Company Name: Encompass Health Corporation (EHC)
Event: Jefferies 2020 Healthcare Conference
Date: June 3, 2020

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

Hi. Good afternoon, and welcome to the 2020 Jefferies Global Healthcare Conference. I am Brian Tanquilut. I'm the health care services analyst here at Jefferies. Our next presenter is Encompass Health. They're the largest operator of inpatient rehab facilities in the U.S., one of the largest operators of home nursing agencies and hospice as well also in the U.S.

Joining us this afternoon are the company's CEO, Mark Tarr; the company's Chief Financial Officer, Doug Coltharp; and also Crissy Carlisle, who heads IR is with us in the background. We really appreciate you taking the time today, guys. And I guess I'll start by saying, Mark, if you don't mind just giving us a little bit of an update on the latest things going on in Encompass. I know you filed an 8-K this morning, giving some detail on recent trends.

So yes, I'll pass it on to you. Thank you.

<<Mark J. Tarr, President and Chief Executive Officer>>

Thanks, Brian. Thanks to all of you that dialed in today. As Brian noted, we did file an 8-K last night in an effort to update the investment community on where we are relative to our volumes. And we're very happy to be able to show a very strong trajectory coming out of a COVID period, which had us bottoming out over the Easter weekend in terms of our three service lines, and then starting in April through May and that continues to today, a very strong trajectory in terms of recovering our business. We're seeing things much more active in terms of the number of referrals with acute care hospitals. We're seeing our sales and marketing teams that are out in the various marketplaces have greater access to the discharge planners and the referral sources within the acute care hospitals. So we're very pleased with, first of all, with how our staff performed during the COVID crisis ourselves and then how we've come out of that since that Easter weekend.

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

No. That's a great intro, Mark. So I guess as I think about it, right, I mean, I'm looking at the data that you put out this morning, your IRF volumes are now at 94% of what they were pre-COVID. I mean home nursing is a good bit above at about 111%. And then hospice is at 95%. So pretty good recovery there. But as I think about -- let's start with IRF, is there a wide variation geographically in terms of the bounce back? I know some of your key states, Georgia, Alabama, Tennessee and Texas, have reopened. Is that a good way to think about the pace of progression in the IRF business?

<<Mark J. Tarr, President and Chief Executive Officer>>

Yes. We see -- in general, we've seen a nice trajectory. We have had a number of states. And if you think about where the hotspots remain for COVID, you think about up in Massachusetts, our facilities in New Jersey. Those have been some areas that certainly have recovered a little bit slower just because of the concentration of COVID in those areas. We

continue to treat COVID patients in those marketplaces. But we are fortunate as an organization to not have a high concentration of either hospitals or home health agencies and what was identified as being hotspots for COVID in the U.S.

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

I will just add to that as well. In a lot of those markets in the Northeast, we operate a lot of facilities that have semi-private rooms. And as we have adjusted those facilities to be able to treat patients who were recovering from COVID, in many instances, we've had to convert those rooms over to single occupancy on a temporary basis, and that restricts some of our capacity. So that has limited the degree of recovery in those markets. Then there are a very small number of markets, when you count them, on less than one hand, where we've actually had an outbreak occur in our hospital and we'd have to either limit admissions for a period of time and/or again reduce occupancy in those facilities. And so there have been pockets that have been impacted like that.

<<Mark J. Tarr, President and Chief Executive Officer>>

Brian, I think over the last two weeks is the -- you've seen the surgery procedures increase in acute care hospitals. Acute care hospitals have opened up significantly. When COVID came through, not only did they eliminate all their elective procedures, but they sent many of their staff home, too. So just the normal referral processes of the clinical communications of potential patients in acute care hospitals out to post-acute. That entire model was impacted. So now they've gotten more volume back in acute care hospitals because of elective procedures. Even though we don't have a large number of admissions that come into our IRFs directly due to elective procedures, it still has reestablished the normal referral pattern or processes that existed from the acute care hospitals to post-acute.

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

[Indiscernible] (0:05:23) Brian, is that we have benefited certainly from the Medicare waivers and also from the waiver of pre-authorization requirements by the managed care plans, specifically within Medicare Advantage. Firstly, all of the pre-authorizations have been reinstituted as of the end of May by the Medicare Advantage plans. So we're going to have to see if that delays any admissions in the IRF segment. Ultimately, we think we'll continue to see the kind of beneficial growth within MA that we've experienced recently, and we would attribute that to at least two things.

One is during this period of time that they have been able to continue the momentum that exist pre-COVID in establishing our value proposition to those plans and effectively treating highly acute patients. And then the second thing is that there's really not an ability based on limitations that were established both by SNFs and by local health agencies to send a lot of patients that require post-acute inpatient stay directly into a SNF setting.

