PARTICIPANTS

Corporate Participants

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Mark J. Tarr – President, Chief Executive Officer & Director, Encompass Health Corp.
Douglas E. Coltharp – Executive Vice President & Chief Financial Officer, Encompass Health Corp.

MANAGEMENT DISCUSSION SECTION

Peter Heinz Costa, Analyst, Wells Fargo Securities LLC

Good morning. I'm Peter Costa, Wells Fargo's healthcare services analyst. Thank you for coming here to the second day of the Wells Fargo conference. We're very pleased to have with us today Encompass Health Corporation. And from Encompass we have the President and CEO, Mark Tarr; and the EVP and CFO, Doug Coltharp. And so we're going to do a fireside chat here today. And if you have any questions, please feel free to throw them in. You just raise your hand and get my attention and you can ask questions. But otherwise, we'll just kick it off here with a few questions, if that's okay?

Mark J. Tarr, President, Chief Executive Officer & Director, Encompass Health Corp.

All right. No, that'll be great.

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QUESTION AND ANSWER SECTION

<Q – Peter Costa – Wells Fargo Securities LLC>: Let's start by talking about CMS's proposed changes to the home health payments in 2020 and how that – and I know it's a small part of your business but it's what I'm focused on and sort of one of the few risks that I think I see for you guys. You laid out on your second quarter call that the structure of the rate changes, if they don't change, call for about a 6.4% payment reduction. But then for you guys, with more rehab, it would be another 5.4% on top of that, so an 11.8% combined impact if you can't change that. Can you talk about what you're trying to do to change that rate cut today and how you'll respond to it if that's what happens?

<A – Mark Tarr – Encompass Health Corp.>: Sure. Well first of all, home health, it is a smaller part of our overall business. About 20% of our overall revenue is between home health and hospice. And so [indiscernible] (00:01:31) is a very important segment for us. I don't want to jump into 2020 without mentioning 2019, the fact that we're getting the first positive rate increase for a number of years. But I will jump to the proposed rule for 2020. I want to make sure everyone knows that a proposed rule which would include a 6.4% behavioral offset assumption from CMS in order to make the rule neutral. And we have also announced that given our patient mix, without any other mitigating activities, it would be a negative 5.4%.

So we do think there are some opportunities between now and 2020 if the rule goes in as written that we could do to have some mitigating offsets on that. And primarily, the most obvious one is to redirect our sales and marketing efforts more towards the acute care hospitals where the patient mix coming out of acute care hospitals speak more likely to need nursing services, the higher component of that. This does not change our overall strategy in terms of clinical collaboration and working collaboratively with our home health agencies and our rehab hospitals where we do have a higher percentage of those patients needing rehab services. But it does give us an opportunity to redirect the sales and marketing team to go out and develop thorough relationships from the acute care hospitals for those nursing service needed patients.

<Q – Peter Costa – Wells Fargo Securities LLC>: Perfect. Do you think this proposed rule could have an impact in 2019 to you guys in terms of as you adjust the business mix and as you try to seek out those different referrals? Is there any way it would impact earlier?

<A – Mark Tarr – Encompass Health Corp.>: It certainly won't be negative. We can certainly – like I said, in terms of redirecting sales and marketing that is something that we would start in place in 2019 and it certainly wouldn't present a headwind to us in this coming year.

<Q – Peter Costa – Wells Fargo Securities LLC>: And alternatively, does it create – perhaps make some opportunities in the pipeline of acquisitions if others are seeing the same pressure and don't have an answer for it?

<A – Mark Tarr – Encompass Health Corp.>: Well historically whenever there are regulatory changes or any type of pricing pressure, it does impact some of the smaller agencies, some of the mom-and-pop-owned agencies that don't have the resources or don't have the flexibility to accommodate a rate decrease or rating pressure. And coming out on the other side of those periods have been periods of growth for us through either acquisition and/or just taking market share in those various markets or certain providers leaving the market altogether.

<Q – Peter Costa – Wells Fargo Securities LLC>: You mentioned already that this year is one of the first years where you had a rate increase in home health. But you've had years of rate cuts in home health and have been able to manage through that. April Anthony [indiscernible] (00:04:35) all the things she has done over the years to adapt to that, can you talk about that a little bit in terms of some of the things that you've done over the years in the past?

