Unverified Participant, J.P. Morgan

Good afternoon. Next on the podium we have HealthSouth and its presenter is Jay Grinney, the President and CEO.

Jay Grinney, President and Chief Executive Officer

All right. Thank you, good afternoon with me are Mark Tarr, Executive Vice President, Chief Operating Officer and Doug Coltharp, Executive Vice President and Chief Financial Officer. Also with us today is Mary Ann Arico, Chief Investor Relations Officer. We've got two documents for you, one is hard copy of the presentation and other is a hard copy of our investor reference book, so if you don't have a copy, raise your hand, Marry Ann will get it to you.

For those of you who are not familiar with HealthSouth, we are an inpatient rehabilitation facility company. There are about 1200 rehabilitation hospitals that go by the acronym IRFs in the country. Most of these are going to be hospital based units. So they are departmental wings of acute care hospitals. They provide inpatient rehabilitative care for patients who are being discharged from the host acute care hospital.

Of the 234 free standing hospitals in the industry, we own and operate 100, so we represent a little less than half of the free standing facilities nationwide. Something that makes inpatient rehabilitation hospitals a little different than other post-acute settings is the fact that there are certain mandated criteria for patients being admitted to our hospitals.

The first is that the patients must require at least two types of therapy, either physical therapy, occupational therapy or speech therapy to help them recover from the illness that they're recovering from and they must be able to tolerate at least three hours of therapy per day. So, they need to be an active participant in their care and obviously they're going to be admitted by a physician.

Hospitals are – inpatient rehabilitation hospitals are licensed as acute care hospitals as such we must have a Medical Director. All of the patients who come in are screened 48 hours before and then within 24 hours post admission. There is an interdisciplinary approach so we have the physician, the case manager, the nurses and the therapists all involved in providing care for the patients and there is a specific requirement for inpatient rehabilitation hospitals called the 60% rule and that rule mandates that 60% of all patients must come from one of 13 conditions that are designated by CMS as a qualifying condition.

HealthSouth is the largest provider of inpatient rehabilitative care in the country. We have 100 hospitals. As you can see, we're located primarily in the eastern half of the United States with a nice array of hospitals in Texas and throughout the Southwest and we currently have quite a few hospitals that are under development.

We've signed an agreement to purchase a 58-bed freestanding hospital in Augusta, Georgia, Walton Rehabilitation Hospital. We have a new hospital opened up in Ocala, Florida that started to see patients in December.

The benefit of that new opening will accrue to the company throughout 2013. We have two other hospitals that we'll be opening up in the second quarter of '13. Several hospitals that are under some Certificates of Need review process, many of those have been approved. We're looking for land and should be beginning construction on them in 2013.

If you look at our portfolio relative to the rest of the industry, we own about 9% of all of the IRFs or inpatient rehabilitation facilities in the country, but because our hospitals tend to be larger, we represent a larger percent, about 19% of the licensed beds. And if you look at all of the patients that are admitted into inpatient rehabilitation hospitals throughout the country we have about 21% market share.

One of things that is unique about inpatient rehabilitation is that most of the conditions that we treat in our hospitals tend to be conditions that are – that you see in the elderly. So it's non-discretionary kinds of care that's needed to help patients who have suffered a stroke, who are recovering from some sort of hip replacement or other orthopedic condition that is impairing their ability to function independently or maybe suffering from some sort of chronic neurological condition, again that limits their ability to live independently and to function on their own.

As you can see, stroke and hip fractures needing hip replacements, the debility condition that I just mentioned, represent the largest number of patients treated in rehabilitation hospitals.

Then one thing that's important to comprehend and to appreciate as a potential shareholder of HealthSouth is that the demand for our care is really driven by the aging of the population with the baby boom generation coming into Medicare eligibility. That growth rate is expected to go from 2% pre-2011 up to 3% per year on a go-forward basis and so it creates a very nice underlying demographic demand for inpatient rehabilitation that I think positions all of rehabilitation providers very nicely for continued growth into the future.

The two hallmarks of any healthcare provider is quality and cost effectiveness. In the case of inpatient rehabilitation hospital there is a standard that is used to determine the effectiveness of the care provided by that IRF for those patients and that measure is the FIM gain. So every patient that gets admitted to an inpatient rehabilitation hospital is assessed on an 18 point scale to determine their level of functioning independence, everything from being able to walk unassisted to ability to swallow, their cognitive tests and a complete array of measures that are used to assess that patient upon admission.

That same patient is evaluated using the same evaluation tool, the FIM game tool at the end of their stay and upon discharge, so there is a FIM score upon admission, there is a FIM score upon discharge and the difference is the FIM gain and that is a measure of how much success that patient has had in their length of stay within that inpatient rehabilitation facility.