<<Mark J. Tarr, President and Chief Executive Officer>>

Brian, we've always taken great pride in our quality outcomes as you know. And I think that's one of the things that the COVID crisis has really pointed out in terms of the fact that not all post-acute providers are equally capable of taking certain kinds of patients. And I think that will only make us shine even greater with our value proposition.

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

But we do want to point out that the re-institution of those pre-authorization requirements could have the effect of damping down the very positive trajectory that Mark referenced earlier for at least a period of time. We don't think it'll be permanent. But if we saw that flatten out for the next month or so, it wouldn't be terribly surprising.

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

That makes a lot of sense. So Doug, as I sit here and say, okay, your business is -- really, this was a structural change. The temporary structural change have prevented you from seeing patients that you would normally see through your doors, right? But once we normalize in this, assuming we don't have a COVID 2.0, how are you thinking about the ramp in the business between Q3 and Q4 that you need to prepare you for 2021? Meaning -- or I guess, another way of thinking about it is, are we at that point where we feel like we can say 2021 should be back to where we thought it would be pre -- before COVID happened?

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

That's our underlying assumption. Again, the primary premise underlying our growth assumptions as we presented on Investor Day prior to COVID-19 rolling out was based on the underlying demographics, the incidence of the maladies that we effectively treat in our facilities and on a home basis occurring in an aging demographic, and there isn't anything that has changed that view. So if anything, we believe here in the back half of the year that the increase from elective surgeries and the fact that May patients who would have been eligible for post-acute care, both on an inpatient basis and home-based care, chose not to receive it here during the height of the pandemic is going to lead to increased volumes in the back half of the year. Think about it, there's no -- really not much of a thing called an elective surgery for the elderly population. They're not getting a lot of cosmetic surgery. They may choose not to have a knee replaced. That's a deferral. That's not a decision to ultimately truly not elect to have it done.

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

No. That makes a lot of sense. And since you mentioned the growth outlook and the Investor Day comments that you guys made, as I look just beyond 2021, I mean, I get the fact that 2020 was a baseline for the growth guidance that you gave. But taking that out of the equation, the 2020 dip, is it right to think that nothing has changed with the long-term fundamentals, whether it's bed additions, opportunities for de novos, all the other things? I mean if you don't mind, maybe you can walk us through what the driving factors are. But is it right to think that all of those things are intact?

<<Mark J. Tarr, President and Chief Executive Officer>>

That's correct, Brian. I mean as you noted -- I mean Doug mentioned the underlying demographics. The fundamentals of our business, we don't think have changed in the long term. And this whole COVID crisis was a blip that we'll all get through, but the demographics is what's driving the underlying continued demand for our service. And we absolutely see that continuing in the future.

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

And we are being very active on the business development side. You probably saw that just this week, we got another new de novo opened up in Coralville, Iowa. We're very excited about that. Next month, we'll be bringing on our first IRF in the state of South Dakota with the Sioux Falls opening. We have eight IRF de novos that we've already announced that are targeted to open in 2021. And based both on the opportunities that we discussed at the Investor Day in Florida and elsewhere in the country, we think that we're going to be running at a higher rate for the foreseeable future both in terms of bed additions and IRF de novo development.

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

And Doug, just to hit on that point, right, I mean, we've seen some discussion -- or you guys have talked about pulling back on CapEx a little bit, at least near term. I mean does that have an impact on your 2021 or 2022 growth? I know you've just laid out the openings that you're planning, but where does the CapEx pullback impact the business going forward?

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

It could potentially have an impact of moving a project's start or opening date a quarter or two. So there's a possibility that something that was scheduled to open in the latter part of 2021 would wind up opening in the first part of 2022. That's the potential. Much of that $100 million is attributable to project pacing. And where it's on de novos, it's not really a proactive decision on our part not to start or delay up a project. It's due to the fact that virtually all businesses, including municipal governments, if you want to classify them as such, have been working remotely as well. And that's challenged their ability to pace with us on moving certain projects forward. We're seeing some of those log jams, to the extent that they existed, start to alleviate. But really, that -- again, the impact of that $100 million that we sited was almost due to project pacing. We don't see it having a material impact on the openings and the capacity additions we'll have in 2021 and 2022, but it could shift some of the timing between those two periods.

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

That makes a lot of sense. And then I guess just to follow up on the de novo discussion. So you've got two opening pretty much right around the quarter. How are we thinking about the ramp or the earnings drag that we would expect from the de novos coming into the system?

