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Encompass Health Corp. (EHC)

Q4 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone, and welcome to the Encompass Health's Fourth Quarter 2021 Earnings Conference Call. At this time, I would like to inform all participants that their lines will be in a listen-only mode. After the speakers' remarks, there'll be a question-and-answer period. [Operator Instructions] You'll be limited to one question and one follow-up question. Today's conference call is being recorded. If you have any objections, you may disconnect at this time.

I will now turn the call over to Mark Miller, Encompass Health's Chief Investor Relations Officer.

Mark David Miller

Chief Investor Relations Officer & Senior Vice President-Investor Relations and Strategic Planning, Encompass Health Corp.

Thank you, operator, and good morning, everyone. Thank you for joining Encompass Health's fourth quarter 2021 earnings call. With me on the call today are Mark Tarr, President and Chief Executive Officer; Doug Coltharp, Chief Financial Officer; Barb Jacobsmeyer, Chief Executive Officer-Home Health and Hospice; and Patrick Darby, General Counsel and Corporate Secretary.

Before we begin, if you do not already have a copy, the fourth quarter earnings release, supplemental information, and related Form 8-K filed with the SEC are available on our website at encompasshealth.com. On page 2 of the supplemental information, you will find the Safe Harbor statements, which are also set forth in greater detail on the last page of the earnings release.

During the call, we will make forward-looking statements, which are subject to risks and uncertainties, many of which are beyond our control. Certain risks and uncertainties, like those relating to the spin-off of our home health and hospice business and its impact on our business and stockholder value, as well as the ongoing effects of the pandemic that could cause actual results to differ materially from our projections, estimates and expectations are discussed in the company's SEC filings, including the earnings release and related Form 8-K, the Form 10-K for year ended December 31, 2021 when filed. We encourage you to read them.

You're cautioned not to place undue reliance on the estimates, projections, guidance and other forward-looking information presented, which are based on current estimates of future events and speak only as of today. We do not undertake a duty to update these forward-looking statements. Our supplemental information and discussion on this call will include certain non-GAAP financial measures. For such measures, reconciliation to the most directly comparable GAAP measure is available at the end of the Supplemental Information at the end of the earnings release and as part of the Form 8-K filed yesterday with the SEC, all of which are available on our website.

I would like to remind everyone that we will adhere to the one question and one follow-up question rule to allow everyone to submit a question. If you have additional questions, please feel free to put yourself back in the queue.

With that, I'll turn the call over to Mark Tarr.

Mark J. Tarr

President, Chief Executive Officer & Director, Encompass Health Corp.

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Thank you, Mark, and good morning, everyone. 2021 brought both continued and new challenges to healthcare providers. Our hospital and home care teams have consistently provided high quality, compassionate care to patients in need of our services throughout the pandemic. The dedication of our team members allowed us to make significant operational and strategic progress and to generate strong financial results in spite of these challenges. We remain confident in the future prospects of each of our businesses and continue to enhance the positioning of each to capitalize on growth opportunities ahead.

Starting with the recap of our financial results. On a consolidated basis for fiscal year 2021, we generated 10.3% revenue growth and 19.5% adjusted EBITDA growth, surpassing the $1 billion milestone in adjusted EBITDA for the first time in our company's history. Both businesses contributed to the growth in adjusted EBITDA with the IRF segment increasing 16.3% and the home health and hospice increasing 29.5%. We continue to invest in capacity expansions across our service lines. In 2021, we opened eight de novo IRFs and added 117 beds to existing hospitals, increasing our licensed bed count by 4.4%. We also closed on approximately $102 million of home health and hospice acquisitions and opened three de novo locations.

In 2022, we plan to open 10 de novo IRFs and add more than 100 beds to existing hospitals. We'll continue to pursue home health and hospice acquisitions and currently have an active pipeline of potential deals. We're also planned to open 10 additional de novo locations. As we recently announced, we are proceeding with the spin-off of our home health and hospice business as an independent, publicly traded company under the new brand identity of Enhabit Home Health & Hospice. Our board believes this will unlock significant value for the business and our shareholders. We are targeting consummation of the spin-off in the first half of 2022 and we've included additional detail on Pages 5 through 7 of the supplemental slides accompanying our Q4 earnings release. This decision comes more than a year after we first publicly announced the decision to review strategic alternatives for home health and hospice business. The duration of the review reflects the careful and thorough process undertaken by our company to select an alternative that maximizes value.

From the outset of this process, our board has been vigilant regarding its fiduciary duties, and it remains committed to evaluating all reasonable means to achieve the objective of long-term value creation. The board has considered an array of alternative strategies and structures and dynamic market environment with the advice of our financial advisers and legal counsel, and with input from shareholders and taking into account various factors, including execution risk, tax efficiency and capital structure. We believe the establishment of Enhabit Home Health & Hospice as an independent company will provide a number of significant benefits, including enhanced management focus, separate capital structures and allocation of financial resources, better alignment of management incentives and the creation of independent equity currencies. The announcement of the spin-off and the introduction of the Enhabit brand have been received with great enthusiasm by our associates in the home health and hospice segment. Rebranding of our home health and hospice branches to Enhabit will begin in April and is expected to largely be completed by the consummation of the spin-off.

