcare services including the payment arrangements and terms of managed care agreements;
- changes in or failure to comply with Federal, state or local laws and regulations affecting the healthcare industry including healthcare reform proposals currently being debated in Congress; and,
- the possible enactment of Federal healthcare reform laws or reform laws in states where we operate hospital and pharmacy facilities (including Medicaid waivers and other reforms);

Acquisition Related Matters

- the availability and terms of capital to fund acquisitions;
- impairment or uncollectibility of certain acquired assets;
- assumed liabilities discovered subsequent to an acquisition;
- our ability to integrate acquired healthcare businesses and implement our business strategy; and
- competition in the market for acquisitions of hospitals and healthcare businesses.

As a consequence, current plans, anticipated actions and future financial condition and results may differ from those expressed in any forward-looking statements made by or on behalf of SunLink. You are cautioned not to unduly rely on such forward-looking statements when evaluating the information presented in this Form 10-Q. We have not undertaken any obligation to publicly update or revise any forward-looking statements.

Corporate Business Strategy

SunLink s business strategy is to focus its efforts on internal operations of its existing healthcare facilities and pharmacy business, supplemented by growth from selected rural and exurban healthcare acquisitions, including but not limited to hospitals, nursing homes, home care businesses, and pharmacy businesses. However, as was the case in 2004 with the sale of our Mountainside Medical Center hospital and in September 2009 with the sale of three home health agencies, we consider dispositions of one or more of our facilities or operations. Dispositions may be considered based on a variety of factors including asset values, return on investments, competition from existing and potential facilities, capital improvement needs, corporate strategy and other corporate objectives.

Operations

Our operational strategy is focused on efforts to improve operations and generate internal growth. Our primary operational strategy for our community hospitals is to improve the operations and profitability of such hospitals by reducing out-migration of patients, recruiting physicians, expanding services and implementing and maintaining effective cost controls. Our operational strategy for our nursing homes and home health agency is similar to that for our community hospitals and is focused on expanding services and implementing and maintaining effective cost controls. Our operational strategy for our Specialty Pharmacy segment is focused on continuing the integration of the Carmichael operations acquired in April 2008, increasing market share, expanding services and implementing and maintaining effective cost controls.

Acquisitions

Although the Company s situation could change, based on its current financial position as well as uncertainties in the healthcare industry, the Company is not actively seeking acquisitions for its Healthcare Facilities or Specialty Pharmacy segments. However, we continue to evaluate certain rural and exurban hospitals and healthcare businesses, which may be for sale, and monitor other selected rural and exurban healthcare acquisition targets which we believe might become available for sale.

Critical Accounting Estimates

The preparation of financial statements in accordance with U.S. generally accepted accounting principles requires us to make estimates and assumptions that affect reported amounts and related disclosures. We consider an accounting estimate to be critical if:

- it requires assumptions to be made that were uncertain at the time the estimate was made; and
- changes in the estimate or different estimates that could have been made could have a material impact on our consolidated results of operations or financial condition.

Our critical accounting estimates are more fully described in our 2010 Annual Report on Form 10-K and continue to include the following areas:

- Receivables net and provision for doubtful accounts;
- Revenue recognition / Net Patient Service Revenues;
- Goodwill and accounting for business combinations;
- Professional and general liability claims; and
- Accounting for income taxes.

Financial Summary

The results of continuing operations shown in the financial summary below are for our two business segments, Healthcare Facilities and Specialty Pharmacy.

Equivalent admissions Equivalent admissions is used by management (and certain investors) as a general measure of combined inpatient and outpatient volume for our hospital operations. Equivalent admissions are computed by multiplying admissions (inpatient volume) by the sum of gross inpatient revenues and gross outpatient revenues and dividing the result by gross inpatient revenues. The equivalent admissions computation is intended to relate outpatient revenues to the volume measure (admissions) used to measure inpatient volume to result in a general approximation of combined inpatient and outpatient volume (equivalent admissions).

