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Encompass Health Corp. (EHC)

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OTHER PARTICIPANTS

Kevin Fischbeck
Analyst, BofA Securities, Inc.

MANAGEMENT DISCUSSION SECTION

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Well, thank you, everyone for joining us today. It's my pleasure to introduce Encompass Health. Encompass is the largest operator of inpatient rehab facilities as well as one of the largest providers of home health and hospice. Presenting today, we have Mark Tarr who is President and CEO as well as Mark Miller from Investor Relations. Before we jump into Q&A, I think there's some forward-looking statements that you guys...

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

Yeah. So, first of all, it's great to be here. I've been asked to remind everybody that our disclosure statement can be found as part of our 8-K filing for our Q1 earnings, and that's out there on our website. So I can check that box now.

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QUESTION AND ANSWER SECTION

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

All right. Excellent. So I guess maybe jump into one of the big themes this week is labor. So can you talk a little bit about, I think, you guys raised your labor outlook for the ERF business with Q1. Home health, I guess, was maintained. So what are you seeing as far as the labor outlook? And is this something that is a new base or do you expect there to be some [indiscernible] (01:07) that we start to actually see improvement over the next year or so?

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

A

Yeah. So on our Q1 earnings call, I stated that I felt like we had seen a peak at the – particularly around contract labor. We continue to believe that. Really, our two segments, our hospitals or ERFs had significant use of contract labor. It wasn't such a factor on home health and hospice. The labor issues around home health and hospice dealt more with quarantined staff that weren't able to go out and care for the referrals we had. So we had plenty of demand. Just the inability in the first quarter to go out and meet that demand.

At one point, we had as many as 1,300 staff out on quarantine, and so we were just undermanned. And now, we've been in the process of hiring new nursing staff and adding to that has helped on to accommodate the volume. On the hospital side of the business, we did have excessive contract labor just trying to meet the demands of the high volumes that we experienced in Q1. And in the first quarter we had over $40 million worth of contract labor usage, which is about a normal range would be $10 million to $12 million. And so it was on both the amount of FTEs, at one point we had 750 contract FTEs and if you think about what a normal run rate for the company would be, it'd be around 200 to 250 contract FTEs.

So lot of usage on that. Since the peak in the first quarter, we are starting to see some signs that that is coming down. We've had a number of our hospitals that have been successful in terms of eliminating the number of contract FTEs and replacing that with our own full time staff. The applications for open nursing positions continue to rebound and have increased from the low point right after the holidays is just never a good time to try to find somebody that's looking for a job.

But that has increased and we've been successful in negotiating lower rates for the contract use that we have. And then we're starting to see some indications for the duration of the contract as not only at a hard fast 13-week. We've had some negotiations lately that allow us to have a two-week out clause on those contracts. So altogether, we're starting to see some softening in the marketplace, which would be positive for us. We are certainly factoring it in for the second half of the year in terms of our guidance and what we're factoring in in terms of market factors around labor. It's still very challenging out there, but we feel like we're getting our arms around it and starting to see some traction in our efforts to reduce the excessive costs.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

And I guess when we think about that hiring dynamic, I guess, there's just been a lot of conflicting views sometimes from the providers, sometimes from the staffing companies about where the nurse labor market is today, how much burnout there is, people permanently leaving the healthcare system or moving to more 9 to 5

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type jobs even if they're at a clinic or what have you. And then their willingness potentially to reengage back into the site of care they were at before. I mean, the fact that you're hiring more nurses, I guess, is a bullish sign. But like, where do you see this ending up? Are we going to end up at a vacancy rate that is above where it was pre-pandemic, but better than where it is now, or can we get back to where we were previously?

