PARTICIPANTS

Corporate Participants

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

Other Participants

Brian Tanquilut – Analyst, Jefferies LLC

MANAGEMENT DISCUSSION SECTION

Brian Tanquilut, Analyst, Jefferies LLC

Hi, good afternoon, and welcome again to the third day of the 2021 Jefferies Global Healthcare Conference. I'm Brian Tanquilut, I'm the healthcare services analyst here at Jefferies. Our next presenter is Encompass Health. They're the largest operator of in-patient rehab facilities in the US, and they're also one of the leading operators of in-home nursing through Encompass Home Health. And joining us this afternoon are the company's CEO, Mark Tarr; and the company's CFO, Doug Coltharp. Guys, thank you again for doing this. Really appreciate you taking the time. So, Mark...

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

Brian, it's our pleasure to be here today.

 Copyright © 2001-2021 CallStreet

FACTSET:callstreet
corrected transcript

QUESTION AND ANSWER SECTION

<Q – Brian Tanquilut – Jefferies LLC>: Yeah. No, appreciate it. And I'll see the first question to get the ball rolling. So, obviously, lots of stuff going on with COVID. So maybe, Mark, can you give us just some update on the business? What do you see in terms of volumes in operations especially with COVID in the background and as we kind of exit the pandemic here?

<A – Mark Tarr – Encompass Health Corp.>: Sure. Well, you may recall that we had said on our first quarter call that we're very encouraged by some of the trends that we saw particularly in margin and we had expected to bring those into the month of April which we in fact did and we continue to see trends improve. And I'll give you just a couple focal points as we see it.

So at the height of the pandemic, we had as many as 30 of our hospitals that had some limitations or caps on volume simply because we had so many COVID patients. We had to deal with isolation of patients in semiprivate rooms. Or in many cases we had so many of our staff who were in quarantine. We only had so many staff that we could have to – available to us to treat patients and handle the incoming volume.

So that went from 30, and now we're down to 1 or 2 at any given week. We continue to see elective procedures come back in the marketplaces which is a very favorable sign for both of our operating segments. We've said that we didn't expect our age cohort, that 76, 77-year-old to be the first one to rush back for an elective procedure. And I think that is playing out. But nonetheless we're seeing an increasing confidence in our patient population to go and access, once again to access healthcare which was a major hurdle that we had to clear before we would see the corresponding positive trends.

So we're starting to see a more normalized patient mix, program mix, diagnostic mix from the acute care hospitals as they gain momentum back. From the home health side, we now have access to assisted living facilities and skilled nursing facilities which historically has accounted for about 15% of our total admissions. What we haven't seen yet are the census levels, the volume levels in those settings come back to their historical norms. But we're very confident that those patients will once again come back to those settings and that volume will come back as well.

So between the electives, between what we're seeing from the acute care hospitals, the elimination of any volume cash due to COVID, the increasing percentage of vaccination rates across the country, we're very encouraged by what we continue to see and quite frankly it feels quite good to look on it right now where we were versus this time last year.

<Q – Brian Tanquilut – Jefferies LLC>: Yeah. No, that's great. That's great color. So I'm sure you're probably tired of talking about COVID in your business now. And as we exit, it's probably better to refocus on what the business looks like going forward. So, if I recall, pre-COVID you hosted your Investor Day, right at the very beginning of COVID really last year and you gave some growth guidance ranges then which you've since updated. But as we think about the core inpatient rehab business, what do you think is the right way to think about the growth opportunity there whether it's new bed adds, with all the de novo opportunities, JVs, any color you can give us in terms of what the right growth outlook is for that business?

<A – Mark Tarr – Encompass Health Corp.>: So we continue to be encouraged and believe that the aging demographic and the tailwind behind it with that 76, 77-year-old and the CAGR of 5% for the next five or six years will continue to drive the increased need or demand for our services. Just a fact of life that as we grow older, the likelihood that we'll have some sort of a condition that would warrant rehabilitation services is going to increase. And so that is a key driver.

 Copyright © 2001-2021 CallStreet

I think another area to look at that is, if you think about the fact that we've seen a significant increase in the 65 plus, I think it's somewhere around [indiscernible] (05:18) increase and 65 plus for last number of years. At the same time, the capacity or the number of beds in our industry has been fairly flat. So you've had an increasing need, you've had a flat supply and so there is an imbalance that exists out there as well. So, we have in our growth targets that you alluded to earlier Brian, we have about 6 to 10 new de novos per year. You probably know that we've announced already 8 for this year. We have 12 that have been announced for next year. We're very encouraged and excited about the pipeline that we have out there to meet this increasing need.

