A.J. Rice, Analyst, UBS Securities LLC

I think we'll get started with the next presentation. I'm A. J. Rice, healthcare service analyst at UBS, and next up in this room is HealthSouth, a leading provider of inpatient rehabilitation services in the U.S. And we're happy to have Jay Grinney, President and CEO of HealthSouth, to tell us more about the HealthSouth story.

Jay Grinney, President and Chief Executive Officer

Good morning, everyone, and thank you, A. J. With me today are Mary Ann Arico, who is our Chief Investor Relations Officer; Doug Coltharp, who is our Executive Vice President and Chief Operating Officer.

For those of you who may not be familiar with the company, as A. J. mentioned, we're the largest provider of inpatient rehabilitative services in the country. There are 1,139 inpatient rehabilitation facilities goes by the acronym IRF. And we treat patients who are discharged from acute care hospitals, most of whom tend to be elderly, most of whom have some kind of neurological condition that impairs their ability to function independently.

In addition to the stroke and neurological patients that we treat, there is another wide range of patient conditions including orthopedic conditions such as hip fractures, hip replacements to a lesser extent and only for patients who are medically complex knee and hip replacement surgeries that result in the patient needing inpatient rehabilitative care. But 95% of our patients are admitted directly from an acute care hospital into one of our hospitals. They're admitted by an admitting physician. They have to meet a certain criteria established by the Medicare program to qualify for admission.

Once they're in our hospital, they need to be able to tolerate and participate in at least three hours of active therapy, physical therapy, occupational therapy or speech therapy, three hours per day, five days a week. The average length of stay for the patients coming into our hospitals is about 13 days. As you can see from the slide, we have a very strong presence throughout the northeast down through Florida over into the southeast, into Texas and then into Arizona. We have a couple hospitals in California. As the list on the far left implies, we also have a pretty aggressive growth plan both by building new hospitals or de novos hospitals and acquiring freestanding hospitals or units.

The most recent acquisition that we completed was that of 58-bed Walton Rehabilitation Hospital in Augusta, Georgia and that we closed on April 1. We've been very pleased with the results thus far and expect that hospital to be a very strong contributor going forward. We also have a number of hospitals that are in some level of development. We opened up our newest hospital, our 102nd hospital in Littleton Colorado last week. I think we already have 16 patients in that hospital.

Before that we had opened up a hospital down in Ocala that has exceeded our expectations in terms of the growth and the number of patients that we've been able to treat. And as you can see in the balance of that list, we have other projects that are either under construction and soon to open or we're working on a certificate of need adjudication process to get that hospital opened in the near future. Beyond what you see on this slide are many other projects that we're working on either joint ventures, acquisitions or de novos that will allow us to continue to grow this company going forward.

If you look at the bottom box in the middle, it gives you an idea of the size of HealthSouth and our market share. Although, we only own and operate about 9% of all of the IRFs, again 1,139 of these facilities and we have 102 of those, our hospitals tend to be larger and by virtue of the larger operating platform, the efficiencies that we're able to generate and drive from that platform, we see more patients on average. So we have more of the beds and then we have about 21% of the market share. So if you think about it, about one out of every five patients who receives inpatient rehabilitative care in the United States gets that care at a HealthSouth hospital. And that's without any presence in the State of New York and with limited presence in the state, at least currently in the State of California. So it gives you an idea of the size and the scope of this company.

As we reported recently, we're very pleased to post another very strong quarter. Our business model has been one that we feel has withstood both good times and bad. We've been able to execute under a wide range of circumstances. Our discharge growth was up 4% in the quarter and that was against a 6% prior year comp that included an extra day because of – of leap year last year. We had some nice pricing growth on top of that. So top line grew 6%. Adjusted EBITDA was up almost 10% and you can see earnings per share up 20%. The 20% year-over-year EPS is a little bit misleading because we had some adjustments last year due to some accruals on the payroll side that we didn't see this year, but still very strong year-over-year growth across all of the key operating metrics of the company.

In addition to posting very solid operational results in Q1, we also had a couple other milestones that we're very pleased with. The first was the successful tender for about 9.5% of our outlying shares. We purchased those at a price of $25.50. We funded that both by tapping into the revolver and utilizing some of the cash that we had on hand. And as of the end of that tender, we have about 87 million common shares outstanding.

In addition to a very successful tender that we're extremely pleased with, we also were able to finalize a settlement with the Internal Revenue Service, which yielded an addition to our net operating losses of about $260 million. That was some cleanup activities for years 2008 and prior, if you remember, we had a settlement in 2006 that was for years 2006 and before. So now we've sort of cleaned everything up and we're very pleased that we're able to get to that point with the IRS. We worked very hard on this for over a year. The net result of which is an addition to the NOL.

And by the way, we will see the impact of that in the second quarter, so there will be a non-recurring a benefit from an EPS standpoint that you can see there on the bottom of this slide.