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

I think some of this is with us. Look, we had a nursing shortage well before the pandemic, and it was already a challenging environment. The pandemic just made it that much more difficult. If you look at the average aged nurse in the United States, it's well into the 50s. So, I mean, it is – that's an aging aspect. On a positive note, the applications for nursing schools have gone up, I think, since COVID, and that's going to be a longer-term part of the overall solution. When we think about labor, specifically around nursing, we think about retention. At the same time, we think about recruitment. Obviously, if you're not turning over your staff, you're not having to hire as many people.

So we put just as much effort into our retention of our existing nursing staff from everything, from educational opportunity, certification. We make sure that we are paying a market driven rates. We've done market adjustments in the past year, year and a half to make sure we are staying at or slightly ahead of the marketplace. So we're not having to have that excessive turnover. We've added significant resources into our talent acquisition team, both in Birmingham as part of our hospitals, as well as the home health team in Dallas.

And we've grown more sophisticated about how we recruit. I mean, the nurses are looking for jobs in a different manner than they did several years ago. So things like platforms like Indeed and the algorithms that are out there to get in front of nurses with social media. And we've just become much more sophisticated around that, which I think has led to some of our success with the ability to make Encompass Health known and the opportunities that we have for nursing positions. And we have 147 locations now. So we have a good geographic coverage across the United States that offer opportunities for nurses that want to be in certain parts of the US.

And then finally we brought on eight new hospitals last year and each one of those de novo hospitals. I was proud to say we had no contract labor in the new hospitals. So that showed us that some of the functions around recruitment could be centralized as part of the talent acquisition team in Birmingham. They were the ones that helped us staff all the de novo hospitals.

So we're learning as we go along. And I'd say we're getting more sophisticated about it. It's a changing environment. And, you know, if you're not first to market, if you're not the first one to reach back out to a nurse candidate that shows some degree of interest in your company, you're going to lose out to the five other opportunities they have out there. So, we want to make sure we're very responsive to the changing marketplace.

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

And anecdotally, we've seen a couple of examples in our hospitals where nurses that left to go to acute have returned back to the IRF, where they had worked originally.

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

It's good. I think that – one thing, inflation's going to force some of the nurses back into the marketplace. And I think that there is some element of structural changes, but I also think that there's opportunity for nurses to kind of

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sit on the sideline. They're coming back into the marketplace now. And so, I think that longer term, this will kind of resolve itself, but I think that all of us that employ nurses have had to look at different ways of appealing to the workforce, whether that is flexible scheduling or other benefits that need to be considered in there. And just try to get creative in a manner that maybe we weren't as responsive as an industry in the past to a changing workforce.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

So is 4% to 5% wage growth on the IRF business the way to think about 2023 as well? Or does it start to come back down to 3% to 4%?

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

A

[indiscernible] (09:15) put out there for our guidance considerations for this year. I'd like to think that there would be some normalization for next years. Probably a little bit early to say on that, but we do think that there is going to be a certain degree of normalization of labor force the second half of this year, and hopefully that will continue into 2023.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

And how do you think about the ability of the company on both sides of the business to get the pricing you need to offset these labor pressures? I mean, usually Medicare is always a little bit low and a little bit lag. So, I mean, how does that work?

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

A

The Medicare rate increase, and just talking about the ERF side of our business first, we get one rate increase a year. And that is typically kind of controlled by a rolling four-quarter period, of which CMS is pulling data for. So to think that that period is going to match up exactly with where our labor cost increase took place is little bit unrealistic. So I think that the likelihood to catch up with accelerated labor cost is more likely to be over more than one period. In other words, maybe part of it is this year and part of it is next year and gets caught up to where that should be.

And so on the home health side of our business, we're absolutely going back and working with the contracts that we have, working with the payers where we have opportunities to renegotiate with those payers. I think home health in the past has been a bit exploited because it's been a very fragmented industry. And so there's been an element of treating it a bit like a commodity by some of the payers knowing that if one agency wouldn't care for the patient, well, there'd be others that would be willing to step up.

