Gary Lieberman, Analyst, Wells Fargo Advisors LLC

Good morning, everybody. Welcome to day two of the Wells Fargo Health Care Conference. I'm Gary Lieberman, Wells Fargo's Healthcare Facilities Analyst. We're very happy today to have HealthSouth with us. From the company, we have Jay Grinney, President and CEO; and Doug Coltharp, CFO. Also with us is Mary Ann Arico, Chief IR Officer.

We're going to keep this strictly to questions. So I have a number of questions for the company. But if you have any questions, please put your hand up, and we will get a microphone over to you to get your question.

So with that, I guess the first question I have is HealthSouth's volume growth has been very impressive, both compared to the inpatient rehab facility, but also to other acute and post that you operate. Can you talk about how you are able to keep the volume growth as robust as it is and if you think over time you'll move towards the industry meaning or what the outlook is for that?

Jay Grinney, President and Chief Executive Officer

Yeah. I think first of all, just so that everyone is familiar with what we have, we have a deck of material that we sent out in advance of today's conference. And then we have in the back what we refer to as our investor reference book. And we may be referring to pages in these documents as we answer some of the questions from Gary.

So first of all, I think you have to keep in mind that the fundamental demographic trends in inpatient rehabilitation are very favorable. We treat primarily Medicare patients. The conditions that are treated in rehabilitation hospitals tend to be those that are seen in the elderly strokes, chronic neurological conditions that are debilitating in nature, limits the patient's ability to function independently.

We also deal with people who have had hip fractures. As a result of that, they're again incapacitated. And then they come into our hospitals, stay two weeks on average, get intensive therapy, and then are discharged. So the underlying demand for inpatient rehabilitation is growing about 2%, 2.5% per year and is projected to continue along that growth trajectory for the next 5 to 10 years, in large part because of this large baby boom cohort that is just now entering Medicare eligibility.

So we've got this large baby boom generation that is going to be aging. And then one of the inevitable consequences of the aging process is higher incidence of stroke, higher incidence of neurological conditions, higher incidence of other types of conditions that we treat in our hospitals. So that's one fundamental that's driving our ability to outpace others in healthcare services. Second is that those services that I just described tend to be nondiscretionary in nature.

So if you look at the acute care world, there are a lot of discretionary conditions. People tend to defer certain treatments on the inpatient acute care side that they're really not able to defer on inpatient rehabilitation. Then, I think what differentiates perhaps HealthSouth, is that we have positioned our hospital in markets where that underlying demand is growing at the high end of that 2% to 2.5% range on average. So we're in Florida. We're in Pennsylvania, which is the second largest concentration of Medicare enrollees. We're in Texas. We're in Arizona. We're in the Southeast. So all of those things, I think, contribute to that fundamental demand for our service.

On top of that, we put in place in 2008 a standardized process of identifying potential patients who could benefit from the care that we offer. Standardizing then the protocols for assessing those patients and getting a decision back to the referring hospital and the referring physician in a timely manner, so that when the case manager of the acute care hospital is sitting there having to make a discharge decision for that patient, we're in a position today to be very responsive to their needs, and to do so in a way that allows us to bring those patients in, continue the care, and to do so in a very timely manner.

So all of that, I think, is contributing to what we've seen in our company as really significant year-over-year, quarter-over-quarter growth in our volumes. And we think that that is sustainable for all those reasons that I had just mentioned well into the future. And then if you look at the growth that we're bringing online with new hospitals, that obviously is going to continue to fuel that growth going forward. We have seven hospitals today that are in some form of construction. Some of those will be opening in 2013. The full balance and the full benefit, I should say, of all of those will really start to be seen in 2014. And then we have a pipeline of additional hospitals that we're going to bringing online after that.

So, all of that kind of long-winded answer to the question, but it is probably one of the most important questions for our company and for any health services company is, can you continue to grow? And we're very confident that our track record speaks for itself and that what we have in place, both in terms of fundamentals and then what we put in place as far as our business model, will allow us to continue to grow into the future.

Gary Lieberman, Analyst, Wells Fargo Advisors LLC

With the 2% sequestration cuts that Medicare is facing in 2013, how do you think about that and what kind of things do you think about in terms of trying to offset some of those cuts?

