John W. Ransom, Analyst, Raymond James & Associates

Good morning. Welcome to day two of the 33rd Annual Raymond James Conference. I'm pleased to introduce the management team of HealthSouth. Leading us off will be Jay Grinney. A couple of things to think about with HealthSouth, first of all, we think this has been a remarkable seven-year turnaround from a company that was mired in scandal and leverage and not much cash flow to a company whose leverage has been cut in half, who grew EBITDA at a double-digit clip in 2011.

And I think the company is entering a new phase away from deleveraging and more into growth and square foot expansion. And we also think this has a little bit of an aspect of the acute care hospital story of a company with we think around a 20-point margin advantage relative to its not-for-profit peers, so we think that the Darwinian shakeout for market share will continue to flow their way.

And with that, I will turn it over to Jay Grinney.

Jay Grinney, President, Chief Executive Officer & Director

Great. Thank you, John, and good morning everyone for those of you waking up for a 7:30 presentation. Mark Tarr, Executive Vice President and Chief Operating Officer; Mary Ann Arico, Chief Investor Relations Officer are also with me this morning. It's a pleasure to be here.

Forward-looking statements, everybody is familiar with that. For those of you who don't know too much about HealthSouth, we are the largest provider of inpatient rehabilitative services in the United States. We take care of patients who have been discharged from an acute care hospital. They've had a stroke. They suffered from a chronic neurological condition that is debilitating in nature, impairs their ability to function independently. They may have a hip fracture. We have some spinal cord injuries and other neurological conditions that typically afflict patients in their later stages in life, so most of our patients are Medicare.

We have 8% of the entire number of inpatient rehabilitation facilities nationwide, but because our hospitals tend to be larger and because we see more patients in those, we had 18% of the licensed beds and 23% of the patients served, so we've got a pretty good footprint in the space. We have 99 hospitals today. Most of those are in the Northeast and then through the Southeast and Southwest. To augment those inpatient services, we also have some outpatient physical therapy clinics and 25 home health agencies that are associated with our hospitals and provide follow-on care primarily therapy care for patients who have been discharged from our hospitals and still need some therapy in their homes.

You can see we've added a couple of hospitals in 2011, and then we've got a pretty nice pipeline of new hospitals that we're looking to add over the next two years, and that pipeline is growing almost every day. We feel pretty excited about where the growth opportunities are, and we'll talk about that in just a minute.

As John said, we are very proud of the track record that we've established over the last several years. In 2007, we completed the divestiture of three non-core segments of the company. We reduced the company's size from a $4 billion revenue base to a $2 billion revenue base, from 6.7 times leverage down to where we are today under three times, and you'll see some of the graphs that illustrate that in just a minute. Well, we've been very pleased with those, the consistency of our performance above from a discharge standpoint, if you look at the overall market, there's been about 1% to 2% growth in the industry. We've significantly outperformed that and done that on a consistent basis. We believe that it's the result of our single focus on inpatient rehabilitative care, that's all we do. Most of our competitors are units or departments of acute care hospitals. They tend to be 15 to 20 beds in size. They may be treating eight to 12 patients per day. They don't have the same clinical focus, the same technology focus and commitment that we have because of our singular nature in the focus that we have.

The revenue growth has been reflective of the discharge growth. You can see that there's not a lot of pricing in our business. Most of our business is Medicare for an 18-month period of time in 2008 to 2009.

We went 18 months without any increase from Medicare, and despite that, we were able to continue to take market share, grow top line. And as you can see in the EBITDA CAGR of 11%, we've been very disciplined in our management of our expenses, and so every incremental patient that comes into our hospitals, we're able to treat on a high-quality basis but also on a very incrementally beneficial basis.

In 2010, we reversed a valuation allowance that we had against our very significant net operating losses about one event. It was a non-cash event, skewed the net income for 2010, but you can see that we've had pretty good results from a net income standpoint over the last couple of years. This is probably one of the slides that I'm the most pleased with because I mentioned a minute ago in 2007, we were highly leveraged. And that was a reflection of the debt that the previous management had put on the company while they were cooking the books, and we had to deal with all of that as I came in in 2004, brought in a new management team, replaced the board, reset the direction of the company, took care of the non-core businesses, sold those. We sold those for a trailing multiple of just under 11 times back in 2007. And some people were criticizing us at the time for doing that, but in retrospect I think our judgment was spot on. We were able to use those proceeds to pay down a significant amount of debt and really repositioned the company for growth going forward.

So you see today, we had over $2 billion at the end of 2007. At the end of 2011, we had $1.2 billion and we were 2.7 times leveraged. From a cash flow standpoint, the first full year of operations as a pure play focused exclusively on inpatient rehabilitation company, we were only able to generate $9 million of free cash flow. At the end of 2011, that's grown to $243 million. And if there's one takeaway that you would – well, I would ask you to take from this session and about HealthSouth is the significant free cash flow generating capabilities that we have, and we'll talk a little bit later on how we plan to invest that free cash flow going forward.