	THREE MONTHS ENDED December 31,			SIX MONTHS ENDED December 31,		
	2010	2009	% Change	2010	2009	% Change
Net Revenues - Healthcare Facilities	$ 37,267	$ 38,161	-2.3%	$ 72,569	$ 76,201	-4.8%
Net Revenues - Specialty Pharmacy	11,484	12,235	-6.1%	20,386	22,261	-8.4%
Total Net Revenues	48,751	50,396	-3.3%	92,955	98,462	-5.6%
Costs and expenses	(48,580)	(50,319)	-3.5%	(95,392)	(98,679)	-3.3%
Gain on sale of Home Health businesses	-	-	N/A	-	2,342	N/A
Operating profit (loss)	171	77	N/A	(2,437)	2,125	N/A
Interest expense	(3,229)	(859)	275.9%	(4,077)	(1,778)	129.3%
Interest income	1	6	-83.3%	2	9	-77.8%
Earnings (Loss) from continuing operations before income taxes	$ (3,057)	$ (776)	N/A	$ (6,512)	$ 356	N/A
Healthcare Facilities Segment:						
Admissions	1,674	1,858	-9.9%	3,294	3,708	-11.2%
Equivalent admissions	5,524	5,955	-7.2%	11,393	12,378	-8.0%
Surgeries	808	1,018	-20.6%	1,668	1,979	-15.7%
Revenue per equivalent admission	$ 6,746	$ 6,408	5.3%	$ 6,370	$ 6,156	3.5%

Results of Operations

Our net revenues are from our two business segments, Healthcare Facilities and Specialty Pharmacy.

Healthcare Facilities Segment

Net revenues for the three months ended December 31, 2010 were $37,267 with a total of 5,524 equivalent admissions and revenue per equivalent admission of $6,746 compared to net revenues of $38,161 with a total of 5,955 equivalent admissions and revenue per equivalent admission of $6,408 for the three months ended December 31, 2009. Net revenues for the six months ended December 31, 2010 were $72,569 with a total of 11,393 equivalent admissions and revenue per equivalent admission of $6,370 compared to net revenues of $76,201 with a total of $12,378 equivalent admissions and revenue per equivalent admission of $6,156 for the six months ended December 31, 2009.

The following table sets forth the percentage of net patient revenues from major payor sources for the Company s hospitals during the periods indicated:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Source				
Medicare	40.6%	38.3%	39.9%	37.7%
Medicaid	17.1%	18.2%	15.5%	17.4%
Self-pay	13.0%	12.6%	14.9%	13.2%
Commerical Insurance & Other	29.3%	30.9%	29.7%	31.7%
	100.0%	100.0%	100.0%	100.0%

Admissions decreased for all payor sources for the three months ended December 31, 2010 compared to the comparable prior year period. For the six months ended December 31, 2010, admissions decreased for all payor sources except Self-pay, which increased 9%, compared to the prior year. These decreased admissions resulted in net revenue decreases in Medicaid and Commercial Insurance and Other net revenues this year, while we had slight increases in Medicare and Self-pay net revenues. We experienced a net loss of one physician during the three months ended December 31, 2010 and four physicians during the six months ended December 31, 2010. The loss of four net physicians combined with the continued weak local economies of our service areas resulted in decreased Healthcare Facilities net revenues for the three and six months ended December 31, 2010 compared to the prior year s comparable periods.

The Company has responded to this by:

-increasing physician recruiting efforts,

-employing additional physicians, and

-opening additional clinics, including Rural Health Clinics.

In addition, we continue to seek increased patient volume by attracting additional physicians to our hospitals, upgrading the services offered by the hospitals on an as-needed basis, and improving our hospitals physical facilities based on the availability of capital resources and our assessment of expected return on capital. We currently have ongoing searches to recruit primary care physicians and general surgeons at four hospitals. During the three and six months ended December 31, 2010, SunLink expensed $207 and $434, respectively, on physician guarantees and recruiting expenses compared to $195 and $384, respectively, for the same periods last year.

Net revenue for the three months ended December 31, 2010 and 2009 included $273 and $538, respectively, from state indigent care programs. Net revenues included an increase of $847 and $559 for the three months ended December 31, 2010 and 2009, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports. Net revenue for the six months ended December 31, 2010 and 2009 included $243 and $948 respectively, from state indigent care programs. Net revenues included an increase of $856 and $459 for the six months ended December 31, 2010 and 2009, respectively, for the settlements and filings of prior year Medicare and Medicaid cost reports.

We also have expended approximately $3,371 for capital expenditures to upgrade services and facilities since July 1, 2009.