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<A – Mark Tarr – Encompass Health Corp.>: Sure. Well as you note, we're very proud of the responses at our home health and hospice leadership. Overall, April has assembled a really strong management team with a lot of management depth out there that have utilized Homecare Homebase which the IT solution that they use in terms of increasing productivity of the therapist. There are a lot of logistics that go in place relative to making sure that you have the right clinician with the appropriate skills mix to treat the needs of the patients and getting them there in the most efficient manner from just managing a mobile workforce. So all those areas in terms of productivity, in terms of managing skills mix, in terms of overall efficiencies throughout the system have been areas that they've really done a great job on and tweaking over the years and responding to those multiple years of rate decreases but still showing strong growth.

<Q – Peter Costa – Wells Fargo Securities LLC>: Can telehealth help in some way for that going forward?

<A – Mark Tarr – Encompass Health Corp.>: We think long-term, yes. I mean we are certainly trying some pilots now where we are doing some follow-up phone calls and making sure that we have some idea of the status of the patients through the feedback from the calls. But we do think longer-term, there will be technologies that will help assist in the home health industry overall.

<Q – Peter Costa – Wells Fargo Securities LLC>: All right. Let's move away from that and move to the rehab business which seems to be moving forward with great growth. As the largest provider, you now operate I think about 10% of the facilities out there but, by my math, probably closer to 30% of the discharges.

<A – Mark Tarr – Encompass Health Corp.>: That's correct.

<Q – Peter Costa – Wells Fargo Securities LLC>: So your significant share of the market today, is there still a lot of room for you to grow within the market taking share or is it just really the market growth that's going to drive your growth?

<A – Mark Tarr – Encompass Health Corp.>: Well we think growth is going to come in each way. We think that we'll continue to take market share from other providers. We've seen that over the years where our same-store growth has outpaced certainly the industry. At the same time, you have this demographic tailwind with the aging population. And our average age patient for hospitals is 76, and 77 for home health. So if you think about the aging population and the fact that the [ph] bolus (00:07:15) of the baby boomers have yet to reach our average age of our patients. That'll be happening in the next four to five years, the initial cusp of that. So we think that there will be a continued need and increased demand for our services. We have really fine-tuned our clinical programming so that we have the opportunity to show the best outcomes in terms of getting our patients back home, back to the community, have reduced our discharges to skilled nursing facilities after they receive care in our hospitals. We think a big part of that is the collaboration that we have with our home health and creating this transition from our hospitals to the home setting and be able to coordinate that in a manner. So we think there are still a lot of opportunity for growth both from same-store and total-store.

<A – Doug Coltharp – Encompass Health Corp.>: I think another area of potential growth for us is to grab market share from the SNFs, and that's really something that we're able to do with both of our business segments. The higher end of the acuity spectrum that historically has gone to the SNFs, those are certainly patients that are candidates to come in to the IRFs, and we've had success there particularly with stroke as an example. And then the lower acuity patients, we're finding that with our effective home health offering we can bypass a post-acute inpatient stay altogether with a more intensive home health episode.

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<Q – Peter Costa – Wells Fargo Securities LLC>: Great. Let's talk about acquisitions for a minute. You've talked about four to six new facilities per year. I think if we look at de novos, you've got sort of four de novos this year and four more planned for 2019. So does that mean the incremental potentially two would be potential acquisitions or could there be more de novos really for 2019?

<A – Mark Tarr – Encompass Health Corp.>: Say, do you want to take it?

<A – Doug Coltharp – Encompass Health Corp.>: Yeah. I think it could be either. There aren't a lot of other portfolios of IRFs that are available for sale in the same manner that we did the Reliant transaction in 2015. There are some out there that are private equity-owned. They tend to be owned with other assets and we haven't necessarily seen anybody out there with enough willingness to separate the IRFs out. So any acquisitions would likely be one-off facilities but we've had some success with those before. Two relatively recent examples will be the Walton Rehabilitation Hospital that we bought in Augusta, Georgia. That's been a great addition to our portfolio as has Cardinal Hill which is a large rehab hospital in Lexington, Kentucky.