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

Well, it's going to be hard to separate here in the near term from the overall impact of COVID-19 and everything going out there. On a normalized basis, what we've said is you typically have two sources of drag from the opening of de novo. We normally incur approximately $1 million. Sometimes depending on the size of the facility in the market, it could be up to $1.5 million in preopening expenses related to bringing staff on board in advance of the opening and so forth and doing that kind of training. Then you've got the initial period of time where we have to treat was – gone from 30 to 20 Medicare patients before we can get our Medicare certification qualified for reimbursement. And then you

typically got between six months and a year when the facility is operating below its stabilized occupancy level. And so it's not generating positive four-wall EBITDA.

So, depending on the timing of these facilities, you'll have a little bit of a drag. We're going to be in a better position as we enter 2021 where we anticipate this ramping up of de novos to be able to quantify and target on the preopening expense of the drag when we reinstitute our guidance and then provide that at the outset of 2021.

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

That makes a lot of sense. Mark, I guess just kind of going back to the growth discussion, especially in the IRF. I mean it's still 80% of your business. MA has been showing some pretty good growth for the IRF segment. And I think on the last call, you talked about stroke being a good driver of that. I mean is there any color you can provide on why we're seeing that pickup in stroke growth? And then also as I think about Medicare Advantage growing faster than fee-for-service, is that something that is consideration or are we at that point where we're pretty agnostic to it?

<<Mark J. Tarr, President and Chief Executive Officer>>

Well, as you know, we have focused on stroke program now for the last several years. And we – for a number of reasons, a, we're very good at it. We get great outcomes. We saw the stroke population as a population that was having their needs not very well met by other providers. So, we have structured our hospitals relative to equipment, training, medical staff and support to be able to take a higher acuity, and more specifically, patients that have suffered from stroke. We have about 5% market share of the total occurrences of stroke in the United States. And so we feel that there is definitely a long runway for us to continue to show growth with our stroke programs. We mentioned earlier about the value proposition. And this is an area that we have made some nice progress and strides with the MA plans as they've looked at our outcomes versus those that have been achieved in a skilled nursing facility. There have been independent research projects that – and publications that have shown the outcomes that patients suffering from stroke that needed inpatient rehabilitation have received better outcomes in IRF versus skilled nursing facilities.

So, we think there's a lot of momentum around this program. We think that it can also lead towards other diagnostic categories, that MA plans will be more likely to work with us as well, such as just other neurological categories in addition to stroke that they see the difference in terms of outcomes.

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

And Brian, recall that on the IRF side, we came into 2020 with – riding a very strong wave in terms of growth of Medicare Advantage and a narrowing of the differential in pricing between Medicare Advantage and Medicare fee-for-service. So we had almost 20% Medicare Advantage discharge growth in the back half of 2019. When we looked specifically at what has transpired in 2020, it is accelerating. And it has accelerated in part due to COVID-19 and the related waiver of the pre-authorization requirements.

To give you some specifics around there, if we look at – and here for this analysis, I'm eliminating two holiday weeks. I'm taking the first week of January off the table because it

had a holiday. And I'm taking the last week of May off the table because it had a holiday. But if you look at weeks two through five start of year and compare those with the four-week period that ended prior to Memorial Day week, then our referrals from MA, which is the starting point on how we get our volume, are up about 8.7% on a weekly basis.

The admissions, though, are up 72%. And that's because our conversion ratio has gone from, in that first four-week period that I referenced, just under 35% to, in this last four-week period, almost 55% or 58% increase. We've been able to do that without seeing any kind of material change in the overall acuity level of the MA patients we're treating or without any change in the length of stay, which would be another indicator of that.

So, we currently believe that although we benefited from the waiver of the pre-authorization, that we're doing so with the right kind of patients and that we're generating the right kind of clinical results for that payer class. And those same trajectories, the same trends do not exist on the Home Health side where there continues to be a much larger disparity in the payment rates between Medicare Advantage and Medicare fee-for-service. And so whereas we are agnostic between those two payer classes on the ERF side, we have not reached that point of indifference on Home Health.

<<Mark J. Tarr, President and Chief Executive Officer>>

Brian, one more comment on stroke. We'll be entering or now in our third year of our branding relationship with the American Heart – American Stroke Association. And that, too, has been a nice opportunity to reach out certain segments of the population that would otherwise not have been introduced to Encompass Health or the Encompass Health name. It certainly helps us to be associated with quality outcomes for stroke patients. And so that's just yet another opportunity that we have to continue to take advantage of and brand ourselves and associate ourselves with the stroke program.