Specialty Pharmacy Segment

Specialty Pharmacy net revenue for the three months ended December 31, 2010 was $11,484, a decrease of $1,041, or 6.1%, from $12,243 for the three months ended December 31, 2009. The decrease was primarily due to lower sales of pharmacy products, primarily due to the loss of supply arrangements with two long-term care facilities compared to the same period last year. Net revenue for durable medical equipment decreased approximately 8.5% this year due to lower demand. Sales of a seasonal infusion therapy drug decreased approximately 4% this year compared to last year due to the deferral of the start and the shortening of the overall dosage regimen period under Louisiana Medicaid this year. Specialty Pharmacy net revenue for the six months ended December 31, 2010 was $20,386, a decrease of 8.4%, from $22,261 for the same period last year. The decrease was primarily due to an approximately 20% decrease in the sale of the seasonal infusion therapy drug.

Healthcare Facilities Segment Cost and Expenses

Costs and expenses for our Healthcare Facilities, including depreciation and amortization, were $35,442 and $36,850 for the three months ended December 31, 2010 and 2009, respectively, and $71,878 and $74,217 for the six months ended December 31, 2010 and 2009, respectively.

	Costs and Expenses As % of Net Revenues Three Months Ended December 31,		**Costs and Expenses As % of Net Revenues Six Months Ended December 31,**	
	2010	**2009**	**2010**	**2009**
Salaries, wages and benefits	45.5%	46.1%	46.5%	46.0%
Provision for bad debts	13.5%	15.2%	15.2%	16.0%
Supplies	9.8%	10.3%	10.0%	10.1%
Purchased services	7.2%	6.8%	7.3%	6.9%
Other operating expenses	14.3%	13.1%	14.8%	13.4%
Rent and lease expense	2.0%	1.9%	2.0%	1.9%
Depreciation and amortization expense	2.8%	3.0%	2.9%	3.0%

Salaries, wages and benefits expense as a percentage of net revenues decreased slightly in the three months ended December 31, 2010 compared to the same period in the prior year due to decreased staffing demands in conjunction with lower volumes as well as lower employee benefits expense.

Provision for bad debts decreased as a percentage of net revenue in the three and six ended December 31, 2010 compared to the prior year periods due to increases in indigent care write-offs and increased collections compared to the comparable prior year periods.

Supplies expense decreased in the three and six months ended December 31, 2010 due to decreases in surgeries. The number of surgeries performed in the three and six months ended December 31, 2010 were 808 and 1,648 compared to 1,018 and 1,979 for three and six months ended December 31, 2009.

Other operating expenses increased as a percentage of net revenues in the three and six months ended December 31, 2010 compared to the prior year periods due to recording a new healthcare provider tax for our three Georgia healthcare facilities as other expense. Provider tax recorded in other expense was $875 and $1,747 for the three and six months ended December 31, 2010, respectively as compared to $518 and $1,035 for the three and six months ended December 31, 2009, respectively. States in which the Company operates hospitals have imposed and increased their provider tax in the last two years.

Specialty Pharmacy Segment Cost and Expenses

Cost and expenses for our Specialty Pharmacy segment, including depreciation and amortization, were $11,492 and $12,607 for the three months ended December 31, 2010 and 2009, respectively, and $20,597 and $22,676 for the six months ended December 31, 2010 and 2009, respectively.

	Costs and Expenses As % of Net Revenues Three Months Ended December 31,		Costs and Expenses As % of Net Revenues Six Months Ended December 31,	
	2010	2009	2010	2009
Cost of Goods Sold	73.5%	73.3%	69.9%	70.1%
Salaries, wages and benefits	14.4%	14.3%	16.9%	15.8%
Provision for bad debts	1.0%	1.8%	1.8%	1.4%
Supplies	0.4%	0.5%	0.5%	0.5%
Purchased services	3.6%	3.7%	4.0%	3.9%
Other operating expenses	3.2%	3.0%	3.4%	3.2%
Rent and lease expense	0.6%	0.6%	0.7%	0.6%
Depreciation and amortization expense	3.4%	3.4%	3.8%	3.7%

Salaries, wages and benefits increased slightly as a percent of net revenue in the three and six months ended December 31, 2010 as compared to the prior year primarily due to increased staffing in the accounting and business office areas needed for implementing and improving system controls and procedures. The provision for bad debts as a percent of net revenues decreased in quarter ended December 31, 2010 due primarily to emphasis on and improvements in business office operations and the collection of receivables.

Corporate Overhead Costs and Expenses

Cost and expenses for Corporate Overhead including depreciation and amortization, was $1,646 and $1,125 for the three months ended December 31, 2010 and 2009, respectively, and $2,917 and $2,384 for the six months ended December 31, 2010 and 2009, respectively. The increase was primarily due to $483 of severance expense for four corporate employees in the three and six months ended December 31, 2010.