There is a strategy that we utilized very effectively that really kind of combines an acquisition with a de novo, and that's when we will go into a new market by forming a joint venture with an acute care hospital. As you know, today roughly one-third of our 128 hospitals are operated in joint venture relationships. But we'll seek to enter a market and we'll identify a preferred acute care provider that may have an existing IRF unit within their four walls but typically it's under productive. And we can enter in an agreement whereby they will agree to repurpose that space to a more productive general and medical and surgical utilization. They'll enter into a non-compete for IRF services in that they'll get an in-kind equity contribution for that non-compete into a new de novo IRF that we'll build on or approximate to their campus. So we've essentially acquired their unit but built a de novo as well.

<Q – Peter Costa – Wells Fargo Securities LLC>: Got it.

<A – Mark Tarr – Encompass Health Corp.>: I think two of the ones we have this year are JVs.

<A – Doug Coltharp – Encompass Health Corp.>: Exactly.

<A – Mark Tarr – Encompass Health Corp.>: The JV strategy, we've been partnering with acute care hospital systems now for over 25 years. Our first JV venture started back in the early 1990s. So that is a strategy that has worked well for us and we're very proud of the fact that we've not had a single partnership unwind over those years. So we see that as being indication that we're a very good partner and we have a vast diversity in terms of the types of systems that we partner with. Some are academic-based, some are faith-based, and some are just community hospital-based. But the partnering is something that we've done well and implemented well as a strategy.

<A – Doug Coltharp – Encompass Health Corp.>: And, too, we find the most effective way to manage our business development pipeline on the IRF side is to keep it pretty evenly balanced between solo opportunities and joint venture opportunities. And the reason for that is just anytime you're dealing with a joint venture, particularly with a not-for-profit institution, many times they have – although we have a long history of joint ventures it may be something that is new to them. And things that can add to the gestation period for a new facility are joint venture negotiations and CON requirements. Conversely, the fastest path to opening up a new facility is to do a wholly-owned de novo in the non-CON states. We just try to keep the opportunities that are out there relatively balanced.

<Q – Peter Costa – Wells Fargo Securities LLC>: Makes sense. Other than 2015 when you bought Reliant, your average net new facility was three or four per year whereas now you're talking about four to six. So there were some closures in there that we've had. Are we done with the

closures or should I think there's some closures or consolidations I should say? Should I think about the four to six as being the gross number and then we'll end up with a smaller number of consolidations going forward or should I think about it as an accelerating growth?

<A – Mark Tarr – Encompass Health Corp.>: The most recent consolidation we did in the Fort Worth marketplace was a result of the Reliant acquisition where we knew that in advance and had planned for that. So we don't see a lot of consolidations in the future on the IRF side of the business. There may be one or two as we continue to move forward, but certainly we look to have four to six new hospitals on average coming on this year.

<Q – Peter Costa – Wells Fargo Securities LLC>: Great.

<A – Doug Coltharp – Encompass Health Corp.>: Yeah. We've done – I can think of three closures if you will really in the time that I've been here which is 8.5 years. Two of them were a direct result of the Reliant acquisition. So we knew going in that there was a high likelihood that given the overlap that we were creating in two Texas markets, Austin and then the Fort Worth area, that we would wind up consolidating facilities, and ultimately we've done those two. And then Beaumont was a facility that we just struggled to consistently make an adequate return on that investment. And so at the end of the lease, we decided to exit that facility. But as we look across our total portfolio, we don't have any facilities that aren't generating positive EBITDA other than those that are recent startups and are still in that ramp-up period.

<Q – Peter Costa – Wells Fargo Securities LLC>: Sounds good. Let's talk about the intersection between the IRF business and the home health business. Your collaboration rate has improved to 33% versus the high 20s range back in 2017, so nice improvement there and it's closing in on your target of 35% to 40%. How quickly do you think you can achieve your target and can you get beyond that target down the road?

