Andy Schenker, Analyst, Morgan Stanley

Hello. Thank you for joining us today. I am Andy Schenker, the Facilities Analyst at Morgan Stanley. And I'm pleased to have Jay Grinney, CEO; and Mark Tarr, COO of HealthSouth joining me today. Thank you for being here, gentlemen.

Jay Grinney, President and Chief Executive Officer

Our pleasure.

Andy Schenker, Analyst, Morgan Stanley

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We'd like to keep this interactive, so if anyone in the audience has a question at any time, please raise your hand and someone will come by with a microphone. And with that, let me kick it off. Jay, I think you have some prepared remarks.

Jay Grinney, President and Chief Executive Officer

I do, just a couple of minutes before we jump into the Q&A. And we also have with us Mary Ann Arico who is our Chief Investor Relations Officer. She has available for you what we call our investor reference book. We maybe referring to that during the Q&A. So, if you need one just raise your hand. Mary Ann will get you a copy. We also have copies of today's very brief remarks.

For those of you not familiar with HealthSouth, we're the largest provider of inpatient rehabilitative care in the United States. As a post acute provider, we receive virtually all of our patients directly from an acute care hospital, patients who have suffered from some kind of neurological condition or incident that requires some follow-on care after they are stabilized in the acute care setting.

If you look at the number of inpatient rehabilitation facilities nationwide, there are about 1,150. We own and operate 8% of all IRFs, and the acronym that is used IRFs. Our hospitals tend to be larger, so you can see the percent of beds is 18%, much greater. And then since we have larger facilities, we also see more patients per facility, so the throughput is larger. And as you can see, the market share on a national basis is about 20%. Our hospitals are located throughout the Northeast, Southeast, through the Southwest. We are looking to expand that portfolio, have a number of projects underway as we speak.

The first six months of the year have been very successful for us. Volumes are up 4.5%. We got a little lift on pricing. We are able to leverage our cost structure very effectively to generate 8.3% EBITDA growth. And as you can see, our EPS was $0.79 for the first two months -- excuse me, first two quarter compared to $0.74 last year. If you take out $0.27 of one-time benefit from last year's number you get a more, I think, reflective picture of what the EPS growth has been year-over-year.

As we looked at the second quarter results and went into the third quarter, we started looking at volumes ticking up for the company. We are very pleased with where we are right now. We've said that we thought volumes would be somewhere in the 2.5% to 3.5% range for Q3 and 4. As we look just at Q3 we are going to be at the top-end of that range.

We also amended our credit agreement and created a larger revolver. We eliminated the $100 million term loan. Last week we were out in the market, took advantage of very favorable market conditions, raised $275 million of 12-year paper at 5.75%.

As I mentioned, the growth continues. We acquired a unit in San Antonio and we're looking to complete de novos in a lot of different markets that will come on, one of the end of this year, the balance in 2013 with then additional hospitals opening up in out years.

Just to give you an idea or snapshot of some of the key metrics as we look at de novos, some of these are going to be developed in certificate-of-need states, others are not. The CON process typically reduces the go-forward risk from competitors coming in, but it does elongate the process of getting these hospitals up and running, all of our hospitals, new hospitals or private rooms. And we're able to build a 40-bed hospital somewhere in that $20 million range.

You can see there are some pre-opening costs that we have to incur. But then once that's up and running, our hospitals tend to be EBITDA positive somewhere in that four to eight-month timeframe.

In terms of guidance, the end of Q2, we increased our guidance for the balance of the year. We now have as guidance out there, EBITDA $487 to $495 million. That represents a 4.5% to 6.2% growth year-over-year and then from an EPS standpoint, we raised the guidance to $1.45 to $1.50.

So when we look at the company, we think there are lots of things that make this very attractive investment for you. Number one, we're in a sector that is growing at a very nice rate. The underlying demographic trends bring this industry growth to about 2% to 2.25%. We've got the single largest position in that industry. Our cost structure is very, very disciplined. We are able to bring new patients on in a very advantageous way. On a marginal basis, we own most of the hospitals that we own and operate. We only leased about a third of those. So we don't have this huge escalating rent cost that we have to deal with year-over-year.

