HealthSouth Corporation (HLS)
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<<John Ransom, Analyst, Raymond James Financial, Inc.>>

Good afternoon. I'm happy to introduce Doug and Mary Ann from HealthSouth. We've recently had an opinion change on HealthSouth that was a positive one, yes, in the mid 30s. We think this company – two things to notice, a very strong free cash flow generator particularly in the years remaining when it's not a taxpayer. And they made what I thought was an interesting and important movement to an another post acute vertical. And the way we figure this is the transaction was over $40 million accretive to pretax free cash flow because the company financed it in a very cheap way and they also refinance some other debt.

I think Doug's laddered the capital structure in a very thoughtful way and we note there's some more relatively expensive debt that's now callable. So, we think this was driven by strong EBITDA growth by redeployment of free cash flow. And we now have a company with a flexible balance sheet and $35 billion Home Health industry, which we think is right for consolidation given the closing of the verticals that our opinion between all the four post-acute service.

So with that I will turn it over to Doug.

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

Thank you, John. And John has hit on many of the key elements of our investment thesis, so I can wrap this up in just a couple of minutes. As John mentioned, I'm Doug Coltharp, I'm the Chief Financial Officer at HealthSouth and I'm joined by Mary Ann Arico, who is our Head of Investor Relations. We thank you all of your time and consideration today.

I'd like to start with just a brief overview of the company. I know many of you are familiar with our company, so I won't spend too much time on that and then we'll get into some of the recent elements of our financial performance and then also the components of our strategy. We start as always with the cautionary disclaimer regarding any forward-looking statements. And this is an updated chart that we now use to provide just an overview of the company.

We are the leading owner and operator of freestanding inpatient rehabilitation hospitals in the country. We provide our services through a portfolio of 107 hospitals that are spread across 29 states in Puerto Rico. We serve predominantly a medicare beneficiary population. About 80% of our revenue is derived from Medicare if you include Medicare advantage.

At the end of the year, we complemented our inpatient rehabilitation business with the addition of a home healthcare and hospice provider and we did that via the acquisition of

Encompass Home Health & Hospice. Like us Encompass is focused very much on the Medicare of beneficiary population and their revenue mix mirrors ours in many respects being oriented about 80% towards Medicare. I'm going to talk more now just about the composition of the Encompass acquisition and also the underlying strategic rationale.

So we closed on this transaction at the very end of the year which is $750 million purchase price and there were – obviously there were some fees and expenses on top of that. It created a cash need for us of about $700 million and the reason that it created a cash need less than the purchase price is because we created a very unique structure that allowed the Encompass incumbent management team including the owner and founder of that business April Anthony to roll an equity stake into our newly formed Home Health subsidiary. Encompass had been owned by a private equity firm, this was their second trip through private equity and they had very well as a management team through the private equity transactions.

The private equity sponsor was Cressey. Cressey put the business out through a competitive auction that began last summer and it was a highly competitive auction in which we were competing with other strategics and also with a large number of other private equity players. And we knew that we wanted to develop a structure that would both incent the continuity of the management team, incent the management team to continue to create the kind of incremental value under the HealthSouth umbrella that they have done for the private equity sponsors. And that would differentiate our bid or at least not in anyway disadvantage our bid versus the other private equity sponsors.

And so, we've developed this concept of an equity roll in the form of liquidity on the equity roll for the management team will be through a series of put options that they have beginning three years from the date of closing with evaluation of that business then based on a number of things including some market derived multiples.

We closed the transaction at year-end and we're able to fund it all with debt using the increased capacity under our bank facility. Shortly thereafter by mid-April – excuse me by mid January, we like the conditions that were being presented to us in the high yield debt market, so we chose to issue $400 million of incremental senior notes. We did that through an add-on to our axed on 2024 notes. We're able to do so at a yield of less than 5.5%. And we use the proceeds to retire some of the bank debt that we had put in place at year-end creating what we thought was a more optimal funding structure for the Encompass acquisition.

At year-end, our leverage stood at 3.7 times which is a bit higher than we typically run at because of the acquisition giving effect to the 2014 EBTIDA from Encompass. So on a pro forma basis that leverage dropped to 3.3 times. We have stated previously and continued to adhere to a run rate target of approximately 3 times. And in just a couple of slides, we're going to get to our guidance for 2015. And if you look at the EBITDA guidance that's included therein. It would suggest that even without retiring any more debt this year. By the end of the year, we should be very close if not below that target.