Now, turning to Q4, our consolidated financial results for the quarter were solid and were in line with the guidance we provided on October 27. Q4 consolidated revenues increased 8.6% and consolidated adjusted EBITDA grew 5.3%. Beginning with the IRF segment, we experienced record level average daily census during the quarter of 7,100 patients, leading to discharge growth of 9.6%, inclusive of 6% same store growth. This increase in volume drove revenue growth of 11.7% for Q4. The acceleration in demand for our services in a tight market for skilled clinicians necessitated an increased utilization of sign-on and shift bonuses, as well as agency staffing. Doug will provide some commentary around IRF staffing costs trends in his remarks. IRF segment adjusted EBITDA increased 8.4% in Q4, with margins impacted by higher staffing costs. Our home health and hospice business in Q4 continued to confront the industry-wide challenges around staffing and patient flows. Those challenges

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notwithstanding, we made progress on key staffing initiatives and saw some green shoots related to volume growth. For the quarter, home health and hospice revenue declined 1.8% and adjusted EBITDA decreased 5.2%.

On the staffing front, we had another strong quarter with net new nursing hires, adding 133 nursing FTEs in Q4 on top of the 127 new nursing FTEs who joined us in Q3. These recent hires will progress through orientation and initial ramp-up and serve as a source of increased productivity in the second half of 2022. Thus far, they have served primarily to backfill for quarantined employees. We estimate a loss of at least 1,700 total home health admissions in Q4, as a result of the staffing constraints.

To ensure a continued increased focus on recruiting new clinical talent and reducing turnover, Barb has added a Chief Human Resources Officer and a Vice President of Talent Acquisition to her leadership team. These roles did not previously exist at her home health and hospice segment, and these hires round out and solidify the senior management team for this business.

With regard to buying trends, our home health business had total admissions growth of 4.7%, inclusive of 2.4% same store total admissions growth. Total starts of care, which includes admissions and recertifications increased 1.7%, reversing a decline of 1.5% in Q3. Growth is occurring in non-episodic volume, which increased 67.6% in Q4, while episodic admissions declined 7.2%. Roughly half of the episodic decrease resulted from the conversion of episodic admissions to non-episodic under the national contract with United Health, initiated in February 2021. We added approximately 3,100 new referral sources in Q4 and a total of approximately 12,200 for 2021. These relationships will serve as a source of revenue and volume growth in 2022 and beyond.

Now, I'll turn to 2022 guidance. As we look ahead, we are confident the fundamentals of our business are intact. We believe the pandemic has created an even stronger awareness of the high level care we provide in our inpatient rehabilitation hospitals and further reinforced home as a preferred care setting. We expect stakeholders will increasingly divert admissions away from skilled nursing facilities to higher value IRFs and home health providers. And as the population ages, the demand for high quality services will increase. We do, however, expect some of the challenges we have been experiencing recently to persist through the first half of the year. Additionally, we are benefiting from the continued suspension of the Medicare sequestration into 2022, but its planned phase out will dilute our pricing increase at a time when costs remain elevated. The re-implementation of the sequester creates an approximately $50 million headwind to consolidated adjusted EBITDA growth in 2022. Our guidance for 2022 on a consolidated basis includes consolidated net operating revenues of $5.38 billion to $5.5 billion, consolidated adjusted EBITDA of $1.015 billion to $1.065 billion and adjusted earnings per share of $3.83 to $4.19. The key considerations underlying this guidance can be found on page 24 of the supplemental slides. We anticipate providing updated guidance for each of the businesses as the separation date approaches.

With that, I'll turn it over to Doug.

Douglas E. Coltharp

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

Thank you, Mark, and good morning, everyone. I'm going to focus my remarks on two areas. I'll review some of the additional detail regarding the spin-off, and I'll provide some additional color on the key trends within both business segments that are informing our 2022 guidance.

As noted on page 5 of the supplemental slides, we currently estimate following separation and as compared to the current segment level operating expenses, Enhabit will incur approximately $26 million to $28 million in incremental annual expenses related to becoming an independent public company. Portion of these incremental expenses relate to standing up capabilities and functions required of public companies, such as a board of

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directors, SEC reporting, Treasury, Investor Relations and tax. The remaining expenses relate to adding capabilities at Enhabit in order to replace services that are currently provided by the Encompass Health Corporate Office, such as information technology, human resources and legal services. Some of these expenses will be incurred prior to the spin-off date in preparation for the spin-off. None of these incremental expenses are included in our 2022 guidance. For a period of time after the spin-off date, certain of these expenses will be incurred under a transition services agreement with Encompass Health. The estimated $26 million to $28 million does not include any cost related to the rebranding as Enhabit Home Health & Hospice. The separation of the businesses is also expected to result in an estimated annual reduction of $5 million to $10 million in the operating expenses of Encompass Health. The position within this range is dependent in part on the scope and duration of the transition services agreement. The expected cost decrease is comprised of the elimination of variable cost and functional capacity reductions relating to services currently provided by the Encompass Health Corporate Office to the home health and hospice segment.