<Q – Brian Tanquilut – Jefferies LLC>: Hey, Mark, just as you mentioned that, how should we be thinking about the ramp in CapEx as you ramp-up the de novo strategy? And maybe for Doug, as I think about rising construction costs across the country, is that showing up? Are you having to redo some of your budgets on the new builds?

<A – Doug Coltharp – Encompass Health Corp.>: Yeah. We haven't seen any of our budgets. Really have to be completely disrupted or blown up in terms of the 2022 or 2021 and 2022 projects as of yet. Part of that is we try to get out in front of it. We are definitely seeing that there are tighter conditions in the construction market, but it hasn't escalated to the point that it's causing us to materially change our budgets to this point.

In terms of the ramp-up in CapEx, obviously, as we accelerate the de novo pipeline, there's an increase in capital expenditures as well. And if we move to 12 next year which we're identifying on average we're talking about $30 million to $35 million per facility in CapEx to build a 50-bed facility, it really depends on the area of the country. And then we're also looking to add 100 to 150 beds to existing hospitals. And all of that is on top of our annual maintenance CapEx. So that number will be going up. We're fortunate that we continue to be a business that generates a very high level of free cash flow. In a normalized year, almost 50% of our adjusted EBITDA flows through to adjusted free cash flow. And so, that's going to allow us to meet the overwhelming majority of these requirements through internal sources.

We have the capacity on the balance sheet to provide some debt financing in the near-term if we need to. But overall, we feel very good about the ability to support this level of growth without any way stressing the balance sheet.

<Q – Brian Tanquilut – Jefferies LLC>: No, that makes a lot of sense. Mark, I'll just pull it back again to the sort of development strategy here. I mean, there is interest for joint ventures it seems like from hospitals. So how do you balance that decision to either joint venture or build de novo from scratch?

<A – Mark Tarr – Encompass Health Corp.>: So as you can imagine, we have a fairly complex model that takes in a number of metrics that we look at to analyze the marketplace. And then part of that consideration are the existing providers in there. We always take a look at the level of managed care. And one of the factors is we look at who are the acute care systems that are in there and are they in rehab? If they are, are they interested in partnering? Do we need a partner in a marketplace is usually the first question? And if so, who would make the ideal partner? And then just weighing the pros and cons of coming into it alone versus needing a strategic partner to be successful in the marketplace.

As you know, partnering with acute care hospital systems has been a business model we've used now for over 30 years. Very successful. We've never had a partnership unwind. And we continue to be excited within the pipeline. We have a nice complement of projects that are both wholly-owned, and we also have a nice complement of JV partner opportunities that are out there. But, yes, you're right. We have since been increasing interest and acute care hospital systems looking at partnering with an operator that has the expertise of an Encompass Health to either expand their footprint and

inpatient rehabilitative services or help them manage what they already have or just overall strategic partner in thinking about where are the opportunities to seize going forward.

<A – Doug Coltharp – Encompass Health Corp.>: And just a point of clarification, Brian. JV is not stemmed from a de novo. [indiscernible] (10:11) de novo opportunities, then we're making a decision as to whether or not we want to pursue it on a wholly-owned basis whether we think that de novo would best be served through a joint venture relationship. And in many instances, what we're doing now is we're determining that a market can support a new freestanding IRF. We'll go ahead and make a commitment to the market and then invite discussions with potential JV partners. But the project itself is not contingent upon securing a JV partner. And we find that moves things along a little bit faster because if you're waiting on the front end to confirm a JV relationship before you make a decision to proceed with a new de novo, there are a number of markets where that's appropriate. But for most part if you're waiting for that, the gestation period with most not-for-profit JV partners just tends to be very long and it could delay your entry significantly and potentially expose you to somebody else jumping in, in front of you.

<Q – Brian Tanquilut – Jefferies LLC>: No, that's so true.

<A – Mark Tarr – Encompass Health Corp.>: Brian, one final comment on that. We have also seen in a number of our partnerships where you may partner on one project and then at some point in the future you find as your partner grows you need the opportunity to grow with them. And Piedmont Health is a prime example of that announcement. We had a couple weeks ago State of Georgia. But we have other examples too where we've done [ph] a hospital one (11:38) marketplace and then maybe they've expanded their acute care hospital footprint. And we've been able to work collaboratively with them that would lead to a second hospital that would be part of the partnership. So it's really been a strong business model for us.

<Q – Brian Tanquilut – Jefferies LLC>: No, that sounds really good. Doug, I'll shift gears here a little bit. We're getting a lot of questions about labor right now as you can imagine, just wage inflation both on the clinician side. Everyone is talking about nurses and the shortage of nurses and then lower skilled kind of like lower wage employees. So what are you seeing on that front and how are you strategizing around that to maintain your cost structure and also adequate staffing?