I think the real story for HealthSouth is the fact that our business model is one that has a very strong historical performance level associated with it. And with that we have been able to significantly increase our adjusted free cash flow over the last several years.

In fact if you were to go back to 2008 that was, excuse me, 2007, that would have been a negative adjusted free cash flow number. So you can see over the last five years, we've really taken this company in a very, very new and very strong direction. As you think about the cash flow that we're generating and then how much of it has to go for debt service, how much of it goes to maintenance CapEx before we get to the adjusted free cash flow, we've profiled for you on this slide, and by the way, we also have, what we refer to as, our investor reference book. I hope you'll get a copy of that, we have copies of that for you today. That's also available online, and all of these slides are going to be in that investor reference book. It's pretty comprehensive document that gives you a very detailed appreciation of the company.

But as you look at the cash flow that we're generating from operations and then what does it take to get to the free cash flow, you can see that our interest expense is going to be somewhere in that $92 million to $97 million. We have about $8 million to $12 million of cash taxes; again that NOL is working to shield some of the taxes for us for a while. We do have some adjustments in the working capital, especially as you think about the new hospitals that are coming online and the cash spend that goes into building those hospitals up over a period of time after they have opened.

The maintenance CapEx is pretty steady. It's going to be about $80 million to $90 million. A big portion of that goes to our investment in an electronic clinical information system. We do not get any hi-tech payments from the government, but we have made that investment and made that decision to invest in a clinical information system that we believe will give us enormous flexibility in the new world order of healthcare if bundling and accountable care organization starts to take hold. We believe that we'll be in a unique position as a post-acute provider to interact electronically with referral sources.

And to the best of our knowledge, we're the only post-acute provider out there making this kind of investment at this time. We have about 20 of our hospitals online today. We'll have another 20 to 25 brought on each year. So by the end of 2015, mid 2016, I think we'll have most of our hospitals brought

online. And then, of course, we do have some preferred stock out there. We pay dividend of about $23 million, $24 million on that.

So once you take the cash that we're generating from operations and we apply it to the interest expense, maintenance CapEx, whatever working capital need there might be. There is a significant amount, as you saw on the prior slide, of adjusted free cash flow that we can invest for the benefit of our shareholders. First and foremost, we're going to be focusing on continuing to grow the company. Our core business is one that is primarily focused on patients who don't have a lot of discretion in their illnesses. And so it's a pretty stable business. The growth rate is expected to be somewhere between 2% and 3% over the next 10 plus years. And that's really just a reflection of the ageing of the population and the fact that the baby boom generation is now hitting that Medicare eligibility threshold. And the older they get, older we all get, the more susceptible we are for conditions such as strokes, chronic neurological conditions and the like, which are the very conditions that we treat.

As you see here, we look to add beds to existing hospitals, where we have reached maximum capacity, 80%-85%. The underlying market dynamics are very strong. We add beds and continue the growth in those markets. We look to adding new hospitals through de novos. We're targeting about four per year. You could see from that first slide that we're ahead of that target and pretty comfortably ahead of that target. And we're looking for two acquisitions a year. And some years it maybe a little bit more, some years a little bit less, but we think that that's about what we should expect to see over the next several years and we think that that will bring some very nice core growth to the company.

We also have opportunities to look at utilizing that significant free cash flow beyond just growing the company. And I will say that we're not limiting ourselves with respect to that core growth. We're not saying we're only going to do four de novos and four only. If we find additional markets that have the characteristics that we believe would allow us to be successful in that market and meet the rehabilitative needs and demands of the patients in that market, we'll go forward and build those hospitals. And, again, I can go back to that first slide and show you and you can see for yourself that we are well above that four per year pace.

That being said, the company is generating a lot of cash, and so we have the unique ability because of what Doug Coltharp has been to do on the balance sheet and creating a debt profile that is very manageable, maturity spread out between now and 2014, the next, I think, maturity is on the revolver 2016. And so we really have a lot of – a lot of flexibility. So one of the things that we're looking to do is to take some of the hospitals that we own, but – that we operate, but we don't own the assets. And in those instances where there is a buyout provision on the lease, we're going forward and looking to take control of those hospitals. We've done that in the past, as you can see, last year it was $19 million, we're expecting a wider range, $20 million to $125 million.

I don't think we're going to be at the top end of that range quite frankly because in some instances, the landlord will be willing to renegotiate the terms on terms that are acceptable to us and in those instances, we'll re-up with the lease. If we're not happy with those terms, we don't believe that it makes sense to move forward then we look to acquire.

We also have the opportunity to distribute the cash either through share buybacks, tender, which we saw was very successful. We have the opportunity to consider dividends either special or recurring. We also have some convertible preferred stock that we could conceivably go after. We've done that in the past in an open market basis. There is not a lot of liquidity in those preferred, but we're always looking for opportunities to address that part of our capital structure. So the takeaway should be for you a lot of opportunities to invest that free cash flow that we're generating.