A portion of the expected cost reductions will take the form of future cost increase avoidance as resources formerly used to support the home health and hospice segment are redeployed to support the anticipated growth of the Encompass Health IRF business stemming from initiatives such as the planned opening of 10 de novo IRFs in 2022. In anticipation of the spin-off, our home health and hospice business will begin rebranding as Enhabit. The rebranding will begin in the Dallas Home Office this month, branch locations will begin rebranding in mid-April. We expect to be largely completed with the rebranding by the date of the spin-off. We estimate the rebranding will result in one-time operating expenses of $10 million to $13 million and capital expenditures of $3 million to $5 million.

None of the expenses associated with rebranding are included in our 2022 guidance. We currently anticipate leverage measured as outstanding debt divided by latest 12-month adjusted EBITDA as of the spin-off date of 3 to 3.25 times at Enhabit and 3.25 to 3.5 times at Encompass Health. The initial leverage for each of the businesses separation will in part be determined by the operating performance preceding the spin-off date. We expect both businesses will have the ability to reduce leverage as a result of future earnings growth post-separation. However, this will be influenced by capital deployment decisions at each company. The initial leverage expectations are not necessarily indicative of post-separation leverage targets for each company.

Turning now to guidance. Our 2022 guidance for consolidated adjusted EBITDA is $1.015 billion to $1.065 billion. This range incorporates uncertainty regarding the pace and trajectory of improvement in the prevailing staffing challenges, which became more pronounced in the second half of 2021. In the IRF segment, staffing constraints have not limited volume growth, but have resulted in an escalation in compensation costs. In Q3 and Q4, our IRF segment SWB per FTE increased 8% to 9% over the prior year period, largely due to increased sign-on and shift bonuses and higher utilization and costs of agency staffing. We were able to partially offset the impact with improved productivity. Our EPOB in Q4 2021 was 3.37 as compared to 3.46 in Q4 2020. But there are limits to what can be done here, particularly given our focus on higher acuity patients.

Let me provide some specifics here. In Q4 2021, we incurred $21.3 million in sign-on and shift bonuses as compared to $9.1 million in Q4 2020 and approximately $21 million for the full year 2019. Further, in Q4 2021, we incurred approximately $30 million in agency staffing cost as compared to approximately $7.5 million in Q4 2020 and approximately $30 million for the full year 2019. The increase in agency staffing costs is both a volume and a rate issue. In Q4 2021, we used 516 agency FTEs as compared to 192 in Q4 2020. That's an increase of approximately 169%. And between these periods, the cost per agency FTE rose approximately 48%. As we have reported in each of the last few quarters in our home health and hospice segment, staffing constraints have both limited volume and increased costs. We estimate that staffing constraints resulted in at least 4,200 lost admissions in the second half of 2021. And our cost per visit increased more than 9% in each of Q3 and Q4 2021

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as compared to the prior year periods. We are making progress addressing these challenges in each of our business segments through strategies such as changes in compensation structures, enhanced scheduling flexibility and increased recruiting teams and resources. We also expect these challenges to subside as COVID eventually recedes.

And now, we'll open the line for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Please limit yourself to one question and one follow-up. But you may rejoin the queue if you have additional questions. We'll take our first question today from Kevin Fischbeck with Bank of America. Your line is open.

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

Hey. Good morning, Kevin.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

Hey.

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

Good morning, Kevin.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

Good morning. So, I guess wanted to maybe better understand there's so many moving pieces right now between sequestration coming back in, [ph] as in part of the year (00:22:37) labor costs higher and then improving. I guess we'd love to hear your thoughts about where you think the margin – the sustainable margin is for the two businesses that you have? And how far off are you today from that? Just want to get a sense of where embedded earnings power might look?

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

Kevin, so this is Doug. I'll take a crack at it and it depends on when things ultimately normalize staying at the segment level for the immediate time being because obviously that's the way that we've been reporting. I would think that once we kind of get through 2022, so that we've anniversaried the ramp-up that we saw in these costs, I think the supply issues on the labor side and the supply demand imbalance that's been related to COVID are going to improve as we get through the course of the year. And then we move through the pricing variability that you have with the phased in of sequestration, which we move out of 2022 to 2023. I think you could be in an environment where at the segment level, the IRF EBITDA margin settling in, in the low 20s and the home health and hospice would be in that mid to higher teens level.

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Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

Okay, that's really helpful. And then I guess is another way of thinking about it on the labor cost side. You guys are obviously guiding to labor increases for the year 2022 below what you're doing in the second half of last year, is the way to think about it, that your kind of guidance for 2022 is more what you think normalized wage growth would be and kind of the delta between what you saw in the back half of the year and what you're going to guide into for this year is kind of the excess cost, if we will or is there a better way to think about that?

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

A

No, I think you're probably right if you're looking specifically at kind of the assumptions that we've dropped in there regarding the annual increases in the guidance for SWB per FTE. I think assuming that even as we move into 2023, we're looking at something in that 3% to 4% range is probably reasonable. Again, right now, you've got a high end of 5% for home health and hospice because there is some more normalization to occur. But I think probably 3% to 4% range for 2023 is a reasonable proxy.