<A – Doug Coltharp – Encompass Health Corp.>: Yeah. So nursing was getting tight before COVID and certainly COVID has exacerbated that for a number of reasons. During the height of the pandemic you saw many of the acute care hospitals providing these contracts to lure nurses in from other markets because of the extreme needs they had. Now fortunately that impacted our business at a time when our volumes were down anyway. And so really didn't create a staffing shortage through most of the deepest part of the pandemic.

What we're seeing right now is that the acute care hospitals are largely returning to normal and some of those travelling nurses are returning to our markets. Nonetheless, there's a real fatigue out there within the clinical workforce. And so many of them are just opting to take some time off and step out of the workforce whether it's due to fatigue alone or due to the fact that they may be facing some home situations that might involve senior care or child care. There's an element of that that will prove to be temporary.

In terms of how that's showing up with regard to wage pressures and inflation, it's more pronounced right now within our home health segment. And there we are having to increase wages a little bit higher than we had anticipated. Substantially we had anticipated we might be just north of 3%. And on average what we're seeing is something that's probably closer to 4% right now. It is not as pronounced, it's more of a market-by-market situation in the IRF sector. We haven't had to revise our estimates for SWB increases this year. But it's certainly going to be a challenge that we continue to face in both of our business segments and that other providers will face as well.

 Copyright © 2001-2021 CallStreet

corrected transcript

Your point on the lower skilled resources is a very valid one as well, and that one is most applicable to our hospitals, and it's areas like housekeeping and food services and so forth. And there what we certainly find is that the incremental unemployment benefits are causing some friction in terms of getting folks to return back to work. And when you combine the extra benefits they can get with some of the same home issues that they face regarding senior care or child care, we just not have seen – we just haven't seen the kind of availability for workers of that skill level that we had seen pre-pandemic.

<Q – Brian Tanquilut – Jefferies LLC>: No, I appreciate that. Mark, let's shift gears a little bit. I told myself that I'm not going to ask you about the strategic review of the home health business because I figured there's not much you're allowed to say right now.

But just taking a step back, right, when you bought Encompass six years back, there was a strategic rationale for it, right? I think you guys saw the value of vertical integration or having a one-stop-shop offering. So, where do you stand in terms of that view on the importance of integration? And maybe let's just put a hypothetical that if you decide to either sell or spin-off the home health asset, are there ways to keep that strategic relationship intact to keep – to maintain the benefit?

<A – Mark Tarr – Encompass Health Corp.>: Yeah, absolutely, Brian. Well, first of all, we referred to that relationship as our collaboration, and that's where we have standardized the process and everything that goes into the discharge process from our hospital and to our home health in our overlap marketplaces. And we've been able to refine that over the last six years since we have been doing this in a standardized manner. It's very important for us. It's a very important quality marker. We think that it makes for a better handoff that benefits the patient in terms of their own satisfaction with the communication and the integration of the care provided. We think it better sets them up to reduce [ph] elimination or (16:34) the potential for them to have a need to be readmitted back to acute care hospital, so there are a lot of reasons we do it.

One of the things that we've learned that we've determined over the last number of years of doing this is and we've been able to compare our overlap markets with our non-overlap markets. And if you look at the number of items or the number of information [indiscernible] (16:55) information provided from CMS now that allows for transparency and you can really compare providers in any given marketplace on quality factors [ph] and again (17:05) you can really hone in to whoever the really strong home health providers and who's not.

We didn't know that back when we first [ph] got into the home health business. As a matter of fact (17:17) our hospitals would discharge patients from an inpatient setting to home health and they may have anywhere from 10 or 12 different home health agencies of which they really had no way of differentiating the good ones from the bad ones and we knew very little about what happened to our patients after the time of discharge. That whole world is different now.

We have a lot of information available to us. We're working on non-overlap markets with a number of home health providers that are interested in working in a [indiscernible] (17:50) manner and do many of those same elements of the process that we have standardized in our overlap markets. So, getting back to your initial question, we believe that we can maintain a strong level of collaboration but we don't have to own it and we can still have those strategic relationships and partnerships without having that ownership portion of that. So we think absolutely we can continue that going into the future regardless of which direction our strategic evaluation takes place.

<Q – Brian Tanquilut – Jefferies LLC>: Now, that makes a lot of sense. So shifting gears towards the operational side of your home health business. One of the things that I noticed in this past quarter is the announcement of the home health contract with United that's on a non-episodic basis. So how are you thinking about pushing more into MA, one? And then maybe second, Doug, kind of like balancing that with the margin impact of taking non-episodic business in home health.