<A – Mark Tarr – Encompass Health Corp.>: Sure. For those of you that may not be familiar with what we term as our clinical collaboration rate and what we call overlap markets which is 60% of our overall markets where we have a rehabilitation hospital, we also have one of our home health agencies. So the goal is to integrate the post-acute care. Almost 60% of the discharges out of our rehab hospitals go back to the community needing home health, so it's an opportunity for us to go in. And what we term as clinically collaborate in those overlap markets where we coordinate the discharge of course with patient preference, and the patient always has a choice, at the time of discharge from our rehab hospital into the home health agency.

So most recent quarter, we're a little bit over 33%. We have stated that our near-term goal is 35% to 40%. It's certainly something a level that we've hoped to reach in the next few quarters. Once we do that, we will reassess and set our next goal. We think longer-term, that collaboration percentage can be as high as 60%. There will always be certain reasons why we wouldn't get 100% of those patients, whether it's patient choice, whether a patient has a preexisting relationship with a home health agency that a referring physician may have, it could be a payer-oriented situation, it could be where we may have a partner hospital that has home health services that we don't want to impose upon. But we do think there's plenty of opportunity to increase that collaboration percentage.

Our ultimate goal here is to enhance the coordination of the transition from one setting to the next which is, quite frankly, something in healthcare that has been a challenge for everyone. We're starting to see some positive evidence now where in these overlap markets we've been able to achieve an increasing trend in patient satisfaction with the discharge process. We're starting to see evidence that we've been able to have more patients discharged from our hospitals to the home setting versus to a skilled nursing facility where the clinical team is more confident, that the patient can excel in a home environment, more confident with the relationship that they have with the home health clinicians, more confident that the patient would be in a safe setting. And then ultimately, the goal is to make sure that we get the patient home safe and not have that patient be re-admitted

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back to an acute care hospital which of course increases the overall cost for Medicare. So we're starting to see some positive evidence. It's early on but that's our ultimate goal in terms of our clinical collaboration as we see it longer-term.

<Q – Peter Costa – Wells Fargo Securities LLC>: You touched on it there a little bit but a couple things to define. There's the obvious capturing the revenue in the home health side from the discharges you otherwise have. But are there other financial issues that make having the two parts of the business together useful for you which might include referrals coming into you guys and managing that patient from coming back to the hospital and being a problem for the hospital? Or any other thing you want to talk about that in terms of how important it is beyond just capturing that extra revenue and then maybe a better outcome for the patient?

<A – Mark Tarr – Encompass Health Corp.>: Sure, sure. Well discharge planners from acute care hospitals are looking for not only a quality post-acute provider but they're also looking for someone that's easy to refer to, someone that they can have confidence in, that will do a great job with their patient and be responsive to them. It's one of the reasons we think having both a facility-based option and a home-based option and then having the opportunity to coordinate the two presents a solution to a discharge planner that they don't have to think through every step of the process. We can be of help to them in providing good solutions for where they refer that patient to next and have positive outcomes. We also think longer-term that it gives us an opportunity to go in and work with the payers and having some sort of a bundled rate or eventually even begin to start taking on some degree of risk and having one bundled payment that we would take and care for a patient in both whether that's facility-based, home-based or the combination of the two.

<Q – Peter Costa – Wells Fargo Securities LLC>: Sounds good. Can you talk about your other capital deployment priorities this year within the home health/hospice area? You completed the Camellia Healthcare acquisition. I think your guidance calls for hospital acquisitions of $160 million to $185 million this year. You've completed $136 million of that so far in the first half. What's the rest of it going to be and can you talk about sort of how you're targeting those acquisitions? And this gets back to that 60% market overlap point that you mentioned before.

<A – Mark Tarr – Encompass Health Corp.>: Do it.

<A – Doug Coltharp – Encompass Health Corp.>: So we're very fortunate that we generate a consistently high level of free cash flow in our business even as we've moved this year and transitioned over to being a full cash taxpayer because the last of our NOLs were consumed during 2017. And so this year our current estimate is it will generate somewhere between $400 million and $500 million in free cash flow which is a substantial amount to be able to deploy. Our highest priority is to continue to invest in the growth opportunities that we have in each of our two business segments. And we feel very fortunate that based on our current position and based on the demographic tailwind that is driving demand, increased demand for services out of our two business segments, that there are some really high-quality growth opportunities.