Operator: The next question comes from Brian Tanquilut with Jefferies. Your line is open.

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

A

Hello, Brian.

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

A

Hey Brian.

Brian Tanquilut
Analyst, Jefferies LLC

Q

Hey, good morning. Good morning, guys. Mark, I guess my first question for you. So, as I think about this labor issue and concerning the labor, right, I mean, you have two sides of the business. Are the factors impacting turnover in the headwinds there? [ph] Are they the same (00:25:32)? Or should we be thinking about how they're probably more company specific challenges in the home health business that will go away once it's spun out and as we refocus in your core IRF business that it's more of just getting through the pandemic?

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

A

Well, the two segments clearly have different challenges. Some of them overlap, but the issue of labor, particularly around quarantine staff has impacted home health much more significantly than it has the hospitals. It's impacted their volume, at the same time, it's impacted their cost or their ability to go out and treat the volume that, that we know the demand is there for both segments, it's been much more difficult to treat that demand on the home health than it has been the hospitals. Hospitals have a much easier time covering for quarantine staff. There's a much greater means of flexibility for covering, so it doesn't impact volume near as much.

So, I think that both segments have done a lot with regards to supporting the recruitment and retention focus. Turnover has been pretty consistent in the hospital segment from one year to the next. Barb is getting her arms around the turnover factors in the home health segment. You heard me mention that she's brought on a new

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Chief Human Resource Officer as well as Talent Acquisition staff. We've done the same with talent acquisition resources for the hospitals here in Birmingham.

So, Brian, I think we're in a much better position going into 2022 to face the challenges. There's been a huge imbalance in the marketplace relative to just nursing staffing with acute care hospitals, as well as post-acute services, all chasing the same limited number of resources out there. And we do think that, that should begin to normalize, particularly in the second half of next year as we see less and less impacts from COVID.

Brian Tanquilut
Analyst, Jefferies LLC

Q

Yeah. That makes sense. And then I guess my second question is just, as we think about home health, I saw in your slide deck that, [ph] you guys still thinking long-term (00:27:51) it's 10% plus grower on the admission side. So, how are you thinking about just – where do we get there? How do we get there? Is it just a matter of getting all the turnover and recruitment issues fixed or just any thoughts on the comfort or confidence of that 10% plus number?

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

A

Yeah. Brian, I'm going to let Barb answer that. Obviously, she's been living and breathing this every day since she's taken on her new role.

Barbara A. Jacobsmeyer
Chief Executive Officer-Home Health and Hospice, Encompass Health Corp.

A

Right. So, I think you hit on is the biggest thing for us is the volumes are there, staffing has been the challenge. So, as we do not only successful in recruitment, but the retention piece, then we can get fully staffed, so that we can be accepting all of these referrals. And then, continuing to increase the number of referral sources. The sales team has been really excited about being able to go out and offer to be able to take more patients than your episodic because we're finding that referral sources need to have a provider that can take the majority of their patients. So, we've seen a nice increase in the episodic come from the same referral sources that are sending us the non-episodic. So, it's really going out there and reopening those doors for the sales team once we have the staff in place.

Operator: [Operator Instructions] We'll take our next question from Matt Larew with William Blair. Your line is open.

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

A

Hello, Matt.

Matt Larew
Analyst, William Blair & Co. LLC

Q

Hey, good morning, Mark. I wanted to ask about maybe how contract labor has trended here as this Omicron has started to dip to the first few weeks of 2022, have the new quarantine guidance has had any impact on labor availability and to – in line with how your vaccination rates have trended?

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

A

So, I'm going to let Doug go into the contract labor costs and I'll touch on the vaccine. I'd tell you that both segments right now relative to vaccine, the compliance with the CMS guidelines were both in the mid-90s on each segment. So, we've made significant progress there and made significant progress every week with getting our staff fully in compliance with the CMS guidelines.

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

A

So, the staffing constraints that we've experienced are directly related to the presence of COVID and the staffing constraints that would give rise to the use of the agency staffing. And obviously, Omicron remained very present during January. So, we really did not see much difference in the month of January, but we remain optimistic that things will improve as COVID begins to recede, which the CDC has indicated appears to be happening over the balance of the quarter.

Matt Larew
Analyst, William Blair & Co. LLC

Q

Okay. And then obviously, you had strong hiring quarters in Q3 and Q4. Just curious if there are other things you're thinking about to be more proactive about labor moving forward. We've seen some companies acquiring staffing agencies, investing in or acquiring nursing schools. As soon as it's sort of becoming more of a strategic priority, I'm curious what other things you can do to sort of avoid those contract labor spikes in the future?

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

A

Yeah, Matt. We are throwing everything we can come up with at this challenge. We do have, particularly on the hospital side affiliation with Chamberlain University for RNs and supplementing that tuition costs. We have initiated a branding campaign here recently through television ads and online media that better shows what it's like to be a nurse in Encompass Health Rehabilitation Hospital because there's just a significant lack of awareness about what it's like to be a rehab nurse. So, we have really pivoted a lot of resources to in different directions, all with a strategic focus of both recruitment of new nurses into our system as well as retaining the nurses that we have.