 Copyright © 2001-2021 CallStreet

<A – Mark Tarr – Encompass Health Corp.>: So we've been very discerning in terms of the contracts we've signed with the MA in both of our segments. But I think particularly home health as an industry has been challenging because so many of the payers just need it as a commodity and didn't really evaluate the various providers in terms of their clinical outcome. So we wanted to make sure that we were working with payers that had a degree of understanding for the quality that's provided and that it would be more of a strategic partnership. And we felt that with United. And it is – yes, it is a discount to what our fee-for-service historically have been. They were paying us out-of-network rates in the past before we signed this national contract. We don't have a lot of history with it yet, but we do have a number of months and it looks like it's been overall positive thing in terms of we've had strong volume. As you know, it's non-episodic and paid on a per visit basis versus episode. But we think all in all, strategically, it's positive to us. And the trade-off in terms of the volume and margin or rate at this point has been a positive impact. But I'll let Doug go in further on the margins, so.

<A – Doug Coltharp – Encompass Health Corp.>: It is a transaction [indiscernible] (20:33) contract that makes sense for us strategically. I would not say it was one that we ran with great gusto into. As Mark said, we had been picking up a pretty good amount of volume from United on an out-of-network basis which paid on [ph] an episodic (20:50) rate and paid at the same rate as Medicare fee for service. And we have had multiyear discussions with United about moving that volume in network and the point of contention had always been that they wanted to move it to a per visit rate and that that rate was initially offered to us at about a 40% discount to the applied fee for service rate. And we just didn't want to deploy a limited supply of clinicians to take on that business.

Ultimately, we got to the point where United essentially drew a line in the sand and said you will not get any more volume out of network and you got to pull that in network. We were able to negotiate a rate that had been better than was offered for but still represents a very substantial discount to fee for service. We're optimistic based on the discussions that we had with United moving into this, but as we demonstrate our volume or our quality and how it is differentiated for many of the health care providers out there in terms of the quality of our outcomes that that will lead to higher rates and close the gap between that and fee for service.

In the interim, we've got kind of one foot on the gas and one foot on the brake because we're encouraged by the incremental volume we're seeing as we moved in network. But it is at a substantially lower volume. And because of the staffing constraints that are out there, we're going to give a fee for service patient a priority [indiscernible] (22:19). So we're going to continue to see – as Mark suggested, we're early on. I don't know that I would suggest that this is an arbiter of things to come with other MA contracts. There are a number of different models that are underway.

Within the home health space, we still haven't seen the recognition of differentiation regarding quality providers that we've been able to see on the IRF side. The rate differential that exist in home health right now between MA and fee for service is essentially where the IRF business was seven or eight years ago. But by establishing our value proposition and the quality of our outcomes, we've been able to move from just over 50% of our contracts eight years ago that were paid on an episodic basis to almost 85% of our MA revenue in the IRF business now being on an episodic basis. And the rate differential between MA and fee for service is 8%. So there is progress that can be made. It just takes some time.

<Q – Brian Tanquilut – Jefferies LLC>: Yeah. No, that's great. Last question for me. One question that we're getting from some investors is the fact that obviously your CEO in the home health business left. I think you've said that you're running a search. But people are asking, what's the depth of the management team that's left there? I know you've got Luke who's been at Encompass for a long time. But how should people think about the team and the bench strength to run that business on its own?

 Copyright © 2001-2021 CallStreet

<A – Mark Tarr – Encompass Health Corp.>: Yeah. They should think about being a very competent team. They're a very engaged team and there is a lot of depth there. I mean, it's a large organization that had some long-term managers that have risen up through the ranks and started out at kind of at the ground level and have shown the ability to be great operators and have multi-site responsibilities. So, I'm very confident that the team will continue to perform.

<A – Doug Coltharp – Encompass Health Corp.>: It's been a great partnership with April for 6.5 years and she is a unique leader and a very special leader in many ways. So we are so grateful for her contributions and she leaves behind some big shoes to fill. But we're very encouraged by the candidates who have expressed an interest in that job and we're confident that we're going to fill that leadership role with somebody who is really dynamic and can take that business to the next level.

Brian Tanquilut, Analyst, Jefferies LLC

Now, that's awesome. Well, guys, we're at the end of our time here but I really appreciate the time that you took today and the insights that you shared with us. So, thank you again. And we look forward to speaking very soon.

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

Thank you, Brian.

Douglas E. Coltharp, Chief Financial Officer & Executive Vice President, Encompass Health Corp.

Thank you, Brian.

Brian Tanquilut, Analyst, Jefferies LLC

All right. Thank you.

corrected transcript

Disclaimer
The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2021. CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.