Jay Grinney, President and Chief Executive Officer

Well, it is inevitable, unless Congress does something to reduce that tip. I think there are a couple of comments. Number one, we're the only industry that I know in health services that has actually had to live through an extended period of no increase from Medicare. In the second quarter of 2008 through the third quarter of 2009, all inpatient rehabilitation facilities and hospitals had their Medicare pricing reduced back to levels that were equal to what we were receiving in the third quarter of 2007. So for 18 months, we went with no price increase from Medicare at all.

In that environment, we grew volumes. We grew EBITDA. We grew net income. We grew free cash flow. And in your investor reference book, there'll be a slide that is on – we'll find it for you. Slide 14 that will give you some of the data behind that that shows the volume growth, the EBITDA growth. And so, we're not looking toward a sequestration. Nobody is. But I think that what we've demonstrated is that we can grow through that environment. And I think that sort of a global response to that question is that it will also, we believe, create some growth opportunities for us in terms of acquisitions, joint ventures, consolidations in the market, because I believe what we're going to see is that health services providers are increasingly going to have to pick and choose what services they can offer and do so on a high quality basis.

The idea that hospital systems or any provider can be all things to all people in today's reimbursement environment, I think is very, very difficult to realize. And we saw that actually – yesterday, we announced that we purchased an inpatient rehabilitation unit from the CHRISTUS System in San Antonio. Highly accretive to HealthSouth. We'll buy that business. We'll buy the assets. CHRISTUS then will close that unit. We'll sign a long-term non-compete, and we then have taken a step to consolidate that market. I think that that's indicative of what we're seeing in our development pipeline. And many other hospital systems, both for profit and not-for-profit, are realizing that today, things are tough from a reimbursement standpoint.

If you get down into 2013, you got the third year of the pay for or Affordable Care Act or Obama Care. There'll be continued reductions on Medicare payments as a result of that. Presumably, that will continue. I mean who knows what happens after the Supreme Court decision. But then in 2013, you start seeing the first year of what will then be a 10-year period of sequestration. So, the reimbursement environment today is challenging as it is. It's going to be even more challenging in the future. And I think that that creates opportunities for companies like ours that have a very low cost structure and a very strong business model that will allow us to grow in that kind of environment.

Gary Lieberman, Analyst, Wells Fargo Advisors LLC

Other than inpatient rehab, what post-acute businesses do you think are relatively well positioned?

Jay Grinney, President and Chief Executive Officer

Well, frankly at this point, I don't think any are well positioned vis-à-vis their status with CMS. And most of the post-acute services provide services for Medicare enrollees predominantly. Home health is due for some rebasing in 2014. Maybe it'll happen next year. Obviously, there's then the whole talk about potentially introducing co-pays for homecare. I think there's wide spread belief that that will create a chilling effect on volume growth there. Skilled nursing is still digging out from their 11% cut. I think that that's going to be something that the skilled nursing industry is going to have to just really deal with and wrestle with for a long time. Those are big deep cuts. And I think as companies report in Q2, Q3 and Q4, we'll start to see what the impact on that segment is.

Long term acute care, even though the rate of growth has relatively plateaued, it's still a service that is in flux with respect to CMS regulation. And I think we all know they're really subject to a moratorium right now. CMS cannot come in and introduce any additional new regulations to long term acute care until that moratorium expires. That moratorium expires later this year. CMS is talking about introducing patient criteria that will limit and define the kinds of patients that can be treated. In LTAC, we've got the whole issue of what about the 25% rule, does that apply, does it not apply. So, I mean you go through in every single segment is under some kind of scrutiny. Our view is that our scrutiny has already occurred. We had the 60% rule. We had new coverage requirements that we had to absorb. We had our rebasing all in the past.

So, as we look out over the next couple of years, we think that inpatient rehabilitation is going to be relatively untouched by outsized regulation. And then the only other comment that I would make is that if you look at the rate of growth of spending on inpatient rehabilitation from a Medicare standpoint, we do have that on slide 11 of the conference deck. You can see that the rate of growth for inpatient rehabilitation has actually leveled off. As a percent of a total Medicare spending, it's about 1.2%, 1.3% and has been at that level for the last four years. So, it's not a segment where the margins are high for the industry. It's not a segment that is growing at an exponential rate. In fact, the rate of growth is actually pretty much leveled off. So, we don't see inpatient rehabilitation being a problem child, if you will, that needs to be fixed from a regulatory standpoint.