We've created a very strong balance sheet that I think will give us a lot of flexibility going in to the next couple of years, which undoubtedly we'll be characterized by lot of uncertainty. And despite that uncertainty, we see some very compelling and attractive growth prospects for us in our core business of inpatient rehabilitation.

So with that, I'll sit down and we will go in to the Q&A.

Andy Schenker, Analyst, Morgan Stanley

Great, thank you very much. Maybe we will just stop there and remind everyone, if you have a questions, please feel free to raise your hands after the prepared remarks. Anything from the audience here? Okay, great. We'll just jump in to it then.

So you mentioned in the prepared remarks, but you guys did do a securities offering last week, restructured your debt and capital structure. Are you guys happy with where it stands today and any changes to look for going forward?

Jay Grinney, President and Chief Executive Officer

No, we are pleased with what we've been able to do. And with respect to that capital structure, we've looked at not only how much debt do we have, but what are the maturities of that debt. And we've created I think a very flexible structure. Our first maturity isn't until 2017. That's a revolver. And then starting in 2018 and every other year, we have somewhere in the $270 to $300 million that will be coming due with the series of notes.

As we know, last week we did raise $275 million. Part of the proceeds from that will be used to call the 2018 and 2022's. We've got the ability to call 10% of the outstanding balance. And so, we will exercise that and take those two notes down by 10%.

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Andy Schenker, Analyst, Morgan Stanley

Great. I think you've mentioned little in the prepared remarks, but you just kind of update us on utilization environment and keep in mind that HealthSouth able to grow kind of faster than the industry for several years now. What is driving that above market growth and is it sustainable?

Jay Grinney, President and Chief Executive Officer

Yeah, that's interesting. First of all, we definitely think it's sustainable. We've been getting that same is a sustainable question since 2008. And it's the same question quarter after quarter. And we keep demonstrating that it is indeed sustainable. And the reason it's sustainable is really there are two major factors. Number one, our industry is growing somewhere in that 2% to 2.25% per year pace. And that's really driven by the demographics.

Most of our patients are Medicare eligible. And it's not because we've targeted this business to go after Medicare patients. It's the nature of rehabilitative medicine is such that we treat patients who have conditions like a stroke, hip fracture, some sort of chronic neurological condition that impairs their ability to function independently. And to treat those patients and to get them back into a some level of normalcy requires inpatient therapy like physical therapy, occupational therapy, speech therapy along with 24-hour, 7-day a week nursing care.

We do that, we believe, better than anybody else. And there are metrics out there that are used in the industry. We always far outpace the competition in any those metrics. And at the core of what is driving our volume growth is the fact that our hospitals are dedicated and focused exclusively on inpatient rehabilitative care. Most of our competitors are units or departments of acute care hospitals. And as such, they tend to be non-core service lines for those acute care hospitals. And for us, it's everything that we do.

So we believe that at the core of our volume growth and our market share gains is the fact that we can demonstrate to physicians, to patients, to family members, to case managers in acute care hospitals, that if the patients are admitted to a HealthSouth hospital, there is a significantly greater likelihood that that patient will be discharged directly home with a good outcome.

And that is at the core of that value proposition. And then you superimposed on top of that, the fact that that industry is growing at 2% to 2.5% gives us, I think, a lot of confidence that the market share gains and volume growth is sustainable.

Andy Schenker, Analyst, Morgan Stanley

That's great. And kind of building of your comments there, what is your strategy for maybe -- or your outlook for joint ventures with acute care hospitals versus standalone facilities?

Jay Grinney, President and Chief Executive Officer

We certainly have a very open mind with respect to joint ventures. About a third of our hospitals are in a joint venture today. So, if you look at our portfolio of 99 hospitals, 32 of them are in some kind of joint venture arrangement, be it with University of Virginia, Barnes-Jewish in St. Louis, Vanderbilt University. We also have joint ventures with large systems on a local level, non-academic medical centers. We are opening a brand new building with a partner down in Stuart, Florida, Martin Health, a joint venture hospital.