We prior to the acquisition of Encompass had a very, very small presence in the Home Health space only about $25 million revenue business through 25 hospital based Home Health agencies. It is our intent through the course of this year to integrate those over to the Encompass platform. And we will retain the Encompass trade name and that is the business under which our Home Health – or that is the band under which our Home Health business will fly.

And then the transaction is going to be immediately accretive to our 2015 results. We are suggesting that after minority interest and it's the minority interest that's created by management's retained ownership interest in our Home Health subsidiary that the Encompass will add $72 million to our 2015 adjusted EBITDA and about $0.15 to our earnings per share.

There are number of reasons why we felt that it was a compelling time for us to enter the Home Health space. And let me begin by saying that Encompass was the right asset for us. We began our dialogue with April Anthony and got to know Encompass beginning back in 2011. She had been referred to us by many people as we chose to get edified on the Home Health space as a best-in-class operator and our discussions with her did nothing but solidify that view.

Ultimately, the timing of this transaction was driven by the fact that the management team and the sponsor were ready to monetize the asset and start an auction process, but we also felt that was an appropriate time for us to expand into this adjacent space. And that was driven predominantly by the fact that we felt like we had clarity into the reimbursement environment in both our core IRF space and also in the Home Health business that we were looking to expand into.

Specifically to the Home Health business, they had been through two years of rebasing and we were able to see how the business was able to respond to those pricing reductions and we had good visibility into the extent and the impact of rebasing out through the conclusion of that period in 2017. When we look at the Home Health business and specifically the Encompass asset, we believe that there is a very significant growth opportunity embedded here and for a number of reasons.

First, again with this business focused predominantly on the Medicare population, we see the same favorable demographic tailwind driving this business that drives our IRF business. If you look at both of those businesses focused on the elder population, we see a growth trajectory in the over 65 population that is significantly in excess of national population growth. It's driven on the front-end by the aging of the Baby Boomers, the Vanguard of which is now crossing over 65 and on the back end by the increase in life expectancy.

We also looked at the fact that there are a significant number of discharges to Home Health coming out of our IRF facilities that we were not currently capturing. And this charge is a bit busy, but gives you an example of some of the opportunity that we believe will exist down the road for end-market revenue synergies. So if you start in the upper left hand portion of this slide out of – a little over 130,000 Medicare discharges out of our

inpatient rehab facilities in 2014, about 54% or 72,000 – a little bit more than 72,000 were discharged through a Home Health destination.

Through our owned 25 hospital based agencies, we captured only 8% of those, less than 6,000. And although Encompass was not a part of our company, during 2014, they captured a very small piece about 1% or 850 discharges. Narrowing this focus to adjust those markets where there is existing overlap between HealthSouth and Encompass really where there is no excuse not to have a higher conversion rate. You can see that there are 21,700 discharges from IRFs – from our IRFs into a market where Encompass has a presence.

And yeah we continue to capture just a very small percentage of those less than 18% between HealthSouth's existing Home Health agencies and Encompass. We think this really points to the opportunity to capture the end market revenue synergies. This is not going to happen overnight. A couple of things need to happen in order to make this occur. First is we've got to change the referral patterns that are occurring from the attending physicians in those markets.

We think we'll be able to provide those physicians with very strong evidence about the high quality outcomes that Encompass is able to produce and that that compelling evidence will ultimately rule the day, but it doesn't happen overnight. It is something that we think will begin to get traction on in 2015 and hopefully [indiscernible] significant momentum behind as we enter 2016. We're also looking to reorient the Encompass development pipeline such that ADC acquisition opportunities are more targeted in markets where we have – where we currently have in IRF and Encompass is not currently have a Home Health presence.

This slide really demonstrates that regardless of the economic cycle or the reimbursement environment, we've been able to grow our core financial metrics. You can see the left to right upward sloping curves that characterize the consistent growth we've been able to produce in key metrics like revenue and EBITDA. We expect the Encompass acquisition to be accretive to both our revenue and EBITDA, CAGRs on a go-forward basis.

One of the most attractive features of our business model is that we generate a very high and consistent level of free cash flow and that free cash flow has given us a great deal of flexibility to invest in our business in a number of different ways. It's allowed us to fund high growth opportunities and we'll talk about the different modes that we have for doing so in our core IRF space. It's going to facilitate the growth via acquisition in the Home Health space. It's allowed us to maintain a relatively low degree of financial leverage on our balance sheet to engage in opportunistic share repurchases and also beginning a little over a year ago, actually about a year and half ago to initiate a quarterly cash dividend on our common stock.