There are two major database sources that are used by inpatient rehabilitation facilities to report quality and other data, most of which then goes directly to CMS. The largest is called UDS, Uniform Data System and that's the database that HealthSouth participates in. So you can see on this slide that if you go back all the way to Q1 of 2009 the FIM gain in the UDS population is significantly less than the FIM gains experienced by patients coming into HealthSouth hospitals.

And I think that it should be noted that the UDS average includes those patients who are part of HealthSouth. So if you took that out, there would be an even bigger differential. So we use this and the industry uses this as a measure of differentiating quality from one provider to the other and it's something that we take tremendous amount of pride in that we have consistently outperformed the rest of the industry.

The second measure that I think is important for all healthcare providers, you need to be able to provide high quality care, you need to be able to demonstrate that that quality is superior. The second most important is to be able to provide that care on a cost effective basis. So there are lot of data points here on this chart, but – and you'll notice that at the bottom there's 1139, the other slide showed 1165 two different sources, this is from the Medicare rate setting file, the first slide was using MedPAC data from their most recent report. So we haven't really gone in and tried to reconcile that difference, but I did want to point that out to you. Again same kind of profile, most of the IRFs are departments or units of acute care hospitals and as we all know about 85% of all acute care hospitals are not for profit. So the predominant numbers of our competitors are not for profit units in acute care hospitals in the markets where we have a presence and then the balance is freestanding.

A couple of things before we get to the far right hand side. You can see that our hospitals on average tend to be larger. We treat a fairly significant greater number of Medicare patients per berth than the rest of our competitors.

Again I think that, that starts to build the case for then why we are able to provide that care on a very low cost basis. So that third column, the average estimated total cost per discharge is the cost that we are able to provide that care to those beneficiaries that are receiving the care in our hospitals and you can see how that compares to other average cost of other freestanding – other hospital units and then looking at the total average.

Again this, I think really speaks to the value proposition that we can bring not only to patients today on the quality side, but as you look down the road at bundling ACOs risk sharing the ability of HealthSouth to able to be a significant contributor to any type of risk sharing environment by virtue of our ability to provide that care, that high quality care on a very cost effective basis.

The other thing that I think is important to note is that we're generating that revenue on a relatively inexpensive basis from a Medicare standpoint. So you look at that far right column and that's the average estimated payment per discharge, so that's what Medicare is paying us on average compared to other free standing hospital units and then you can see the industry total.

So from a Medicare standpoint they are getting a real bargain when patients are admitted in to HealthSouth hospitals because on average they are paying us less than they are other rehabilitation providers.

We are providing that care on a superior basis from a quality standpoint and we believe that combination of high quality cost effective care is exactly what Medicare is looking for is what the commercial payors are looking for, it's what we're all looking for and we're delivering that and doing that today.

We got a pretty good track record of successfully executing on our business plan, very healthy discharge growth CAGR over the last several years of over 4.5%, revenue of about 6%. I think as everybody knows the reimbursement environment for Medicare dominant providers has been a little bit difficult for 18 months. In 2008 and 2009 rehabilitation providers went for 18 months without any increase from Medicare.

So on April 1, 2007 the pricing that we were getting; the unit pricing we were getting from Medicare was actually reduced and held at that lower level for 18 months and the reason for that was to pay for a revision to that 60% rule that I mentioned just a minute ago. So it was a pay for to get some legislation passed that set that threshold at 60%.

I think the thing that's important for you to consider as we look into the future and consider the uncertainty in the healthcare environment today and people are wondering how are providers going to survive in a tight reimbursement environment. There is at least one company out there HealthSouth that has been able to point to a track record of growth even during times of very tough reimbursement and in our case actually reduced reimbursement for 18 months.

I think that the success that we've had in the past is certainly continuing into 2012. We're very pleased with the results that we've been able to accomplish. We started the year with EBITDA guidance between $475 and $485 million. We upped the guidance after the second quarter – excuse me the third quarter call and now we're providing some additional guidance into what we think 2012's EBITDA is going to be and so we peg that at somewhere between $495 million, $498 million.

I think it's important as the slide shows to point out that that is inclusive of a one-time bonus in lieu of merit increase that we gave to all of our line employees in December that was designed to replace an annual merit increase that they would have otherwise received and would have carried on into 2013. The reason we did that was because of the threat of sequestration in 2013. And so, rather than adding to our cost structure permanently with a merit increase, we decided we're having a very good year in 2012.

We were going to give our employees an amount equal to their – what they otherwise would have received in a merit increase net of their – the health benefits that we're going to absorb, health benefit insurance cost that we're going to absorb, give it to them one time and then allow us to get into 2013 with a lower cost structure going forward.