Operating Profit

SunLink had an operating profit of $171 and $77 for the three months ended December 31, 2010 and 2009, respectively. Operating loss for the six months ended December 31, 2010 was $2,437 compared to operating profit of $2,125 last year. The increase in operating profit in the quarter ended December 31, 2010 compared to the operating profit in the prior year was due to lower operating expenses and depreciation and amortization in the current year. The decreased costs more than offset the decreases in revenues of both the Healthcare Facilities and Specialty Pharmacy segments. The decrease in operating profit in the six months ended December 31, 2010 compared to operating profit in the prior year period was due to decreased revenues of both the Healthcare Facilities and Specialty Pharmacy segments in the current year and non-recurrence of the pre-tax gain on the September 2009 sale of three home health businesses.

Sale of Home Health Businesses

In September 2009, the Company sold three of its home health businesses for approximately $3,300 resulting in a pre-tax gain of approximately $2,342. Included in the net assets of the three home health businesses sold was $429 of goodwill related to the Healthcare Facilities segment. The home health businesses were located in Adel, GA, Clanton, AL, and Fulton, MO.

Interest Expense

Interest expense was $3,229 and $859 for the three months ended December 31, 2010 and 2009, respectively, and was $4,077 and $1,778 for the six months ended December 31, 2010 and 2009, respectively. Interest expense for the three and six months ended December 31, 2010 increased from the same periods last year primarily due to approximately $984 in waiver fees paid in the quarter ended December 31, 2010 as required under the Credit Agreement Waiver, $990 of increased deferred financing cost amortization this year resulting from the change in the termination date of the 2008 Credit Facility from April 2015 to September 2011 and increased interest rates charged as a result of the Credit Agreement Waiver.

Income Taxes

Income tax benefit of $978 ($983 federal tax benefit and $5 state tax expense) and income tax benefit of $365 ($308 federal tax benefit and $57 state tax benefit) was recorded for the three months ended December 31, 2010 and 2009, respectively. Income tax benefit of $1,788 ($2,000 federal tax benefit and $212 state tax expense) and income tax benefit of $218 ($218 federal tax benefit and $0 state tax benefit) was recorded for the six months ended December 31, 2010 and 2009, respectively. The high effective income tax rate of 61.0% for the six months ended December 31, 2009 resulted from the tax non-deductibility of $429 of goodwill included in the net assets of the home health businesses sold during in September 2009.

We had an estimated net operating loss carry-forward for federal income tax purposes of approximately $6,150 at December 31, 2010. Use of this net operating loss carry-forward is subject to the limitations of the provisions of Internal Revenue Code Section 382. As a result, not all of the net operating loss carry-forward is available to offset federal taxable income in the current year. At December 31, 2010, we have provided a partial valuation allowance against the domestic deferred tax asset so that the net domestic tax asset was $4,048. Based upon management s assessment that it was more likely than not that a portion of its domestic deferred tax asset (primarily its domestic net operating losses subject to limitation) would not be recovered, the Company established a valuation allowance for the portion of the domestic tax asset which may not be utilized. The Company has provided a valuation allowance for the entire amount of the foreign tax asset as it is more likely than not that none of the foreign deferred tax assets will be realized through future taxable income or implementation of tax planning strategies.

Loss from continuing operations were $2,079 ($0.26 loss per fully diluted share) for the quarter ended December 31, 2010 compared to loss from continuing operations of $411 ($0.05 loss per fully diluted share) for the quarter ended December 31, 2009. The increased loss in the current year s quarter resulted from increased interest expense related to waiver fees and interest rate increases as a result of the Credit Agreement Waiver. Loss from continuing operations was $4,724 ($0.58 loss per fully diluted share) for the six months ended December 31, 2010 compared to earnings from continuing operations of $138 ($0.02 earnings per fully diluted share) for the comparable period last year. Loss from continuing operations in the current year decreased from the prior year due to a decrease in net revenues in the six months ended December 31, 2010 and higher earnings in the prior period from the sale of three of our home health agencies in September 2009. The decrease is also due to increased interest expense related to waiver fees and interest rate increases as a result of the Credit Agreement Waiver.