You've mentioned some of those. We are looking to build or acquire 46 new IRF units per annum, and in addition to that add approximately 100 beds to our portfolio. And then we had historically recently been out there with a range of $50 million to $100 million in home health and hospice acquisitions. This year, because there was a little bit of lumpiness with us closing on the Camellia acquisition on May 1 which was about $135 million, we bumped that level up but that's going to be where we first turn to deploy capital.

When we look at the overall balance sheet right now, we are at a 3 times leverage. And just based on the growth in EBITDA even without any further bad debt repayment, that number is coming down. So we don't feel the need to direct any free cash flow towards voluntary debt prepayments. In addition to the leverage level, we feel very good about the overall composition of our debt capital. And then you get into the category of shareholder returns. We have a common dividend that will

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consume a little bit over $100 million of that free cash flow. We think that that's something that our investors have appreciated. I do note that it was initiated first in July of 2013 and has been increased every year on an annual basis since then.

And then kind of a new category that popped up this year, although I think there was visibility into this item previously, is that when we first acquired Encompass Home Health and Hospice back at the end of 2014 we utilized a unique structure both to make sure that our bid was competitive and to ensure that April Anthony and the management team had the appropriate financial incentives to continue to try to grow the business, and that was that we allowed them to roll certain members of management, including April, to roll some of their equity proceeds from the sale to our business into the home health subsidiary. And their liquidity around that is a series of put options. The first was actionable on the first day of this year. They exercised that put option so we repurchased a little over 5% of the management's stake or a 5% interest in the home health and hospice subsidiary for $65 million. And if you look at that whole list of items, that pretty much accounts for the $400 million to $500 million we anticipate generating this year.

<Q – Peter Costa – Wells Fargo Securities LLC>: Thanks. Let's probably go back to the IRF discharges for a minute. First half of this year they were up, same-store about 4%. Your stated long-term target is up 2%, so you're well ahead of your long-term target. Can you tell us why you're so much stronger this year and whether that can possibly continue going forward?

<A – Mark Tarr – Encompass Health Corp.>: We do think there's some strong tailwinds behind the overall IRF discharge growth. And we've got 3% total plus in our 3-year business outlook, so we think that hopefully that's the floor. But given the demographics that are out there, the aging population we've already spoken to continues to drive the demand for the services. We feel like the last year, year and a half we have been able to use information and data to further elaborate and expand upon our value proposition particularly for patients in certain classes such a stroke where perhaps when you compare just on a per diem cost of an IRF versus a nursing home, a nursing home is certainly less expensive. If you look at it more of an episode of care for a longer period of time, the value proposition of an IRF comes into play where we are able to get over 80% of those patients back home and have a much lower occurrence of readmission back to the acute care hospital.

So it's this whole data that we've been able to wrap around our value proposition. The data that's been released from CMS over the past couple years on the outcomes of various post-acute providers, we can get very specific on where our total costs are versus other providers in a specific marketplace. It is part of the data not only from CMS but it's part of the data that we're working with Cerner on a post-acute innovation center which Doug has been very involved with with Cerner and are working to develop systems and information and best practices that we can utilize longer-term and our position of working with these acute care systems and overall post-acute continuum.

<Q – Peter Costa – Wells Fargo Securities LLC>: Can you talk about the Camellia Healthcare acquisition, how's it going at this point in time and what are you seeing there? Has there been any surprises? Has there been any positives or negatives?

<A – Mark Tarr – Encompass Health Corp.>: First of all, the integration has gone extremely well. I would say that there's not been any surprises. That was an organization that our home health and hospice team knew very well based in Hattiesburg, Mississippi. They are a Homecare Homebase user so we had great insight in that organization from a culture standpoint. It blended very well with our culture, and so we're right on cue in terms of that integration and where we thought we'd be.

<Q – Peter Costa – Wells Fargo Securities LLC>: Great. Talk about the MAC transition going from Cahaba to Palmetto and what that's meant in terms of your claims and claim denials and how they are in processing through the backlog of claims. And really importantly, the new denials seem

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to be declining and seems really positive, and it's not clear to me that you've fully taken that into account perhaps in terms of going forward, though it could be much better going forward.