So we're open to that. If the market conditions are such that we feel we are better served going into that market on a partnership basis, we will do so. If, on the other hand, the market is highly, highly fragmented and we believe there is an opportunity to go in basically on a Switzerland basis and be responsive to all of the patients in that market, we'll do that.

Andy Schenker, Analyst, Morgan Stanley

Great. Changing gears a little bit, you talked about utilization. Can you maybe characterize the current rate environment across all payor classes and specifically what do you think the outlook for Medicare reimbursement is in 2013 and maybe 2014 as well?

Jay Grinney, President and Chief Executive Officer

Yeah, I think that's the biggest issue facing all healthcare providers, is the fact that the rate environment is difficult today and it's going to get worse. I don't know anybody that thinks that the reimbursement out of Medicare is going to be any better in 2013 and 2014 than it is today. I mean we know that we've got additional years of mandated cuts from the Affordable Care Act, where every single year for the next eight years there is going to be reductions on Medicare payments. And then staring in 2013, sequestration will be in effect.

I know there are some out there who say, well, sequestration is there, but it's going to be repealed. I see no chance of that. Now, the defense spending, maybe. To cut back on -- to do away with sequestration for Medicare providers, I don't see it. I mean there is going to have to be a pay for somewhere. And in today's environment, where is that going to come from, especially if there is going to be money going back into defense.

So I think that the rate environment is going to be very challenging. The thing that I keep reminding our investors is even in a rate environment that is very tight, the demand for services is not going to go away. So those who are successful or who will be successful are those who have focused on the balance sheet over the last five years. They don't have any near-term maturities. They are not burdened with excessive interest expense. There is flexibility in their business model and they have a cost structure that allows them to take patients on, on a highly incremental and profitable basis. So our flow through -- every new dollar of revenue that we get in, our flow through is anywhere from 30% to 40%. So we can bring a patient in and get a dollar of revenue and only have to spend, say, $0.35 of additional cost. I don't know if too many providers that have that kind of flexibility in their cost structure.

Andy Schenker, Analyst, Morgan Stanley

That's good. So going to the next question here I know you've been successful increasing your operational efficiency over the last few years. Is that trend sustainable as well and are there other areas for operational efficiencies over time to help offset any reimbursement headwinds like sequestration?

Jay Grinney, President and Chief Executive Officer

Yeah, I think that – certainly, we think that the business model that we've created is sustainable. We've invested a significant amount of resources in our IT capabilities from a management reporting perspective. We refer to that, our internal system, as our Beacon system. It gives our hospital teams all the way down to the department manager, to the senior management team, regional level up in to corporate, and the ability to manage all of the key components of what we do on a day to day basis with real time information starting with labor. And that's 50% of our revenues go to labor as you would expect; physical therapy, occupational therapies, speech therapy all very labor intensive.

Longer term we think that the implementation of the EMR system that we are putting in place will be helpful to us on a cost structure basis. I think it will give us some efficiencies. I think it will improve the outcomes and we are very excited about what that's going to be able to do for our patients and how that's going to differentiate us longer term.

Andy Schenker, Analyst, Morgan Stanley

Just -- if could talk about your clinical information system roll-out in a little more depth, I mean, you guys don't get meaningful use dollars.

Jay Grinney, President and Chief Executive Officer

Right.

Andy Schenker, Analyst, Morgan Stanley

So what motivated you to implement and what do you hope to be the kind of ROI on the investment?

Jay Grinney, President and Chief Executive Officer

Well, what motivated us to do it is that's where the industry is going. The incentives were put in to the acute care hospitals and all post acute providers are dependant on those referring hospitals. Our belief was that if we didn't have a system that allowed us to connect digitally with the referring hospitals that we would find ourselves disadvantaged. Or really looking at it from the positive, we wanted to differentiate ourselves with the ability to connect digitally with any of our referring partners.

So you think about down the road -- if we go down an ACO route or some kind of risk sharing pathway, there is going to be a need to make sure that the acute care and post acute provider can connect digitally and we will be, I think, the only post acute-care provider out there with that capability. So that was one of the main reasons.