The quarter from a volume standpoint was very healthy, 5.4%. Some of that was a function of patients that were admitted in the third quarter that got discharged in the fourth. But overall, we felt very good about the way we ended the year, very good about the results that we've been able to achieve and as you see we're able to raise our guidance for that year.

From an EPS standpoint, we're also raising our guidance here and project EPS to come in somewhere in the $1.53 to $1.55 per share and you can see the breakdown of how we're going to arrive from EBITDA down to EPS.

I think the next couple of slides are probably the most important that we have in the deck and I think it's certainly something that I hope all of you appreciate. As we look out over the next couple of years the healthcare environment is unquestionably going to be with more risks and more challenges than we've seen in a very long time.

As we look out, we see those risks but we also see tremendous opportunities for HealthSouth and HealthSouth shareholders. Despite the risks of sequestration, despite the pay for ObamaCare we believe that over the next several years with 2012 as the baseline in calculating the CAGRs that we can grow our EBITDA somewhere in that 4% to 8% and a free cash flow between 10% and 14%.

Now obviously if Congress decides to come in and do something very, very draconian, we'll go back and we'll revisit this, but we feel very confident in the sustainability of our business model, the ability to continue to take market share, the ability to bring that volume on in a very disciplined way from a cost standpoint and to continue to grow the underlying portfolio with acquisitions with de novos and with opportunities to use the balance sheet to bring value to our shareholders.

Something that I want to point out on the delevering strategy, in the past that parenthetical phrase was that we would keep our leverage ratio at three times or below subject to macroeconomic conditions. Implication being if things got really difficult, we might see that leverage ratio actually going down.

We are now looking – we think we've got enough visibility going forward, we're confident enough in the cash flow generating capacity of this company that we are now saying we may actually see that go up slightly maybe 3.75 maybe a little bit more if we saw an opportunity to go and access the credit markets for strategies that might bring additional value to the company.

And I think that the hallmark of our overall approach is that we've worked very hard in a very disciplined manner to bring our debt level down, to bring that leverage ratio from over 5.5 times down to 2.5 times over the last 5 years. We've built up an enormous amount of liquidity both with cash on the balance sheet and then with a revolver capacity and we're generating significant amount of free cash flow.

And as we look at how to deploy that free cash flow, we focus first and foremost on growth within the inpatient rehabilitation space; that demand of 3% per year of the Medicare population yields a very nice growth curve for patients who are ultimately going to need and will benefit from inpatient rehabilitative care. So we're going to be able to continue to pursue that growth, continue to take market share by adding beds to hospitals that are at or near capacity in our existing portfolio, adding new hospitals through de novos, acquisitions, and joint ventures. You saw the list of those that were currently in progress right now and then exercising the ability to execute on those that are in the pipeline today.

We also have the opportunity to take some of our leased properties, we have 34 of our hospitals that are leased, 17 of those are going to be eligible to be purchased over the next several years – 5 years, five of which will be available to us to purchase in 2013 and if we can do that we will be able to take control of those assets, reduce the rent expense and gain flexibility in the use of that asset going forward.

In addition, we will be looking in 2013 much more aggressively and much more creatively at other ways to use the balance sheet and the free cash flow generating capacity of the company to bring value to our

shareholders be it through share repurchase, tender for the convertible preferred or evaluating dividends either on a one time or recurring basis.

Those are things that we are looking at being able to do to bring value to the shareholders as a result of the discipline that we put into executing our business model over the last several years. And we think that 2013 despite the challenges of sequestration and regulations in Washington creates for our company, some very unique opportunities and very exciting opportunities.

So in summary, we think that HealthSouth is a strong company with very sustainable business fundamentals. As I said, we are in an attractive sector in healthcare, the volume is growing and it's non-discretionary, it's age related.

Hard reality is the older we get, the more susceptible we are to the kinds of conditions that are treated through inpatient rehabilitative care. We are the number one provider in that space by a long shot with our 100 hospitals, the next largest aggregation is about 12 hospitals and then from that point on the industry is very, very fragmented.

You saw the ability to provide that care on a cost effective basis and how we stack up with our peer group and I would argue that we stack up extremely well. We have the ability to control more of our real estate portfolio.

We are not going to be vulnerable as other providers are to that ever escalating rent increase that will be there for them to deal with as reimbursement pressures continue. We have a very strong balance sheet. We have ample liquidity and we're generating a significant amount of free cash flow all of which give us the opportunity to pursue growth opportunities in the inpatient rehabilitation arena as well as creating value for our shareholders by looking at other means of bringing value to you.

So, with that, I think we have one minute that would maybe allow us for one question before we go into the breakout, if there are any. Seeing none, we are going to the breakout session. Thank you.