<A – Doug Coltharp – Encompass Health Corp.>: Yeah. We began really talking about the change in the whole ADR scenario at the end of the second quarter last year and that was when the new CMS guidelines for how MACs approach ADRs came out under TPE initially in a pilot form, and then ultimately last fall those were extrapolated or rolled out across all of the MACs. During that same timeframe our largest MAC covering more than 80 of our IRFs who had been highly problematic to deal with, Cahaba, got fired and ultimately that contract was re-let and was awarded to Palmetto. But there was a transition period that took place from September when the contract was re-let to February 1 when Palmetto took over. And as both of those things were happening, we saw a dramatic slowdown in new ADRs. But it was difficult for us to predict whether or not that slowdown was going to be a sustainable trend or just a response to newness. And so we remained somewhat cautious about our assumptions as we moved into 2018 regarding the level of IRF segment bad debt or I should say from an accounting perspective now the line item formerly known as bad debt expense because it's now a component of revenue.

Through the first two quarters of 2018 those trends have sustained. We've seen very little in the way of new ADR activity not only from Palmetto but really from the other MACs as well. And yet what we've done in our guidance is roll forward the assumption that we return to that kind of [ph] $1.6 million to $1.9 million (00:28:30) level for the back half of the year. And that's really a result of just wanting to see further evidence both in terms of the relationship with Palmetto and the adoption of TPE by all the MACs before we declare a new appropriate run rate on bad debt. That being the case, there may be some conservatism in those numbers but it could turn relatively quickly. That's on new ADRs.

The second part of your question related to the backlog, we've got more than $165 million of previously denied claims still awaiting adjudication through the ALJ proceedings, and some of those claims are now as old as seven years. We historically prevail at about a 70% success rate against those; the 30% that we don't prevail on is already fully reserved. There is pressure on CMS to make some progress against that backlog because of the pending lawsuit with HHS which has not gone in their favor. And there are continuing negotiations through various industry associations and on our own CMS about ways to potentially resolve that, but there's no solution forthcoming and there really hasn't been any increase in the processing speed of the backlog claims for us or for other parties.

<Q – Peter Costa – Wells Fargo Securities LLC>: The backlog seems fairly quantifiable for me in terms of the information you provided. The new ADRs is harder for me to quantify exactly. Where do you think that could be if you were to adjust to where the new rate is today?

<A – Doug Coltharp – Encompass Health Corp.>: So right now, without resolving the backlog, if you assume you're at essentially zero in terms of new ADRs, bad debt would run at about 1.1% to 1.2% per quarter. If you go back to the former level of ADRs that we had say back in the second quarter of 2017 where we were running gross ADRs of a little over $20 million per quarter, that would put bad debt in kind of that 1.8% range. So I think that brackets it for you.

<Q – Peter Costa – Wells Fargo Securities LLC>: Okay. We're sort of running out of time here. Can you quickly go over the headwinds and tailwinds going into next year for us that we should be thinking about?

<A – Mark Tarr – Encompass Health Corp.>: So the tailwinds, Doug has mentioned a couple of the tailwinds if you think about the bad debt and the group health. The additional tailwinds would be the ongoing demographics that we've alluded to earlier that's driving the ongoing need and demand for our services. We will continue to enhance the clinical collaboration between our two business segments. We see growth opportunities in the hospice service line that we have within our home

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health and hospice segment. The demographics are the same for hospice in terms of this aging population. There's a societal acceptance of hospice care that is increasing. This will all drive the ongoing need and growth for hospice. So those are just a number of the tailwinds that we see that will help to drive our growth for next year.

In terms of headwinds, clearly we've mentioned some of the regulatory items that will be in play in 2020 that we will continue to lobby for and continue to work with CMS and see if we can't have some changes between now and then. And if not, we'll continue to work on our mitigating actions that we can take in the field.

Peter Heinz Costa, Analyst, Wells Fargo Securities LLC

Terrific. Well thank you very much for coming. We appreciate it.

Mark J. Tarr, President, Chief Executive Officer & Director, Encompass Health Corp.

Thank you.

Peter Heinz Costa, Analyst, Wells Fargo Securities LLC

Thank you all.

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