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

A

It's clear that there's an industry-wide challenge regarding the availability of nurses that was there before COVID came in, and it's been exacerbated by COVID. But the trends that we saw on the back of the year were almost exclusively related to COVID and it's across the healthcare system as I know from your universe of coverage. But it really starts – you've got a demand supply imbalance that is specifically related to the presence of COVID. It starts with the acute care hospitals where the demand has increased due to COVID patients requiring hospitalization, at the same time, an increased number of nurses have been sidelined for reasons that have ranged from contracting COVID to needing to quarantine due to exposure, to potentially having elder or child care issues due to facility closures and the fatigue and burnout that they've experienced related to living with this for almost two years now. As COVID recedes, which it eventually will do, the demand will decrease and the supply will increase. And when that happens, our use of agency staffing and the cost of it are going to decrease as will the frequency and the level of the sign-on and shift bonuses that we used in the second half of the year.

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Operator: The next question comes from A.J. Rice with Credit Suisse. Your line is open.

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

Hello A.J.

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

Hi A.J.

A.J. Rice
Analyst, Credit Suisse
Q

Hi, everybody. First, just want to ask two aspects of the home health and hospice business. You've got this dynamic of your shifting from episodic to non-episodic, mainly driven by that big contract you signed. Are you at a normalized run rate there and you're talking about the decrease in EBITDA being all staffing and that's certainly what we've talked about. But does that dynamic of the switch have any impact on the margin? And then on the hospice side, your same-store measures I think are down 14.5%. I know that isn't a huge part of the overall pie, but I'm just curious, is that the same type of staffing issues? Are there something different about hospice? Because you're attributing that to staffing constraints, I just wondered if there's some other aspect of what's going on with hospice [ph] and how (00:34:50) mix of people that you have working there are a little different than in the traditional home health.

Barbara A. Jacobsmeyer
Chief Executive Officer-Home Health and Hospice, Encompass Health Corp.
A

Sure. So, let me start with the first question. Yes, we are seeing the increase in the non-episodic. But we're also seeing that Medicare volumes are lower across healthcare, both in acute care and in our public peer information. So, as I mentioned earlier, one of the things that we've done is really gone back out and opened doors of referral sources that historically have said, I can't use you if you can only take one type of patient. And now with those some local, regional and national contracts, we're able to go back out and knock on those doors of referral sources. The good news that we saw was that the non-episodic growth that we saw in 2021, those referral sources that sent the majority of a non-episodic business also sent us an additional 4,500 Medicare admissions compared to prior year.

So, we feel that really, that does align with what the sales team is telling us, and that is that as we grow the non-episodic, we're going to be able to continue to go after the episodic. It does have some pressure on the margin and I would say right now the most difficult part would be as we're growing both episodic and non-episodic, the focus for us is on productivity and optimization to try to mitigate that margin compression, but that's been really difficult to do in this current environment with all the quarantines. Right now, it's about getting the staff out to see the patient, provide the high quality of care, even if that means driving further, even if that means not optimizing an RN with an LN. So, it's been a little bit different environment to try to manage the cost to mitigate some of that margin pressure from the non-episodic growing.

On the hospice side, I will say that, yes, staffing constraints have been the majority of the issue there. We've had 18 branches in three key states that have accounted for about 73% of that same store decrease. It is a little different because the staff on the hospice side have a caseload of patients and whereon home health you can maybe cover a visit here or there. When you have a staffing impacted at a hospice agency, it impacts your ability

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to take those additional admissions because there's only so much ADC you can be covering with your staff if someone's out.

So, you do feel that one person being out much more acutely at a hospice branch than you do at home health branch.

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

And then A.J., maybe just to further follow up when you think about the growth between episodic and non-episodic as we move into 2022, we're going to anniversary the initiation of that United contract in February. And so, that has driven so much of the growth in the episodic. We expect incremental growth out of that but those growth rates on the relative basis are going to come down. We would expect to see further growth under that contract. We would expect to see additional non-episodic growth out of other contracts with managed care providers and Medicare Advantage. There is an issue there, as Brab mentioned, with regard to pricing and its impact on volume. As we've quoted many times over the years and it's really been over about a decade, we have made substantial progress underscoring our value proposition with those payers on the IRF side. And as a result, as we sit here today, more than 80% of our Medicare Advantage volume on the IRF side is on a CMG basis versus a per diem basis and the discount between fee-for-service and Medicare Advantage is only 7% for us, it's about 25% on non-Medicare Advantage managed care. Conversely, within that episodic volume or non-episodic volume book of business and home health right now, the discount is about 44%.

Now that's an industry-wide problem and if you think about the impact that the labor issues and all of the other issues that have existed within home health over the last couple of years that had on a fragmented industry, it's going to be taking capacity out and at least for a period of time the supply of available clinicians to conduct business in the home is going to be somewhat limited and those are going to get allocated to higher paying sources. And so, the managed care companies and Medicare Advantage are going to have to wake up to the fact that they can't continue to pay these kinds of rates and expect to get quality care delivered in the home.