I mentioned previously that last week, we had released our financial results for 2014 and it is customarily our case we also provided our initial guidance for the current fiscal year. As you can see from this chart, our guidance for adjusted EBITDA for 2015 is a range of $670 million to $680 million and I'll just highlight some of the key considerations that

are outlined on this page. Our primary business continues to be inpatient rehabilitation and we are anticipating another year of very solid revenue growth from our IRF segment driven both by pricing and volume increases as outlined here.

We do have some expense initiatives that we are investing in through the course of 2015 that are going to impact results primarily at our IRF segment. Those totaled approximately $10 million, one of them is simply the ongoing investment in our clinical information system. This is something that we have been doing proactively for a number of years.

I want to remind everyone and perhaps follow the acute care sector that unlike the reimbursement or the subsidization for investing in a clinical information system that the acute care facilities have received under the HITECH Act, no such subsidization was available for post acute players. So we did this on our own. It's a system designed by Cerner with our input that's tailor made to inpatient rehab facilities and it's been more than 60 of our hospitals right now. We continue to roll this out at a pace of more than 20 hospitals per year.

We also are now eligible as inpatient rehabilitation facility provider to participate in one of the bundled payment initiatives being administered by CMS. That initiative is rolling out through the course of 2015. We have signed up to participate. We will participate with anywhere between 5 and 10 hospitals and we'll do so across a subset of the diagnoses, which we treat in our facilities. Being able to monitor those, the cases that are running through this initiative and an appropriate way requires the addition of resources and staffing up to be able to accurately gauge the progress that we're making in this initiative as part of the $10 million spend.

Two other initiatives I'll point to very quickly. First is over the last couple of years IRFs had been subjected to an increasing number of quality reporting items beginning in October of 2015 compliance with those quality reporting initiatives and the level of which they're achieved will begin caring financial implications. We believe that we perform very well across these metrics, but given the potential financial implications we have elected to invest in additional staffing in all of our hospitals to ensure that we maintain the appropriate degree of compliance.

And then finally, we have formed a new medical services department. This is really in the avenue of physician education and it is targeting the improvement in overall physician documentation for the physicians who are attending to patients in our inpatient rehabilitation facilities with the ultimate financial objective of being able to reduce the number of claims denials that we've received from our fiscal intermediaries, which in very, very few cases are really the result of any kind of medical necessity criteria not being met and frequently when we have a claim denied and don't ultimately prevailing the adjudication process, it is solely attributable to the fact that there has been some kind of documentation deficiency.

I mentioned previously the strength of our free cash flow generation and so these are the items that you need to consider when you – deduct from adjusted EBITDA in order to get

to the adjusted free cash flow that we expect to realize. I won't hit on all of these, but start with the cash interest expense $110 million to $115 million is our current assumption, not embedded in this assumption is any refinancing activity that might occur during 2015. John mentioned earlier, we do have two of our senior notes issuances both of which are relatively high cost, which are callable in 2015. Our 2020 senior notes, which carry a coupon of 8.125% [ph] became callable on February 15, we have some 7.75% senior notes which will be callable in September.

Our cash taxes for 2015, we expect to remain at a very low level of about $15 million to $20 million and this owes to the continuation of a very substantial net operating loss carry forward that's the good news, the bad news is we've been chewing through the NOL based on our enhanced profitability and those ultimately will come to an end. We provided some information in our supplemental slides regarding the balance of the NOL and within effective tax rate assumption of 40%, you can do your own math as to when those NOLs will ultimately be expired. We have a working capital increase some of which is attributable to accounts receivable growth. We outlined the reasons for that in our earnings release in great detail last week, I won't go over that again here.

And then maintenance capital expenditures we've suggested range of $90 million to $100 million. About – virtually all of that with the exception of about $5 million is attributable to our core IRF and corporate business and the balance related to the Encompass business. So once those items are accounted four from adjusted EBITDA, again we think it still provides substantial flexibility to invest that free cash flow. And these are the priorities that we have identified or being able to deploy those resources. And at the top of this chart is putting as much of that capital as we possibly can back into the high growth opportunities that are prevalent in both our IRF space and now expanding in the Home Health space.