Gary Lieberman, Analyst, Wells Fargo Advisors LLC

Okay. Any questions from the audience? Your leverage ratio steadily declined about 2.7 times which puts you in the low end of the range for broadly comparable companies. Should we expect it continue to decline, and kind of what are your thoughts and targets there?

Jay Grinney, President and Chief Executive Officer

I'll ask Doug to answer. I will just put it into perspective. In 2007, our leverage ratio was about 5.6 times. We're at 2.7 times now. It's been a focus of ours. We didn't know that we were going to be in this kind of environment. But we did anticipate that healthcare was going to be scrutinized and that there would be rate pressures put on the industry. And so, over the last several years, sometimes subject to criticism by people outside the company, they were saying, you're putting too much focus on the balance sheet. Today, we're saying, we're glad we put a lot of focus on the balance sheet, because our leverage ratio now gives us a ton of flexibility in dealing with what is most certainly going to be a very challenging environment.

Douglas E. Coltharp, Chief Financial Officer & Executive Vice President

Yeah. I think when we consider our financial leverage, we think not only about the absolute level of leverage, but also about the composition of our debt capital. So from a leverage level perspective at 2.7 times, we're inside the target range that we have previously established. When you then look at the composition of our debt capital, we feel very positive about our schedule of maturities. We have no debt of any consequence maturing prior to 2016. We feel good about the rates at which we were able to refinance our debt. And we also feel good about the financial covenants and restricted covenants contained in those instruments.

So based on all of those factors, we don't feel any compelling need to restructure the debt or to delever the balance sheet any further. Having said that, we will continue to naturally deleverage over time, even absent any voluntary prepayment of debt. And that'll be as a result of the combination of roughly $20 million of acquired principal amortization contained in those instruments per annum and then also the anticipated growth in EBITDA. We do recognize that we're operating in a period of uncertainty that is likely to continue for a period of time. And that probably makes it prudent to continue to operate at a relatively low level of financial leverage.

Gary Lieberman, Analyst, Wells Fargo Advisors LLC

Can you now mention the recent upgrades?

Douglas E. Coltharp, Chief Financial Officer & Executive Vice President

We did in the month of May. We were very fortunate when we received a corporate family upgrade and a specific instrument upgrade from both Moody's and S&P. Significant enough that actually our most senior debt instrument, which is our bank facility, has now got an investment grade credit rating from Moody's. So that's a significant milestone for the company.

I think also just one other comment on the strength of the balance sheet. It won't be too long, I think from a GAAP perspective, when we start looking at leverage to include the obligations that are representative within the operating leases associated with real estate in the provider community. And that's going to show that our balance sheet is even stronger than the competition, because we own about two-thirds of our real estate right now. So the lease obligations that you don't see showing up in the leverage ratio plus our peers right now, for HealthSouth, those are substantially lower than the peer group.

Jay Grinney, President and Chief Executive Officer

And again, just to put where we are today in perspective for those of you who may not be that familiar with the company, back in 2004, 2005, our credit rating was second to the bottom in the junk status. And in a very short period of time, relatively short period of time, we've made huge strides in improving the integrity of our financial statements, but more importantly in the integrity of the financial foundation of this company. And we think that that gets overlooked a lot by investors that as we go into a period that everybody acknowledges is going to be unpredictable and uncertain and pose risks, we have a very strong foundation to enter that environment and we believe to grow in that kind of future space.

Gary Lieberman, Analyst, Wells Fargo Advisors LLC

So I guess maybe just to follow up on that, how should we think about and how do you think about what are the best uses of your free cash flow?

Jay Grinney, President and Chief Executive Officer

First and foremost, it's going to be focusing on and investing in our growth. We have a slide in the deck – maybe you can help me find it, Doug – that outlines where those priorities are. First, it's going to be investing in bed additions in existing hospitals. We add anywhere from 80 to 100, maybe 120 beds in hospitals that are at or near capacity in markets that are growing above the national average, where we know the market, we know the referral sources, and we can add beds on a very, very profitable marginal basis. Slide 10 in this conference book sort of outlines that. So bed additions is number one.