Earnings from discontinued operations of $190 for the six months ended December 31, 2010 primarily resulted from $216 of earnings attributable to our former Mountainside operations, $115 and $26 of losses resulting from domestic pension items relating to discontinued operations. Earnings from discontinued operations of $314 for the quarter ended December 31, 2010 resulted from $327 of earnings from Mountainside and $13 of losses resulting from domestic pension items relating to discontinued operations.

Net loss for the quarter ended December 31, 2010 was $1,765 ($0.22 loss per fully diluted share) compared to net loss of $524 ($0.07 loss per fully diluted share) for the quarter ended December 31, 2009. Net loss for the six months ended December 31, 2010 was $4,534 ($0.56 loss per fully diluted share) compared to net loss of $28 ($0.00 loss per fully diluted share) for the six months ended December 31, 2009.

Adjusted earnings before income taxes, interest, depreciation and amortization

Earnings before income taxes, interest, depreciation and amortization (EBITDA) represent the sum of income before income taxes, interest, depreciation and amortization. We understand that certain industry analysts and investors generally consider EBITDA to be one measure of the liquidity of a company, and it is presented to assist analysts and investors in analyzing the ability of a company to generate cash, service debt and meet capital requirements. We believe increased EBITDA is an indicator of improved ability to service existing debt and to satisfy capital requirements. EBITDA, however, is not a measure of financial performance under accounting principles generally accepted in the United States of America and should not be considered an alternative to net income as a measure of operating performance or to cash liquidity. Because EBITDA is not a measure determined in accordance with accounting principles generally accepted in the United States of America and is thus susceptible to varying calculations, EBITDA, as presented, may not be comparable to other similarly titled measures of other corporations. Where we adjust EBITDA for non-cash charges we refer to such measurement as Adjusted EBITDA , which we report on a company wide basis. Non-cash adjustments in Adjusted EBITDA are not intended to be identified or characterized in any respect as non-recurring, infrequent or unusual, if we believe such charge is reasonably likely to recur within two years, or if there was a similar charge (or gain) within the prior two years. Where we report Adjusted EBITDA, we typically also report Hospital Facilities segment Adjusted EBITDA and Specialty Pharmacy segment Adjusted EBITDA which is the EBITDA for the applicable segments without any allocation of corporate overhead, which we report as a separate line item, gains on sales of businesses and without any allocation of the non-cash adjustments, which we also report as a separate line item in Adjusted EBITDA. Net cash used in operations for the quarter ended December 31, 2010 and 2009, respectively, is shown below.

	Three Months Ended December 31,		Six Months Ended December 31,	
	2010	2009	2010	2009
Healthcare Facilities Adjusted EBITDA	$ 2,863	$ 2,479	$ 2,821	$ 4,308
Specialty Pharmacy Adjusted EBITDA	386	336	569	996
Corporate overhead costs	(1,531)	(1,043)	(2,687)	(2,164)
Taxes and interest expense	(2,440)	(438)	(2,402)	(1,901)
Other non-cash expenses and net change in operating assets and liabilities	(1,645)	(791)	339	(1,200)
Net cash provided by (used in) operations	$ (2,367)	$ 543	$ (1,360)	$ 39

Liquidity and Capital Resources

We generate cash from operations predominately from the operating profit of our two business segments, the Healthcare Facilities and Specialty Pharmacy segments. Working capital requirements, including capital expenditures, are generally funded with cash from operations. During the six month period ended December 31, 2010, we funded our operating cash usage of $1,360 (compared to $39 of cash provided by operations during the comparable period last year) with increased borrowing under the Revolving Loan facility. The cash usage resulted from the operating loss during the period and increased interest expense under SunLink s $47,000 seven-year senior secured credit facility entered into April 23, 2008 (2008 Credit Facility) and fees paid with respect to the terms of the waiver agreement entered into September 27, 2010 (the Credit Agreement Waiver) in connection with the waiver of non-compliance with certain financial covenants in the 2008 Credit Facility, partially offset by non-cash expenses of depreciation and amortization and increased third party payor settlements.