In the IRF space, we have three different ways that we can invest capital for growth. The first and the preferred way is through capacity expansions that are exists in hospitals. I say that because then we're investing into known demand and we're able to leverage components of the infrastructure and it's not infrequent that when we make a capacity addition to an existing hospital, we'll see a return of 35% or 40%. Then we have two separate opportunities to add new units to our hospital base.

One is through de novo activity. In the fourth quarter of 2014, we added four new hospitals to our portfolio: one was a result of acquisition, three were de novo facilities. We have three de novos under construction in 2015 as well and we estimate that spending on those facilities will be between $40 million and $60 million really dependent on pacing.

And then finally acquisitions in the IRF space. We acquired one new facility that closed in Q4 of 2014 and we recently announced two acquisitions that are pending for 2015, one a joint venture with Memorial Health in Savannah, Georgia and the other the acquisition of the Cardinal Hill facility in Lexington, Kentucky. As is customarily the case for us when we close on those acquisitions, we'll provide an updated assumption about the cash usage and also adjust our EBITDA guidance as necessary.

We have penciled in here as well an allocation of $30 million to $40 million to Home Health Agency acquisitions, this is the level at which Encompass has been running for the last couple of years. So, we believe it is readily achievable. This is not to suggest that this is a cap on the amount of acquisitions that we will do in this business but we do believe it serves as an appropriate proxy.

Below that we get into other areas of potential utilization of cash flow. A debt reduction is a category that is here based on the statement that I made earlier that we believe that just by achieving the level of EBITDA within our guidance range without paying down any debt, we'll achieve out targeted level of financial leverage. We don't place debt reduction as a high priority for the current year.

And we will continue to use the shareholder return levers that we have at our disposal. In July of 2013, we initiated our first quarterly cash dividend. On the one year anniversary of that last July, in 2014, we increased that by about 17% and we would expect to see continued increases in the quarterly dividend on an ongoing basis. And then as we've demonstrated over the last two years, we can opportunistically repurchase stock as well. About two years ago from this point, we repurchased about $235 million worth of our common stock, last year that number was closer to $43 million.

Just to give you some additional detail on the pipeline, the development pipeline, for our IRF space out there. I really hit on the first two acquisition opportunities. This provides a little bit more color on those de novos that I mentioned we're underway one is in Franklin, Tennessee, which is suburb of Nashville approximate to some of our other hospitals and then two development opportunities that we're pursuing in California, one in Murrieta and one in Modesto.

The next two slides give you sense as to some of the assumptions that we use in developing our IRF de novos and also our IRF acquisitions, everything starts with the fact that for both of those projects we have a minimum required pretax IRR of 15%. We've been able to get very good opportunities and very good cash payback in each of these you can see on the lower right hand side of this page, the list of de novos that are both currently underway and then have been closed over the last couple of years and then a similar view for the acquisitions that we've been able to do.

And this is a complementary slide that I think points to the acquisition opportunities that exist in the Home Health space. One of the thing that was very attractive to us about Encompass specifically is that we believe it can serve as a platform to consolidate a highly fragmented business. The Home Health business, our Home Health segment is comprised of more than 12,000 agencies and the vast majority of those, approximately 95% have less than $5 million in annual revenue. So it's a business that is really right for consolidation. And we believe that the Encompass management team, business processes, technology commitment and now aided by HealthSouth's free cash flow and balance sheet provide a wonderful vehicle to be able to pursue the consolidation of this space.

Just a couple of more slides to hit on before we open things up. This is a slide. Again, there is a lot of information on here, but its one that that we use to state that although we can't predict the ultimate shape of the healthcare delivery system, we can prepare for it. And first of all, we believe that it will be an evolution and not a revolution, but we do believe that we are moving inexorably towards more integrated care delivery models and to more value based payment initiatives.

Things that we believe are in place in our business model that position us very well to succeed almost regardless of the ultimate shape of the delivery system are the fact that both of our business segments: the IRF sector and the Home Health sector are positioned as the highest quality providers and the most effective providers for the medicare beneficiaries that they serve.

Both of our businesses share a commitment to technology enabled business processes. I mentioned previously our proactive investment in the clinical information system in our IRF segment and April Anthony, the founder of Encompass, was also the founder of Homecare Homebase, which is the technology platform that is utilized not only at Encompass, but by almost half of the Home Health providers that exist today and operate today.