The other thing that I would ask you to take away from the presentation and really that I think distinguishes us from our competitors is the fact that because we have the largest footprint in the country, we are the largest provider of inpatient rehabilitative care, we have the ability over the years to establish clinical protocols. We've been able to invest in the leading technology and place those in our hospitals, the net result of which has allowed us to be the inpatient rehabilitation provider of choice in the markets that we serve. And that is then reflected in our ability to consistently take market share.

So we have a couple of graphs here. Over on the left-hand side is same-store data, and we compare ourselves against a database culled from UDS, Uniform Data Systems. It represents about 70% of all of the inpatient rehabilitation providers nationwide, report their data up through UDS. And what we have here is the same-store comparisons, so it does not add any of the new hospitals that we either brought on in terms of construction or acquisition in that time period.

You can see in 2008, our first year out of the chute, a very significant growth. We put in place in 2007 a standardized sales and marketing program in all of our hospitals. Starting in 2007 – middle of 2007, we knew we were going to emerge as a pure play rehabilitation provider. We knew that the pricing environment was going to be very difficult. But we also knew we had a great product. We had the largest platform of inpatient rehabilitative services in the country. So what we did is we invested about $12 million looking at the range of sales and marketing activities that we had in place at the time in all of our hospitals. We brought in an outside consultant who then helped us go through and break into 15-minute increments everything that we were doing in all of our hospitals from a sales and marketing standpoint.

We brought – collated all that information and then started breaking it down to say, okay, if we were going to build the most efficient process of identifying potential patients and then everything from identifying a potential patient to getting that patient in a bed and treated, what would we do? How would we establish that? What kind of people would we have in the field? How would they be incentivized? What kind of information systems would we give those individuals so that they could be communicating with the nursing staff and the hospital? How would we set up monitoring systems so that on a real-time basis we could be evaluating every single sales and marketing rep in our company as they're going out making contacts, establishing referrals and bringing those referrals in on a medically necessary basis.

So after about a year of effort, we then started testing and piloting that, and the results I think speak for themselves. So this is on an annual basis. I will say in 2010, there was a new set of Medicare requirements that all inpatient rehabilitation facilities had to adopt, and I believe that that was a major contributor. If you go down to the bottom and you'll get the quarterly breakdown on same store, there is a huge shift in the industry in that first quarter. It took a lot of time for the industry to adjust to those new requirements, and you can see that from an industry standpoint, it wasn't until the fourth quarter that they were starting to see growth. It took us a little bit shorter period of time, but we still adjusted in 2010 to those new coverage requirements, and then as you can see, 2011 has been a very successful year for us. On the right-hand side, this is a quarterly discharge growth going back 2009, 2010 and 2011, and this is all in. These are all the hospitals, so this would include new hospitals through acquisitions, new hospitals through de novo activity.

So this is our business plan. This is what we've set out to do. It hasn't changed dramatically over the last several years. Big picture, we like to keep our EBITDA, our compounded annual growth rate in that 5% to 8%. We think that that's very achievable. Clearly, as we provide guidance on an annual basis, we want to keep our eye on that number, but we also recognize that there are going to be some years where the number may be higher outside that range, and there may be some that is lower of that range, but we think that that compounded annual growth rate, 5% to 8%, is very solid and then importantly, on a free cash flow basis, 12% to 17%. So how are we going to do that?

One thing that we have always focused on is taking care to make sure that our balance sheet is strong. Our goal is to get our leverage ratio in the three times range or less. We're there now. We actually took the step of taking down another $73 million in Q4 to get us a little bit inside of that three times range. We wanted a little breathing room. The main reason for that is as we look out over the next several years, we think that the pricing environment for healthcare services is going to get more challenging rather than less. And we feel that it's prudent to have a company that has a very strong balance sheet, a low amount of leverage that gives us the opportunity to weather whatever storms may come but also gives us the financial flexibility to pursue transactions that may be of interest.

So in terms of what those transactions might be, we're obviously focusing on same-store growth. We do add about 80 to 100 beds to our portfolio every year, and those are typically in four, five bed increments in our existing hospitals where the market dynamics are very strong, the demand for our services are great and we just are adding beds to keep in front of that growth profile.

We also have been focusing on de novos. We slowed things down in 2011 primarily because of the uncertainty in Washington with the Budget Control Act and then President Obama's proposed deficit reduction. We really didn't know what the Super Committee was going to do or even if they were going to do anything. So we had a pretty aggressive growth plan in place.