The 2008 Credit Facility includes a revolving line of credit of up to $12,000 (the Revolving Loan) and a $35,000 term loan (the Term Loan). Interest under the 2008 Credit Facility is LIBOR (defined as the thirty-day published rate) plus the applicable margin. Pursuant to the Credit Agreement Waiver, the termination date of the 2008 Credit Facility was changed from April 22, 2015 to September 30, 2011 and the interest rate for the Revolving Loan is LIBOR plus 6.50% from the waiver date through November 14, 2010, LIBOR plus 7.50% from November 15, 2010 to February 15, 2011, LIBOR plus 8.50% from February 16, 2011 to May 14, 2011 and LIBOR plus 9.50% from May 15, 2011 to the September 30, 2011 termination date. The interest rate for the Term Loan is LIBOR plus 8.07% from the waiver date through November 14, 2010, LIBOR plus 9.07% from November 15, 2010 to February 15, 2011, LIBOR plus 10.07% from February 16, 2011 to May 14, 2011 and LIBOR plus 11.07% from May 15, 2011 to August 14, 2011. At December 31, 2010, the interest rate for the Term Loan was 11.82% and the interest rate for the Revolving Loan was 10.25%. We also agreed to a reduction in the revolving line of credit facility commitment from $12,000 to $9,000, which we believe is adequate for our current level of operations. The total availability of credit under all components of the 2008 Credit Facility is keyed to the level of SunLink s earnings, which, based upon the Company s estimates, provided for current borrowing capacity, before any draws, of approximately $38,746 at December 31, 2010. The 2008 Credit Facility is secured by a first priority security interest in substantially all real and personal property of the Company and its consolidated domestic subsidiaries, including a pledge of all of the equity interests in such subsidiaries.

The 2008 Credit Facility contains various terms and conditions, including operational and financial restrictions and limitations, and affirmative and negative covenants. If we fail to remain in compliance with the 2008 Credit Facility, we would cease to have a right to draw on the Revolving Loan and the lenders would, among other things, be entitled to declare a default under the 2008 Credit Facility and demand repayment of the indebtedness outstanding under the Revolving Loan and the Term Loan. If SunLink or its applicable subsidiaries experience a material adverse change in their business, assets, financial condition, management or operations, or if the value of the collateral securing the 2008 Credit Facility decreases, we may be unable to draw on the Revolving Loan. The covenants include financial covenants measured on a quarterly basis which require SunLink to comply with maximum leverage and minimum fixed charge ratios, maximum capital expenditure amounts, collateral value to loan amount and liquidity and cash flow measures, all as defined in the 2008 Credit Facility. At June 30, 2010, SunLink was in non-compliance with certain financial covenants of the 2008 Credit Facility. On October 8, 2010 (the Waiver Date), the Company received, pursuant to the Credit Agreement Waiver, a waiver from its lenders of these financial covenants for the fiscal quarter ended June 30, 2010, and subject to certain conditions, also for the fiscal quarters ended September 30, 2010, December 31, 2010 and March 31, 2011.

Under the terms of the Credit Agreement Waiver, the conditions for waivers of the non-compliance with financial covenants for the quarters ended September 30, 2010, December 31, 2010 and March 31, 2011 include, among other things, compliance by SunLink with minimum consolidated adjusted earnings before interest, taxes depreciation and amortization but at a level reduced from that formerly applicable. The Company was in compliance with the terms of the 2008 Credit Agreement, including the revised levels of financial covenants for the December 31, 2010 financial statements. A waiver fee of 2% of the current 2008 Credit Facility commitment totaling approximately $788 was paid to the Lenders by SunLink at the Waiver Date, which was expensed in the quarter ending December 31, 2010. An additional waiver fee of 0.5% of the total 2008 Credit Facility commitment totaling approximately $196 was paid at November 15, 2010 and additional waiver fees 0.5% of the commitment will be paid at both February 15, 2011 and May 15, 2011. The waiver includes other conditions related to a February 2011 $11,000 term loan reduction covenant which may increase the interest rate for both the Term Loan and the Revolving Loan by an additional 2% over the prescribed interest rate for the remainder of the 2008 Credit Facility. The Company does not currently anticipate having sufficient funds to make the payment to effect the required $11,000 reduction in principal and is in discussions with the lender seeking a waiver. Should such a waiver not be obtained, the increase in interest rates of an additional 2% will become effective February 15, 2011. Amortization of the fees and expenses recorded in interest expense were approximately $995 and $95 for the three months ended December 31, 2010 and 2009, respectively. Amortization of the fees and expenses recorded in interest expense were approximately $1,102 and $192 for the six months ended December 31, 2010 and 2009, respectively.