Operator: The next question comes from Andrew Mok with UBS. Your line is open.

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

Hello, Andrew.

Andrew Mok
Analyst, UBS Securities LLC
Q

Hi, and good morning. If you look at the earnings seasonality prior to COVID, it's pretty evenly split between the first half and second half. Given the phase out of sequestration and assumptions for improvement in labor in the back half of the year, how should we be thinking about the progression of earnings and seasonality embedded into 2022 guide? Thanks.

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

It's going to be back end weighted. You've hit on the two keys, unfortunately more of the EBITDA headwind related to the phased in of sequestration comes in the second half. But in terms of just our expectations regarding the normalization in the staff and which has been a very significant issue as you saw in some of the numbers that are related, but we really expect to get most of that benefit in the second half of the year.

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Andrew Mok
Analyst, UBS Securities LLC

Q

Right. And then just any help on order of magnitude here, is that like 100 basis points to 200 basis points delta or something more significant on the back end weighted?

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

A

Andrew, I think you've got [ph] pieces (00:40:33).

Andrew Mok
Analyst, UBS Securities LLC

Q

Okay. All right, that's helpful. And just a follow-up on the labor dynamic during the Omicron spike, you talked about the contract agency usage, but curious how staff quarantine rates have trended in January and how that compares to the delta spike in Q3. Thanks.

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

A

I think that if we look back, the home health segment had as many as 1,300 staff members out one week in quarantine in the month of January, which surpassed previous year high under Delta. So, I think that reflects the ease of transmission of the virus under Omicron versus Delta. So, it was more significantly pronounced, certainly on the home health and hospice segment during Omicron than it was prior year Delta.

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

A

But certainly the reduction in the quarantine period has helped there. And we do feel like we're past the peak with regard to quarantined employees. A question that came up earlier that occurs to me we did not address and that was with regard to the vaccination rates in both of the two businesses.

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

A

Well, as I mentioned earlier, both of our segments are at a mid-90 plus percent compliance with CMS guidelines for vaccination or exemption. So, we made significant progress and that number gets higher every week as compliance rates go up. But we're in good shape with regard to that.

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

A

And of course, what you're seeing across the country is a lot of, I don't know if we're still referring to them as breakthrough cases of COVID, but as with kind of the general population, what we do see is when we see vaccinated folks contract COVID, they tend to be either asymptomatic or mildly symptomatic. And so, we're really getting them back within that five day period, and that's helping.

Andrew Mok
Analyst, UBS Securities LLC

Q

Great. Thanks for the color.

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Operator: The next question comes from Pito Chickering with Deutsche Bank. Your line is open.

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

Good morning, Pito.

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

Hey, good morning, Pito.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.
Q

Hey, good morning. Thanks for taking my questions. A couple of number of questions here. Looking at the fourth quarter EBITDA results versus your guidance from October, can you walk through the moving parts like the provider tax, additional revenue reserves, contract labor and the medical benefit? I just want to understand where fourth quarter would have been without those to use those as the launch pad for 2022?

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

Yeah. So generally speaking, remember we issued that guidance at the end of Q3 and nobody had ever heard of Omicron at that point in time. We certainly weren't anticipating the pickup that we got in provider taxes. So, that, that was a benefit, but [indiscernible] (00:43:25) expecting the acceleration in those labor cost trends that I referenced earlier. If you just do a comparison to Q3, and I'm, I am focused on the IRF side, in Q3, which we thought was a pretty elevated level, our contract labor expense was $18.3 million and the sign-on and shift bonuses were $15 million. So, that was a total of, call it $33 million. In Q4, as I just cited, the contract labor went to $30 million and the bonuses went to $21.3 million, so that's $51.3 million or an increase of $18 million. I can tell you as we have prepared our guidance at the end of Q3, we were not expecting an $80 million increase in those two buckets.

The other item that we hadn't necessarily anticipated was the pick-up that we got in group medical at home health and hospice. I want to be careful to note, even though that was a $6 million benefit on a year-over-year basis, it was only a $2 million benefit for the full year because a lot of that reversal in Q4 was because we, we trued up the, the overall reserve for the year based on the fact that we were seeing a lower number of claims and less severe claims. But again, that was largely offset by the fact that we had anticipated based on a mitigation of some of the staffing constraints, that we would see both a higher growth in volume and a lower cost per visit.

I think those were the puts and takes, Pito. Did that address your question?

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.
Q

Yeah. It's perfect. And then a numbers questions for Barb. I know that you aren't giving segment level detail yet on 2022 guidance, but obviously [indiscernible] (00:45:17) people trying to value the spin asset sale. Is there anything structurally wrong with taking the fourth quarter EBITDA of $52.6 million, adjust for medical insurance costs and because the fourth quarter already has a lot of pressure from staffing, you grow that at a normalized high-single digit EBITDA growth, putting in some additional cost [ph] lever (00:45:36) pressures and sequestration and getting to around $200 million of EBITDA for 2022 before [ph] additional (00:45:44) G&A rebranding, is there anything structurally wrong with those assumptions?