We hit the pause button in August when the debt ceiling debate occurred. We're talking about the Budget Control Act, sequestration, uncertainty, we hit the pause button. Fast forward to November, December, Super Committee did not get their plan in place. Sequestration then was the default position. There was no consideration of the President's deficit reduction plan, and so we felt that we have some visibility at least into 2012 and 2013 to be able to hit the restart button on the de novos.

So as you saw on that first slide, we've got at least four hospitals coming online in 2013. We have one that will open this year in Ocala. And then we will have the full year benefit of two hospitals that we opened in the fourth quarter for 2011. So we'll have some new store volume in 2012, but the real push, if you will, or the real benefit from these four-plus de novos will be seen starting in 2013 and beyond.

We're also going to be looking at acquisitions. They're a little bit harder to predict. We certainly are pursuing those as we speak rather than putting anything out there and saying, okay, we're confident we can get two a year or four a year. We say our target is to get at least two, either competitors that are in our markets or potentially freestanding hospitals in new markets.

Longer term and even though it's under 2013, 2014, I would tell you that this is a huge question mark for us in terms of timing. We do believe the future of healthcare is going to be one of more integration, more risk sharing, and we believe that in that kind of environment we can operate and be successful as a pure play inpatient rehabilitation provider because of the quality of our services and the fact that we can provide those on a highly cost-effective basis.

Just to put it into perspective, the industry EBITDA average is about 6% to 7%. Our margins are, as you heard from John, closer to 20%. And so it's really we have a huge, huge cost differential, and it gives us the ability to provide consistently high quality. We consistently outperform the industry from a quality standpoint, but we're also doing it on a highly cost-effective basis. So we can be very successful in that future environment, call it ACOs or bundling or capitation or risk sharing. It's all the same thing, and we believe that we can be successful in that kind of environment either as a pure play or potentially taking some of these sales and marketing synergies, some of the back office synergies, some of the labor synergies and build out our presence in other post acute services in markets where we have a presence. But I will tell you that that's really dependent on getting a lot more regulatory clarity. We now need to make sure that the market conditions are ready for that, and we really are going to be looking hard at what kind of price we would need to pay to enter those businesses.

So for those of you who are wondering are we going to be going into post acute services? The answer is maybe, and that maybe is really dependent on those factors that I've just talked about. The near-term focus is exclusively on inpatient rehabilitation and building out our presence in new markets.

We also have some key operational initiatives. The most important one this year is rolling out an electronic clinical information system in all of our hospitals that will create an electronic medical record in our facilities. Inpatient rehabilitation hospitals are not eligible for HITECH payments. We are not eligible for HITECH payments. So we're making this investment strictly on our own. The good news is as you evaluate the company, you don't ever have to worry about how much of the earnings are being driven by the HITECH reimbursement and how much are true earnings of the company because we don't get any of that. Everything that you see is reflective of what the company is able to achieve.

As we look out, I want to give you just a couple of metrics just to help you think about the future as we look at it. We said 2.5%, 3.5% volume growth that excludes acquisitions, but it includes all the of the bed additions I mentioned, the de novos and any kind of acquisition where we buy unit in the market and consolidate that into our existing hospital.

Medicare pricing is pretty complicated. It starts with the market basket. We don't know what that's going to be in 2013, fiscal year 2013. We know that this year was 2.9. Obamacare mandates a 10-basis-point reduction. Obamacare also mandates another productivity adjustment for hospital payments. And so as you see, those really give us a lot left at the end of the day but enough for us to be able to continue to grow the top line through market share additions.

Fiscal year 2013, we're predicting , this is just our guess that market basket will go up in the next two years a little bit. We know what the Obamacare reductions are programmed to be. We don't know what that productivity adjustment might be in the out years, but we're giving you some indication as to how we're thinking about what those numbers might be.

The other thing that's important to note is that in 2013, sequestration begins. To just to put it into perspective, sequestration is not a reduction on the unit pricing. It's a 2% reduction on the revenue. So think of it as a tax on Medicare revenues to providers and a tax that is then being used ostensibly to reduce the deficit. From a managed care standpoint, we think there's a 3% to 5% growth on that small portion of our business. About 20% of our volumes are managed care, actually less than that if you consider managed Medicare. We think 3% to 5% is a good range for you to think about in 2012. That's going to be about 3.5%.

In terms of the expenses, we think we can keep our labor costs in line from an annual increase perspective. We've done a pretty good job on managing our benefits in that 5% to 8% range, obviously, always looking for ways to take that down. G&A is a pretty small and a pretty consistent 4.5%, and you can see some of the other expense assumptions.

So as we look at our initial guidance for 2012, we've got EBITDA pegged at $475 million to $485 million. Here are some of the considerations. We think that discharge growth conservatively will be somewhere in the 2.5% to 3.5% range, discharge – revenue per discharge, about 2%, maybe 2.5% depending on the acuity of our patients. We are going to see some headwinds on the out-patient side. Our out-patient segment, which is very small will see about a $1 million reduction in revenues.