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

Now that makes a lot of sense. So, I guess last question for me is – on this topic, right? I mean as we think about – we have been talking about payer mix a little bit, fee-for-service, Medicare Advantage. As I think about the fact that, what, 30% of your IRF business is still non-fee-for-service Medicare, how do you think about the business and how it would fare in the recession as we think about 2021?

<<Mark J. Tarr, President and Chief Executive Officer>>

Well, history shows that we've not been very impacted by recessions. I mean our average age patient is right at that 76, 77 years. So relative to the demand for our services and the volume side, you don't see much of an impact. We – it may show some opportunities, particularly in support positions and support roles on the salary side or the ability to find qualified staff and retain qualified staff, but really, overall, recessions have not shown to be – certainly, they haven't shown to be negative impact and really not much of an impact at all.

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

So what we haven't seen – what none of us have seen is what the impact of the recession is on the growth of Medicare Advantage, because it wasn't around during the last Great

Recession, but there's no reason to believe that the positive trends that exist within Medicare Advantage won't continue. And the overall portion of our population that's covered by insurance, be it in the fee-for-service program or Medicare Advantage, which is closer to 82% or 83%, is not going to change. You've got another 4% that's covered by the Medicaid program. And then you've got another percentage of the population really when you're dealing with that last 14% that is combination of private pay, private insurance and workers' compensation. That portion could get hit marginally during a deep recession, but we haven't seen that transpire previously. We feel like we are relatively recession-proof.

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

Now that makes sense and I agree with that. I'm proud of myself for not asking too many Home Health questions until now. So I guess I've got a couple of home nursing ones. So, we've obviously seen the recovery in your home nursing census, and it's pretty good. So how do you think about the growth outlook for that business? I mean, do you think there's opportunity to accelerate home nursing growth for your Encompass Home Health side whether it's that – it's from market share gains or just overall secular growth?

<<Mark J. Tarr, President and Chief Executive Officer>>

Yes. We do. I mean our Home Health team has been – has a very strong track record of growth, the ability to bring in acquisitions and ramp them up to their standards and business metrics. They've shown a strong history of the past of being able to adjust to regulatory changes such as PDGM that we're incorporating this year. And you combine that all with just the ongoing viewpoint, which I think was even – has been accelerated through the COVID period, where more and more patients are going to want to be treated in a home setting if they're capable of being treated there. And so we think the future demand for Home Health is very strong. We think we're well positioned to take advantage of both opportunities through acquisitions and taking market share.

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

Like a lot of other players, what we've seen as a result of COVID is the amount of referrals we're getting into our Home Health business out of SNFs have come down very considerably. And a lot of that has to do with the fact that the patients aren't going into the SNF on the front end. And there's a strong bias that is being expressed both by physicians and by patients and their caregivers for care in the home setting and if they can avoid a post-acute institutional setting such as a SNF.

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

No. Definitely. So we're running out of time, but Doug, I've got one question for you. So on leverage, we've gotten a few calls over the last few weeks from investors who are just asking about leverage for Encompass specifically. It screens as three times levered. What are your thoughts on the right normalized leverage levels for the company? And then what's your optimal capital structure in your view and then your comfort level on – with debt as we head into a recession? I mean, I know you're defensive, but just thinking about the debt markets as a whole as well.

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

Yeah. So we think three times, and that's a figure that we've stuck to you for a long period of time, represents a good run rate for our business based on the composition of our business based on the ownership of our real estate and so forth. We're going to be a little bit above that here for a while because we've had – taken a below two LTM EBITDA based on the COVID-19. That will be a temporary thing that works it out. The balance sheet is in great shape. The recent refinancings that we've done starting fall of last year and extending into the most recent quarter were very helpful in positioning us with the appropriate type of debt on our balance sheet with a lot of flexibility. And we really shored up our liquidity position with essentially full availability under our $1 billion revolving line of credit and an excess cash position following those recent notes issuance of over $250 million.

So, I feel great about the balance sheet, the capital structure that we've got in place. The leverage is going to nose up above three-point times, because of the impact of COVID-19. But ultimately, we believe that, that is an appropriate place to run the company.

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

That makes a lot of sense. We're running out of time. So Mark, just short closing remarks. It sounds like you're really bullish and very positive about the business.

<<Mark J. Tarr, President and Chief Executive Officer>>

Absolutely, I mean, we've – like I said, with the exception of COVID being a short-term challenge here, we are very positive with the outlook of our business in both of our operating segments and all three of our service lines.

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

Awesome, guys. Well, thank you so much. Really appreciate for taking time and good luck for the quarter.

<<Mark J. Tarr, President and Chief Executive Officer>>

All right, Brian. I appreciate the opportunity.

<<Brian Tanquilut, Analyst, Jefferies Group LLC>>

Thank you. Bye.