Another reason, frankly, just from an employee retention and recruitment perspective, most of the nurses and therapists are coming out of programs where they have been trained in an EMR environment. And for us to be attractive to those individuals as they come out of their programs, we wanted to make sure that our EMR was there. And then finally, we think that the real value is going to be in improving the outcomes of the patients, reducing the small number of risks that are out there anyway, and improve the patient satisfaction for the patients.

Andy Schenker, Analyst, Morgan Stanley

Okay, great. Any further questions? I think there is one in the back.

Can you talk about the world of vouchers? Where you guys sit, if Medicare was to go that route, what's your vision of the company when there is no government Medicare, but it's just similar to Medicare advantage, but just for everybody at that point?

Jay Grinney, President and Chief Executive Officer

Yeah, I think that in that kind of world, our belief is, first of all, it's going to be quite a ways down the road. I don't see that happening in the next three to five years, and I am sure everybody in this room holds stocks for much longer than three to five years. But if you go down 10 years, I do think that a premium support type system is very plausible.

Our belief is that in that kind of environment, providers who can demonstrate that they can provide a higher quality level of care and be able to do that on a highly cost effective basis, we think those are the providers who are going to be successful. Because I go back to the underlying premise for all the healthcare services is the demand is not going to go away. And in our world, there is not a technological alternative or an outpatient alternative that can be replacing inpatient rehabilitation.

When a patient has a stroke and they need intensive nursing care 24x7 and intensive therapy three hours a day, 13 to 14 days, that can't be done in a home setting, that can't be done in an outpatient setting, that has to be done in a hospital setting. And in a premium support kind of system, there is going to be networks presumably that get formed. And those networks are going to consist of providers who can provide that quality, provide that service on a high quality basis. And then those who can really come in with a very low disciplined cost structure, we think we are perfectly situated for that kind of environment.

Andy Schenker, Analyst, Morgan Stanley

That's great. Any other questions? Okay, we'll move on. You kind of touched on ACOs a couple of questions ago, I mean, how do you envision inpatient rehab hospitals interacting with ACOs or bundled payment arrangements and is HealthSouth participating in any pilots today?

Jay Grinney, President and Chief Executive Officer

I'll ask Mark to respond to what we are doing today and what we are seeing in the market. Now, let me just say that again, it goes back to the premise that in an ACO environment, number one, our belief is that those are going to be created in the same kind of environment we are in right now, which is to say a very, very tight reimbursement environment. That's going to require most acute care hospitals to partner with others to be able to provide the full range of services.

And we think that we, by virtue of the quality and the fact that we can demonstrate that superior quality, have the ability to have a seat at the table. And then you look at the fact that a third of our hospitals today are already in a partnership arrangement. I mean we are already kind of locked in. A third of our portfolio is locked in today to whatever the future might be for that particular acute care hospital. I'm going to ask Mark to respond to what we are doing and what we are seeing in the market.

Mark Tarr, Executive Vice President and Chief Operating Officer

Yes, with regard to ACOs, we've reached out to every one of our, obviously, our partners and our partnered hospitals as well as all of our leading acute care referral sources in our marketplaces. We've gone and talked to their CFOs or CEOs in most cases to let them know that we'd be interested in working with them on any type of bundle payment or ACO type of pilot adventures. Right now, we have six markets or hospitals that have least signed letters of confidentiality to at least share information back and forth with acute care hospital.

I'll tell you that the majority of the acute care hospitals are very cautious when it comes to signing up to participate in ACOs. Many of them remain sitting on the sidelines, waiting to see what further developments happen. And so, we've been more than willing to reach out and eager to participate in those pilot projects that are out there. It's just we haven't seen a whole lot of interest from the acute care side.

Jay Grinney, President and Chief Executive Officer

I think that ultimately, if we go down that road, it's going to be much more of an evolutionary change than a revolutionary change. And I think a lot of that is just driven by the fact that sort of been there, done that. In the 1990s, it didn't work out particularly well. I think people are lot more cautious this year.