As a result of the new termination date of September 30, 2011 for the 2008 Credit Facility, SunLink will be required to refinance or otherwise source funds to repay the existing indebtedness outstanding thereunder prior to the termination date. SunLink is currently pursuing various alternatives, which may include refinancing some or all of such indebtedness or the sale of certain operating assets, the proceeds of which would be used to repay, in whole or in part, such indebtedness. To the extent available, borrowings under any replacement credit facility, excess proceeds from the sale of operating assets, or both also may be used to finance certain capital improvements at SunLink s healthcare facilities. There can be no assurance that the Company will be able to effect any such refinancing or the sale of any operating assets before the 2008 Credit Facility s scheduled September 30, 2011 termination date. The losses from continuing operations reported by SunLink for the last three fiscal quarters and the overall restrictive U.S. credit market during the same period has caused the availability of refinancing sources to be limited and the cost of such limited refinancing options to be higher than previously expected by management. The ability of SunLink to sell operating assets at prices equal to the Company s estimated market value of such operating assets to repay the existing indebtedness has also been restricted by the lack of available financing by potential buyers. SunLink has incurred an operating loss for the six months ended December 31, 2010. During the past five fiscal quarters, SunLink has been negatively impacted by general economic conditions of the local economies in which we operate which has negatively impacted our ability to refinance or repay the 2008 Credit Facility and may continue to do so in the future.

We expended $869 for capital improvements during the six months ended December 31, 2010 and expect to spend approximately $2,100 during the remainder of this fiscal year. We believe attractive and up-to-date physical facilities assist in recruiting quality staff and physicians, as well as attracting patients, and the capital expenditures related primarily to imaging and surgical equipment for the Healthcare Facilities segment and durable medical equipment for rent and delivery equipment for the Specialty Pharmacy segment.

Contractual Obligations, Commitments and Contingencies

Contractual obligations, commitments and contingencies related to long-term debt, non-cancelable operating leases, physician guarantees, and interest (including 2008 Credit Agreement waiver fees and scheduled increases in interest rates) on outstanding debt from continuing operations at December 31, 2010 were as follows:

Payments due in:	Long-term Debt	Subordinated Long-Term Debt	Operating Leases	Interest On Outstanding Debt	Interest On Subordinated Outstanding Debt
1 year (2011)	$ 30,000	$ 300	$ 3,068	$ 3,528	$ 180
2 years (2012)	18	300	1,364	1	156
3 years (2013)	-	300	846	-	132
4 years (2014)	-	300	609	-	108
5 years (2015)	-	1,200	351	-	96
5 years +	-	-	820	-	-
	$ 30,018	$ 2,400	$ 7,058	$ 3,529	$ 672

At December 31, 2010, SunLink had guarantee agreements with four physicians. A physician with whom a guarantee agreement is made generally agrees to maintain his/her practice within a hospital geographic area for a specific period (normally three years) or be liable to repay all or a portion of the guarantee received. The physician s liability for any guarantee repayment due to non-compliance with the provisions of a guarantee agreement generally is collateralized by the physician s patient accounts receivable and/or a promissory note from the physician. All potential payments payable under the four remaining contracts have been paid as of December 31, 2010. SunLink expensed $130 and $207 on physician guarantees and recruiting for the three months ended December 31, 2010 and 2009, respectively and expensed $219 and $434 on physician guarantees and recruiting for the six months ended December 31, 2010 and 2009, respectively. There were no remaining non-cancelable commitments under guarantee agreements with physicians as of December 31, 2010.

At December 31, 2010, we had outstanding long-term debt and subordinated debt of $32,418 of which $29,961 was incurred under the SunLink 2008 Credit Facility, $2,400 was incurred under the subordinated loan, and $57 was related to capital leases. Also outstanding at December 31, 2010 was a revolving line of credit loan of $2,800.

Legal Proceedings

On December 7, 2007, Southern Health Corporation of Ellijay, Inc. (SHC-Ellijay), a SunLink subsidiary, filed a Complaint against James P. Garrett and Roberta Mundy, both individually and as Fiduciary of the Estate of Randy Mundy (collectively, Defendants), seeking specific performance of an Option Agreement (the Option Agreement) dated April 17, 2007, between SHC-Ellijay, Mr. Garrett, and Ms. Mundy as Executrix of the Estate of Randy Mundy for the sale of approximately 24.74 acres of real property located in Gilmer County, Georgia, and recovery of SHC-Ellijay s damages suffered as a result of Defendants failure to close the transaction in accordance with the Option Agreement. SHC-Ellijay also stated alternative claims for breach of the Option Agreement and fraud, along with claims to recover attorney s fees and punitive damages.