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

The answer is, there's nothing structurally wrong with your assumptions.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.
Q

Okay. Perfect. And then let me also squeeze in a sort of quickie in this one. Doug, that you talked about the managed care contracts, which are a low rate and fee-for-service. Can you use like a staffing pressure now to sort of not take those patients, sort of [ph] forced (00:46:15) managed care into higher cost settings like SNF? And is there any indication that maybe those rates can get reset in 2023? Are you having any of those conversations yet? Thanks so much.

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

So, the answer to the second one is absolutely yes. Again, this imbalance between the increased cost that home health providers are experiencing and not seeing that kind of price pass through to the Medicare Advantage and managed care companies cannot exist – cannot persist throughout the industry. In terms of right now if we are given a choice between a Medicare fee-for-service and a managed care patient and we have limited clinical resources, then we would attempt to apply that clinical resource first to the higher paying fee-for-service. But there are many other considerations that go into that and we're playing for the long-term here. So, we're certainly not prioritizing the non-episodic over the episodic, but nor are we completely kind of shunning or turning away patients on the episodic basis as is evidenced in those growth figures.

Operator: We'll take our next question from Matt Borsch with BMO Capital Markets. Your line is open.

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

Good morning, Matt.

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

Good morning, Matt.

Matthew Borsch
Analyst, BMO Capital Markets Corp.
Q

Hi. Thanks for squeezing me in here. I'm just going to ask you on inflation obviously. We're talking a lot about the temporary labor and constraints in the costs around that, but what about other areas of inflation that, that in your cost base or anything else, I'm curious what you might be seeing?

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

We've really done a pretty good job controlling that and I think you can see that by looking at the other categories of expenses in both of the businesses where we've gotten some good, good leverage on a year-over-year basis. We after seeing a lot of improvement with regard to both the availability of supply and the cost of PPE, we're seeing a little bit of a pickup there, but nothing that appears to be overly problematic on the IRF side, getting the,

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getting the testing equipment and supplies in-house has been a real productivity saver as well as a cost saver. And as we get revenue growth, we're getting leverage across the occupancy expense. So at this point in time, we're really not seeing much in the way of outsized inflation in any other expense categories.

Matthew Borsch
Analyst, BMO Capital Markets Corp.

Q

Well, thank you. That's really helpful. And if I could on, on a different topic going back to the, the issue of the Medicare versus Medicare Advantage reimbursement. What – can you just give your thought on maybe why you think this gap has persisted for as long as it has, because literally home health is a far more cost efficient alternative, at least to the extent it is an alternative to facility based care. Do you think it's just one of those things where it's very hard to break the status quo?

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

A

No, I don't think there's been [ph] an impetus (00:49:27) to do it before. So, pre-COVID what you had was a highly fragmented industry with just a few large players. You had a rapidly growing demand. There was not supply constraint with regard to clinicians. And so, it was a land grab where the payers did not differentiate based on the quality of the outcome. And many of the providers were willing to accept lower margin or even negative margin patients in some instance in order to build market share. And I think those dynamics have changed very significantly over the course of the last two years and particularly within the last six months.

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

A

Fragmented or not, I mean, the economics of what's playing out right now with the labor costs affect everyone and those agencies that continue to take the low payment rate are going to be negatively impacted. And it's certainly not a long-term strategy that's going to be beneficial for them.

Operator: Our next question comes from Scott Fidel with Stephens. Your line is open.

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

A

Hi, Scott.

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

A

Good morning, Scott.

Scott J. Fidel
Analyst, Stephens, Inc.

Q

Hi, good morning. Thanks. I just had one question and just interested if you could give us a little more details on the home health and hospice deal pipeline. I think in the prepared remarks, you talked about having an active pipeline. And then just also interested in what you're seeing it just around valuation, expectations around the deal environment. Obviously, public comparable valuations have come down quite considerably over the past year or so. Just interested if that's starting to manifest itself on the private side as well when you look at opportunities across the pipeline? Thanks.

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Barbara A. Jacobsmeyer
Chief Executive Officer-Home Health and Hospice, Encompass Health Corp.
A

Well, I'll touch on that development on the pipeline. Certainly, we have seen an increase of inbound calls, some of that just coming off of fourth quarter which tends to be a quieter quarter. But also our development team feels that the announcement of what our future looks like has helped because with that being a little bit confusing, that's made it difficult for some of the past inbound calls that we have seen an uptick in those over the past few weeks, which has been good to see. And so...

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

Yeah, again we tend – we are for the most part still focused on kind of those regional bolt-on acquisitions that complement our existing footprint. We're seeing opportunities in both home health and hospice, and valuations have absolutely come in from the peak.

Scott J. Fidel
Analyst, Stephens, Inc.
Q

Okay, thank you.

Operator: We'll go now to Sarah James with Barclays. Your line is open.

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

Hi, Sarah.

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

Hey, Sarah.