Let's take a sidebar discussion for those of you who may not be familiar with inpatient rehabilitation facilities, we have a separate set of rules that are promulgated by CMS. The proposed rules for inpatient rehabilitation payment system came out a couple of weeks ago. There are three provisions – the three key provisions. One was on the pricing very much in line with what we expected. On a net basis, it's about 1.8%

increase for the market basket. If you factor in all of the facilities specific adjustments and so on, we think it's going to be just under 2% of pricing increase if the proposed rule becomes final effective on October 1.

There was a change in the outlier or proposed change in the outlier payment methodology, as you see here. And if you could go to page 13 of the slide deck that we have with this presentation, it's also in, I believe it's on page nine of the investor reference book, you'll see we have very little dependency on outlier payments, very, very little and that's a function of our very low cost structure.

Our case mix index is quite high relative to the rest of the industry. In other words, we treat a lot of higher acuity patients, but the way the outlier payments are determined is based on cost-to-charge ratio. Our costs are significantly lower than the rest of the industry. So we have very little of our revenues coming in through the outlier. There is a proposed change on how CMS is going to assess each hospital's compliance with the 60% rule. Some of the changes are going to be fairly straightforward to address; others, I think are going to take a little more work, but we don't think that there is going to be a material impact to us on these proposed changes. However, we are going to be submitting our comments to CMS along with the rest of the industry.

We do believe that removing some of the arthritis codes will potentially limit access for patients who have certain arthritic conditions, limit their access to inpatient rehabilitation hospitals. And the default is going to be they're going to end up in a nursing home. And we don't believe that that is always in the best interest of patients who have serious complicating conditions as a result of their arthritis. And then there is some quality reporting additions, both of which, we think, we can accommodate very easily.

So this is our attempt to sort of summarize what our business outlook is like for the next several years. And you can see, we've added a new element at the very top, shareholder distribution that's something that we signaled in January of this year. We continue to make that a priority. We evidenced that with the tender earlier this year. As I said on the first quarter call, that is not a one and done. This is going to be an active ongoing part of our strategy is to take the cash flow that we're generating, invest as much as we can in building the core business out, our leverage ratio is below three times. We feel very good about that. We are always willing to potentially lever up, if that makes sense, but not dramatically, but use the cash flow and to make sure that we're distributing that in the way that is most beneficial to our shareholders, both looking at growth and looking at distributions either buybacks, dividends or going after the preferred. And then you can see the core growth that we've identified is really the center piece of our strategy going forward.

I will say that at some point in the future, and that is not today, I'll repeat that, that is not today, but at some point, we do believe that there are adjacent services that will make sense for us to explore. And the one that makes the most sense for us, frankly, is homecare. Today, homecare is under a lot of scrutiny. We believe that there is a lot of structural changes that will occur there, over the next several years. And so we're going to be on the side lines, watching and waiting.

But if you think about it five years or 10 years down the road, and I'm sure everybody here has that kind of investment horizon. Five years, 10 years down the road, we do believe that if accountable care organizations, and if bundling both take hold and as a sidebar, I will tell you, that is very much in question right now just based on initial preliminary results of these endeavors. So I think it's going to be an evolutionary change not a revolutionary change. But we do think that that has some high degree of probability of occurring.

Well, in that new world order, what we would like to do is we'd like to be positioned in our markets to provide facility based post-acute services as well as home based post-acute services to provide that full continuum of care for patients coming out of the acute care hospitals.

But I want to repeat and reiterate and underline and underline it again, that is not anything that we're considering at this point. And it will be quite a while before we're in a position to feel comfortable about what's going on and we feel no compulsion to pursue those growth opportunities. We're very, very comfortable with the growth opportunities in inpatient rehabilitation. There is a very long runway and that

development pipeline that we have is actually growing quarter-by-quarter. And we feel very good about where we're positioned, but I do think it's appropriate to at least signal that at some point down the road, we look at other adjacent services as a growth opportunity as well.

Finally if you just want to look at the company and you can read all this, but we're – we feel like we're in a pretty good spot in the healthcare continuum. We're taking advantage or we are positioned to take advantage of the changes in the demographic profile, the ageing of the population. It's a highly fragmented industry. We're the leading provider in that industry sector both from a quality standpoint and from a cost effective standpoint. We have outstanding operating platform. We own most of our hospitals. Those that we don't, we're pursuing opportunities to acquire them. We have a lot of financial flexibility in our capital structure. We have great free cash flow generating capacity as well, and we're taking that cash and we're investing it in a wide range of strategies to bring value to you, our shareholders.

So, with that, my time is up and I believe we'll go to Q&A.

A.J. Rice, Analyst, UBS Securities LLC

Yes. So why don't we do that across the way? It's Carnegie West, it's the breakout room. And I appreciate HealthSouth management team for participating in our conference this year.