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In January 2008, the Mundys filed a motion to strike, motion to dismiss, answer, affirmative defenses, and a counterclaim against SHC-Ellijay. On March 3, 2009, SHC-Ellijay filed a First Amended and Restated Complaint for Damages, which effectively dropped the cause of action for specific performance of the Option Agreement. On May 7, 2009, Mr. Garrett and Ms. Mundy served a motion for summary judgment on all counts and causes of action stated in the First Amended Complaint. The court has postponed consideration of the defendants motion for summary judgment and SHC-Ellijay s response thereto until after a discovery dispute between the parties has been resolved.

SunLink denies that it has any liability to the Mundys and intends to vigorously defend the claims asserted against SunLink by the Mundys complaint and to vigorously pursue its claims against the Mundys. While the ultimate outcome and materiality of the litigation cannot be determined, in management s opinion the litigation will not have a material adverse effect on SunLink s financial condition or results of operations.

SunLink is a party to claims and litigation incidental to its business, for which it is not currently possible to determine the ultimate liability, if any. Based on an evaluation of information currently available and consultation with legal counsel, management believes that resolution of such claims and litigation is not likely to have a material effect on the financial position, cash flows, or results of operations of the Company. The Company expenses legal costs as they are incurred.

Related Party Transactions

A director of the Company and our company secretary (who was a director of SunLink until November 2003 and is now a director emeritus) are members of two different law firms, each of which provides services to SunLink. The Company has paid an aggregate of $166 and $68 for legal services to these law firms in the three months ended December 31, 2010 and 2009, respectively, and $433 and $252 for the six months ended December 31, 2010 and 2009, respectively.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to interest rate changes, primarily as a result of borrowing under our 2008 Credit Facility. At December 31, 2010, borrowings under the facility of $32,761 have been drawn at an interest rate based upon LIBOR. A one percent change in the LIBOR rate would result in a change in interest expense of $328 on an annual basis. No action has been taken to mitigate our exposure to interest rate market risk and we are not a party to any interest rate market risk management activities.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures - We maintain controls and procedures designed to ensure that we are able to collect the information we are required to disclose in the reports we file with the SEC, and to process, summarize and disclose this information within the time periods specified in the rules of the SEC.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 as amended (the Exchange Act)) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective in providing reasonable assurances that information required to be disclosed by the Company in the reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported in a timely manner.

PART II. OTHER INFORMATION

Items required under Part II not specifically shown below are not applicable.

ITEM 1. LEGAL PROCEEDINGS

There have been no material developments in the legal proceeding previously reported in SunLink s Annual Report on Form 10-K except as follows:

With respect to the Mountainside Medical Center asset sale agreement, an agreement was reached on December 6, 2010 whereby SunLink and the buyer released each other from the claim and counterclaim and SunLink received an additional $540 from the buyer.

ITEM 1A. RISK FACTORS

Risk Factors Relating to an Investment in SunLink

Information regarding risk factors appears in MD&A Forward-Looking Statements, in Part I Item 2 of this Form 10-Q and in MD&A -Risks Factors Relating to an Investment in SunLink in Part I Item 1A of the Company s Annual Report on Form 10-K for the year ended June 30, 2010. While we believe there have been no material changes from the risk factors previously disclosed in such Annual Report, except as discussed in MD&A Corporate Business Strategy and MD&A Discontinued Operations in Item 2 of this Form 10-Q, you should carefully consider, in addition to the other information set forth in this report, the risk factors discussed in our Annual Report which could materially affect our business, financial condition or future results. Such risk factors are expressly incorporated herein by reference. The risks described in our Annual Report are not the only risks facing our Company. In addition to risks and uncertainties inherent in forward looking statements contained in this Report on Form 10-Q, additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results. Whenever we refer to SunLink, Company , we, our, or us in this Item 1A, we mean SunLink Health Systems, Inc. and its subsidiaries, unless the context suggests otherwise.

ITEM 6. EXHIBITS

Exhibits:

31.1	Chief Executive Officer s Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
31.2	Chief Financial Officer s Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.
32.1	Chief Executive Officer s Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Chief Financial Officer s Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, SunLink Health Systems, Inc. has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SunLink Health Systems, Inc.

By: /s/ MARK J. STOCKSLAGER
Mark J. Stockslager
Chief Financial Officer

Dated: February 14, 2011