And then we have a lot of one-times in 2011 that need to be considered as you think about 2012. First was our bad debts typically ranged between 1.3% and 1.5% of net revenues so bad debts, 1.3%, 1.5%. Last year, it was down around 1% and in some quarters, a little bit less than that. So what we think is we're going to go back to a more normal pace in 2012.

We also are putting in that new clinical information system. We mentioned that just a minute ago, that's about a $4 million investment. We'll see most of that then throughout the year. A little bit of that will be front end loaded but not by a significant amount.

As we look at EPS, this is a little bit busy, a lot of noise around our EPS numbers in part because we were paying down debt over the last several years and part because we are – with our NOLs, we are a very small cash taxpayer. And in 2011, as we went through the year because of the various things that we were dealing with, our effective tax rate was 19%. In 2012, the guidance that we're giving, the $1.32 to $1.39 is assuming a 40% effective tax rate. But I think it's very important for investors to understand that the cash taxes are only going to be somewhere between $7 million and $10 million and that's again because of the very significant NOLs that we are still carrying on our books.

So what's the quarter look like? It looks pretty good. We feel pretty good about the start to the year. We do have some tough comps almost 8% last year all in, so we're going up against some very good prior year numbers but that being said, we still feel pretty good about the start to the year at least where we are today. We do have – last year, we had a $1.5 million benefit from a provider tax refund, and then we are investing $1.4 million in the first quarter this year. So there's about a $3 million delta just year-over-year. Keep that in mind as you think about the quarter. And then this year, all healthcare providers are going to be required to take their bad debts and have it as a reduction to revenue instead of an expense line item. So that you'll see is a new way of portraying bad debts on our income statement.

As we look at our adjusted free cash flow, we are stepping up the investment in our maintenance CapEx from $50 million to $75 million, maybe $85 million, and that's going to be a function of the investment in the clinical information system and some major refresh programs to some of our hospitals. We've got two hospitals that we're almost rebuilding in place. They've been with us for a long time. We need to refurbish them, and we believe that by doing so, we will be able to take advantage of additional growth in those markets.

And then you can see that there's an uptick in working capital. That is a reflection of A, the growth that we're experiencing but also the bad debt issue that we talked about where it's going back to a more normal level of 1.3% to 1.5%.

So the cash flow that we're generating, we've got a lot of opportunities in terms of where to invest that. First, we want to focus on investing in the growth that we believe is out there both on a de novo basis, continuing to grow on our existing markets and then acquiring either freestanding hospitals or units. We don't see debt repayment today as being a major source of investment about free cash flow. Our leverage ratio is where we want it to be. If something changes down the road in the landscape, the external landscape just dramatically changed, we always have that ability to go in and to prepay some of our debt. We don't have any bonds maturing before 2018, and then each of the tranches that we have are in that

$280 million to $320 million range, and it's 2018, 2020, 2022. We've got a $500 million revolver. We've got some drawn on that today, but we have the obviously, the ability to pay that down that's LIBOR plus 2.25%.

So we also had in place a share repurchase program but clearly, where we're going to be focusing the investment of our free cash flow is up in the – in our inpatient rehabilitation business, so it just gives you an idea of what that investment might be, $20 million to $25 million to add those beds. And just think about that adding 80 to 100 beds that's like adding two new 40 bed hospitals in our portfolio. And all of the new hospitals that we're building are 40 beds in nature. We're expecting that the de novos, finishing Ocala, starting four others somewhere in the $70 million range and then depending on if we have any acquisitions, they'll clearly go up from there.

Talk about the additional investment alternatives, just to give you an idea of the kind of return that we've seen in the past, our cash payback on de novos somewhere in the five to seven years. We try to target at least four de novos per year. You can see the cash payback on the acquisitions is a little bit less, and that's in part because – in fact, large part because as you're building hospitals either as a ramp up period of maybe six to nine months before that hospital is EBITDA positive. So it just gives you an idea of what we've seen in the past, and then this number will grow as we add and announce new hospitals throughout the year.

So in conclusion, we think we've got a pretty good business model. I think we've got a significant track record that we can point to. We've been able to manage successfully even in very difficult times, and we think we're very well positioned to be successful on a go-forward basis.

So with that, I'll conclude.

John W. Ransom, Analyst, Raymond James & Associates

We have time for one question. Anybody who has a question? The audience has been stunned into silence.

Jay Grinney, President, Chief Executive Officer & Director

I think it's the fact that it's 7: 30.

John W. Ransom, Analyst, Raymond James & Associates

Exactly. All right. We're going to breakout. Thanks.

Jay Grinney, President, Chief Executive Officer & Director

All right. Thanks, everyone.