And then we have other means of growing outside of our existing portfolio to add new stores. One is going to be de novos. We have, as I mentioned, seven de novos under some form of construction or in the case of two of those, we're just waiting for final resolution on a certificate of need. We can see that on slide three of the deck that we presented for this conference. And those de novos typically are 40-bed, all private rooms in markets where we have assessed there's a need for inpatient rehabilitative services, but not a supply of adequate beds.

And we also have a pretty good track record of bringing these hospitals on, the de novos on. Within three to eight months, they're EBITDA positive. And within 12 to 15 months, they're at or above the company average in terms of occupancy. So, we've done a very good job of identifying markets where there's a demand for inpatient rehabilitative services and no supply of adequate beds.

We also had the opportunity to acquire free standing hospitals. We've done that a couple of times. We acquired a hospital in Houston. We've acquired a hospital in Las Vegas over the last couple of years. We anticipate that there will be other free standing hospitals that we'll be able to acquire over the next several years. We'll have acquisitions along the lines of the what we did in San Antonio yesterday, where we acquire a unit that is a department or a unit of an acute care hospital, bring the assets over, bring some of the employees over to help accommodate the additional demand, the acute care hospitals and closes that unit, signs a long-term non-compete, and we've just now consolidated the capacity in that market.

So, looking at growth is really where we want to put the majority of our free cash flow. One of the things that I think people do overlook is that we're generating a significant amount of free cash flow in this company. And that free cash flow continues to expand. We don't have a lot of maintenance CapEx. So, at the end of the day, there's going to be additional avenues for investing that free cash flow. Doug mentioned that we own most of our hospitals. We lease some. When those leases are up for renewal or up for the opportunity to buy them out, we'll do that. We've done that several times over the last several years, where we can go in and take control of that asset, and no longer be under a lease obligation. We think that makes sense long-term.

We also, then at the end of the day, will evaluate where we want to put the balance of that free cash flow that we're generating. We have publically said that we have $125 million authorization to go out and selectively buy back some of the preferred. We bought back $25 million in the first quarter. And we'll continue to look at that. And then at the end of this year, we'll look to see whether or not it makes sense to potentially reward shareholders with some kind of special dividend. We do have a share repurchase authorization from the board. Our board tends to be pretty conservative when it comes to share buyback. But we've got really a wide array of investment opportunities for investing free the significant free cash flow that we're generating out of the company.

QUESTION AND ANSWER SECTION

Q – [Inaudible]

Q – Gary Lieberman – Wells Fargo Advisors LLC: Let's just repeat the question. The question was regarding REIT conversions and what the company's thoughts are.

A – Jay Grinney – HealthSouth Corp.: Well, I mean, you mean just sell the company through a REIT? Because that's what...

Q – [Inaudible]

A – Jay Grinney – HealthSouth Corp.: Well, that's what you're really doing. That's what you're doing is you're selling the company to a REIT. Because then you're working for the REIT and spending – the rent payments are there, set. They're going to be going up. It's just another form of debt. The way we look at it, because it's an obligation that's there that you can't manage. You can't manage. So if we stepped in today and said, okay, let's look at what Medicare had, what, $700 million, $800 million of EBITDA, they sold everything to a REIT. Now, they've got, what, $205 million of EBTIDA. And they've got a rent payment of $379 million. That's going up somewhere between 3% and 5% every single year forever. In an environment that we have in health services today, that makes no sense.

Now, have bankers talked to us about it? Yes. Have we been at all responsive to that? No. Because we really don't believe over the long term that that gives us the flexibility that we need to be able to operate in what is a very unpredictable environment, where we know there's going to be pressure on rates. Anybody who doesn't say that there's going to be pressure on rates, I think, is really very naive.

So in a rate pressure environment, why would you want to have this huge amount of, again, debt obligations, you can call it whatever you want, obligation that is growing and that you cannot refinance, you can't touch forever. To me, that's a huge burden on a company that may be on the short term one – for traders in the stock who are in and out, that might make sense. For investors in the stock who are going to be here 3 years, 5 years, 10 years, that doesn't make sense.

Not that we have an opinion. Doug, I don't know if you want to add anything to that?

A – Douglas Coltharp – HealthSouth Corp.: No.

Gary Lieberman, Analyst, Wells Fargo Advisors LLC

Unfortunately, I think that does it for time. Thank you very much for being with us.

Jay Grinney, President and Chief Executive Officer

All right, thanks guys.