Sarah E. James
Analyst, Barclays Capital, Inc.
Q

Hi, good morning and thanks for squeezing me in. So, you talked a couple of times about migration of nurses to acute because of the pay differential. And I'm wondering if you can give us some context around where you see the hourly wage differential for each of your segments versus acute? And then how do you think about the possibility of closing that gap without [indiscernible] (00:52:35) shift in payments and is there any discussions with CMS at this point around recognition of the current environment and how that may manifest in the next rate update?

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

So, let me take your first prior question around acute versus non-acute nursing rates. In our hospitals, we – our nurses are very similar in terms of compensation and skill set with what you see on the medicine for an acute care hospital. So, that's very comparable there. It's going to be less than what you would find in a – in on a surgical or a specialty for an acute care hospital for an RN. But for the lion's share of the nurses, that they would have working with many of the – what would typically be on the medicine for chronic care type of floor were very

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comparable. So, that would be part of the competition that we would see in terms of available resources in any given marketplace.

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

And although we have seen some inflation because of the supply issues and the competition issues in our internal SWB per FTE, the real issue and the reason that I highlighted in my comments has been around the staffing agencies and then the need to use sign-on and shift bonuses. And again, that feels, that feels to be transitory and specifically tied to COVID. Again, it started with the increased pressure on hospitals because of this influx of COVID patients, at the same time that they were experiencing outages related to COVID exposures and the things that I ran to previously. And so, they had to meet that demand with agency staffing. They were willing to pay off. It creates a shortage of even agency staffing available and the price just escalates. It's a textbook inflationary spiral caused by supply demand imbalance. That is going to resolve itself largely as COVID recedes. And the same issues led to the increased use of sign-on and shift bonuses and those things will back off as well. And that's why we have some degree of confidence around the fact that the SWB per FTE growth on a year-over-year basis is going to moderate significantly beginning in the second half and that's why we're able to point to those assumptions with regard to future period inflation in that category for 2023 and forward.

Barbara A. Jacobsmeyer
Chief Executive Officer-Home Health and Hospice, Encompass Health Corp.
A

And from home health and hospice, I mean we've been really pleased with the progress we've made in quarter three and quarter four with our hiring, net, net new hires, so that's taking the terms out. We made some nice progress on our net full time nursing hires and a lot of that's been around the focus of our talent acquisition team. Not so much focused on that rate of pay, but the flexibility that home health and hospice allows for that clinician in their daily schedules and focusing on those other benefits of being employed in home health and hospice.

Sarah E. James
Analyst, Barclays Capital, Inc.
Q

Right. And then just on the rate front, in your discussions with CMS, is there any talk or any indications that they could start baking in the current wage environment into the next rate cycle?

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

Well, that's, that's already built into the rules. And so, it's just a matter of what magnitude we see. But yeah, that is already part of the annual pricing adjustment.

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

It's – ultimately that catches – there's a lag in the wage index, but ultimately that that will catch up within the rules that CMS has already laid out.

Operator: And we'll take a follow-up question from Andrew Mok with UBS. Your line is open.

Andrew Mok
Analyst, UBS Securities LLC
Q

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Hi. Thanks for letting me back in the queue. Just a couple of follow-up questions here. On the 2022 guidance, it looks like adjusted EPS is down 5% at the midpoint compared to adjusted EBITDA which is up 1%. Can you help us bridge the delta between those two numbers in the guidance?

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

A

So, I can and I am just trying to remember where it is. Not too many places it can be. Andrew, we'll get back to you on that one.

Andrew Mok
Analyst, UBS Securities LLC

Q

Sure, okay. And then maybe just another follow-up. Visits per episode, it ticked down to about 15 in the second half of 2021. I think you rolled out Medalogix in the back half of 2020. Can you give us an update on the progress there and the level of [ph] VPE (00:57:26) you think you can achieve in 2022?

Barbara A. Jacobsmeyer
Chief Executive Officer-Home Health and Hospice, Encompass Health Corp.

A

So, we've continued to make progress in the quarter-over-quarter on the [ph] VPE (00:57:33). Some of that will depend upon the acuity. The recommendations that come out of Medalogix [ph] sits (00:57:40) us in making that care plan but it does depend upon the acuity of the patients. So, we feel like right now around that 15 [ph] VPE (00:57:48) is probably a good place to be considering to maintain the acuity of the patients we have as well as the quality outcomes.

Andrew Mok
Analyst, UBS Securities LLC

Q

Great, that 15 is essentially we have embedded in the guide for 2022.

Barbara A. Jacobsmeyer
Chief Executive Officer-Home Health and Hospice, Encompass Health Corp.

A

Yes.

Andrew Mok
Analyst, UBS Securities LLC

Q

Great. Thanks for the color.

Operator: We have no further questions at this time. I would like to turn the call back to Mark Miller for any additional or closing remarks.

Mark David Miller
Chief Investor Relations Officer & Senior Vice President-Investor Relations and Strategic Planning, Encompass Health Corp.

Thank you for joining us today. If you – if anyone has any additional questions, please call me at 205-970-5860. Thank you again for joining today's call.

Operator: This does conclude today's program. Thank you for your participation. You may disconnect at any time.

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