And the only other metric I think is important to note is that when ACOs were introduced as part of the Affordable Care Act, the then administrator of the CMS, Don Berwick, was saying 500 ACOs will be signing up, and he was very convinced that that's the direction of the industry. And we've got way less than half of that number out of 5,000 hospitals nationwide.

So, is it something that will be explored? Yes. Is it something that we want to participate in? Yes. Do we think we can be a valuable provider in an ACO? Absolutely. But we don't see the industry just rushing pell-mell down that road.

Andy Schenker, Analyst, Morgan Stanley

And thinking maybe a little more generally about the Affordable Care Act. I mean how do you see it impacting your business and how are you positioning the company's portfolio for the upcoming changes?

Jay Grinney, President and Chief Executive Officer

The Affordable Care Act really didn't affect Medicare beneficiaries. What it was, as you know, was an attempt to bring those who had no insurance into some kind of coverage. Because of the nature of our business, which is to provide rehabilitative services, and because of the kinds of conditions that require inpatient rehabilitative services, we really don't see much of an impact.

Now, will we pick up maybe a small number of incremental new commercial patients because there are more people enrolled? Perhaps, but it's really not going to move the needle for us. I think the biggest impact is frankly on the pricing side where we're going to have to give up anywhere from 100 to 110, 120 basis points of market basket updates on an annual basis because of the cuts in the Affordable Care Act.

Andy Schenker, Analyst, Morgan Stanley

Okay. Changing gears a little bit here, could you talk about your use of the cash? Can you prioritize for us your capital here, your appetite for acquisitions versus de novo builds maybe and adding beds to existing facilities?

Jay Grinney, President and Chief Executive Officer

Yeah, we have a page in our investor reference book, it is page 54, that kind of outlines what that priority is. First and for most, we think there are lot of opportunities to continue to build and expand our inpatient rehabilitation portfolio through bed additions in existing markets. Those are markets where we've done exceedingly well. We are running out of capacity and we had the ability on a very, very low cost basis to add additional capacity.

De novos, which I mentioned before, we believe we can add at least four new de novos per year starting in 2013. We have acquisitions, some of which are going to be units and then consolidations into an existing hospital like we did in San Antonio. Others maybe acquisitions of freestanding hospitals or other units, we think we can do at least two of those per year.

And then you go down and start looking at some alternatives beyond investing in our core business, we own and operate most of our hospitals. We do have about a third that are under lease. Maybe half a dozen of those leases will be up for renewal or for buyout over the next 18 months. We'll certainly look at those as a potential use of cash. And then as you can see at the bottom of that page, we do have some authorizations for share buyback and then going out and looking for some of the convertible preferred.

Andy Schenker, Analyst, Morgan Stanley

Okay. I guess, we only have a minute left here. So if any closing remarks, I mean, how should we be thinking about the company over the next six months, maybe catalysts and then beyond that?

Jay Grinney, President and Chief Executive Officer

I think that the catalyst really is our track record and the fact that we've been able to demonstrate since 2008, market share gains. We've been able to leverage our cost structure very effectively to generate very impressive EBITDA growth. I think fundamentally what shareholders and healthcare services have to understand is that there is always going to be that potential for headline risk, especially in today's environment. But the demand is not going away.

I mean the fundamental demand, and go back to 1960s when the Medicare program came about and then 1980s with DRGs, there is always some new change that's coming in healthcare. And some people run for the hills and say, "oh, the world is coming to an end." But the dust clears, everybody gets a better vision and say, "yeah, you know the demand isn't going away, the people still are getting sick. Somebody is going to have to take care of them." And there are going to be winners going forward and there are going to losers. And those who haven't focused on the balance sheet, don't have a disciplined cost structure, don't have the scale, I think they are at risk. You look at companies like HealthSouth and I think we're very well positioned to continue to grow, in fact, even grow stronger in the years to come.

Andy Schenker, Analyst, Morgan Stanley

Fantastical. Thank you for coming.

Jay Grinney, President and Chief Executive Officer

You're very welcome. Thank you.

Andy Schenker, Analyst, Morgan Stanley

Thank you.