We are participating both of our – business segments are participating in a number of the initiatives that are out there that are experimenting or piloting, some of the new care delivery message be at ACOs or the bundled payment initiatives that I mentioned previously. I discussed the fact that we've got a strong balance sheet and adequate free cash flow to be able to invest in the business as we see as the environment changes and landscape shifts.

And finally this is a particularly true on our IRF segment. We've already been operating in a partnership mode. Of our 107 inpatient rehabilitation hospitals, 33 of those operate in joint venture arrangements with acute care providers. And Encompass is already well established in an ACO with the premier group in and around the Dallas area.

So this is a slide that we used to wrap up what we think are the key elements of our investment thesis. Again, we operate in what we think our two of the most attractive sectors of healthcare driven by very strong underlying demographic trends. We have an industry leading position in the IRF space with a market share that exceeds 18% in terms of license beds and 21% in terms of patients served and in the healthcare business that is the fifth largest medicare provider with opportunities to consolidate and gain market share.

Both of our businesses are able to provide the highest quality outcomes in the most cost effective way demonstrating an appropriate value proposition to Medicare. On the IRF side, we have taken a strategy that is very different from our peers in the post acute space that is one of owning our real estate. We own almost 75% of the real estate underlying our hospitals. We think this creates greater advantages for us with regard to flexibility on how we manage our portfolio on a market-by-market basis. And it also means that from a

cost perspective, we're not subject to the kind of annual rent escalators that come along with a least portfolio environment.

The strong balance sheet I think I've covered adequately and again many levers that we can pull to drive growth in both of these segments.

And that bring us to the end of our prepared remarks. Are we doing Q&A here or…

<<Company Representative>>

[Inaudible]

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

Okay. So now we've got a breakout session schedule, but we can entertain a couple of questions now if there are any?

Q&A

<Q – John Ransom>: [Question Inaudible]

<A – Doug Coltharp>: We spend a lot of time looking at the possible factor just for that John and it really gets to the patient mix. And I think a good example of that is one of the factors that is driving that is the relatively high penetration that Encompass has an insulin dependent diabetes. And there are others chronic conditions that Encompass is able to treat very effectively within the Medicare population that pushes that episode up.

<Q>: [Question Inaudible]

<A – Doug Coltharp>: We have done a similar analysis. If you look, there is a slide that is included and may have it actually in here.

<Q>: [Question Inaudible]

<A – Doug Coltharp>: Yes, right there, so if you look – I can use my laser pointer now. Right there. So our pricing assumptions for 2015, we start with the market basket update of 2.6% and then you've got the rebasing adjustment of 2.4% and 50 basis points for our Home Health productivity adjustment and that gets us to a negative 30 basis points. Obviously, there are some differences based on patient mix and also based on relative wage indexes, but our overall pricing impact for Medicare assumption is not very different from that.

<Q>: [Question Inaudible]

<A – Doug Coltharp>: That is the average for the government and what I've just suggested is that our Encompass specific is not markedly different from that.

<Q>: [Question Inaudible]

<A – Doug Coltharp>: Yes.

<Q>: [Question Inaudible]

<A – Doug Coltharp>: Yes, and that it – it is a very labor intensive business. So there are number of different ways to achieve scale or at least to get some operating leverage. First is market density helps quite a bit and it helps because obviously then your practitioners don't have to drive as far between visits and so more time can be spend to actually administering care to patients than spending time [indiscernible] (32:04) between them. So when we are evaluating markets in which to acquire new agencies one of the things that we evaluate is the ability to get density. But then it comes into a lot of business processes, which we think that are not only very well designed in Encompass, but which are facilitated by technology.

And so for instance one of the things that Encompass does exceedingly well is to be able to match the skill set of its practitioner to the acuity of the patient. And therefore for instance, you don't necessarily need or want a nurse practitioner to be driving by to administer insulin to that insulin dependent diabetic, if you want them concentrated elsewhere. So matching the skill set of both the nursing staff and the therapist, the acuity of the patient is very important. Your ability to do that has increased in a market where you've got a sufficient density of patients.

As you acquire more agencies, you obviously are able to get leverage across components of the central infrastructure. We have not talked about any specific cost synergy opportunities that Encompass will derive by being part of HealthSouth, but there are some for instance they use pharmaceuticals in their business, we use pharmaceuticals in our business as well then being part of an organization size of ours will allow them to procure those on a more advantages basis. And there is also leveraging against elements of the corporate platform.

<Q>: [Question Inaudible]

<<Doug Coltharp, Executive Vice President and Chief Financial Officer>>

Thank you.