But I think that now going forward the payers are looking for quality care. There are differences among the various agencies and providers out there. And to get the quality you're looking for, you're going to have to account for the labor increase. And so I think that the environment is better now than what has been in the past in terms of going back to the payers that are aware of what the labor market's like and having that negotiated in.

On the hospital side, that will work its way in. We're now down to a differential between our MA reimbursement and our Medicare fee-for-service reimbursement of about 5%. And so we've made great strides in our contracts with MA plans in terms of tying that to our Medicare fee-for-service CMG rate. So about 80% of our contracts now

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are on Medicare fee-for-service. Much different environment on the hospitals than it is on home health with regards to the differential between MA and Medicare fee-for-service.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

Yeah. So I guess, maybe dig into that for a minute. I guess, first, on the Medicare rate in home health, there's a behavioral adjustment which CMS hasn't officially backed off of yet. I mean, what's the outlook there for kind of the rate update? We've seen the hospice rate which was fine, I guess, but maybe probably insufficient?

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

A

Yeah. I think people are tying it to what ended up for the skilled nursing industry and what they did with that and assuming that that is going to be the same for the home health. And I don't think that that is necessarily the case. They may choose to do that. But certainly, industry is pushing back and saying this is based upon data that's been collected during a period of pandemic. And that kind of data should not be used as a means of isolating and pointing at certain behavioral trends during a pandemic that would be conducive with a post-pandemic setting.

And there were reports from Dobson DaVanzo that have produced data that would counter some of the assumptions that CMS would have to take into account in order to put in that 6% behavioral impact. So certainly the industry is pushing back on it. But also we counter – if you think about what the administration has done in terms of talking about the importance of healthcare in the home and how important that is going forward and that is [audio gap] (13:48) out there and healthcare inflation. So it would be very challenging for the industry to take that on right now during a PHE.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

And then on the Medicare Advantage side, it would seem like the shift out of the inpatient into the home would be like the most obvious thing for a managed care company to see the value of. So what has been the historical driver to those discounts and how do you close that gap?

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

A

I think you do it with your quality data. And you have to make a value proposition. You have to separate yourself out from other providers in the marketplace. And so to the extent that your readmission rates are lower than others or your quality indicators or patient satisfaction, I think, most of these firms will be data-driven if you can produce the data and show them the value that it can bring, particularly in a longer-term time period to care for the patient.

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

A

We also have on the home health and hospice side, a team that works – that has done work with ACOs and is now working on value-based care payment methodologies. So to the extent that that's where managed care is looking to go, we already are focused on that.

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

A

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And [ph] that team (15:19), that's a good point, I mean, these additional resources. Historically, we've not done a lot with MA plans. And I think that we certainly try to focus in on Medicare fee-for-service and really target our marketing and sales efforts there. But I think, longer term, we certainly realize that it's important to be involved with MA plans and have relationship with the MA plans that are out there and try to negotiate and work with them for contracts that are inclusive of the quality assumptions that would go along with the care for those patients.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

And what is the delta right now between MA and Medicare?

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

A

Right now, it's about 40% discount between Medicare fee-for-service and MA.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

And for what it's worth, Humana this morning was talking about how they kind of felt like given the labor shortage and your incentive to focus on fee-for-service volumes over a discount that that might help narrow the gap a little bit. But [ph] they own Kindreds and (16:24) maybe they're more open to your concerns than a typical MA company, but I guess there's some optimism there. And so then, obviously, the company is in the midst of a spin. And I guess, from the outside at least, I think the perception has been this has taken a while. So, can you talk a little bit about the process and where we are and from here when you think the resolution of the spin will have?

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

A

So, it has taken a while. I mean, this has been a very comprehensive process taken on by our board. We've utilized outside firms, our banking advisors are Citi and Goldman Sachs and clearly they're two of the best that are out there and [indiscernible] (17:16) from a legal perspective. But the board started this process with no preconceived notion in terms of what the outcomes would be. They didn't go into [indiscernible] (17:33) IPO or spin or sell.

So, evaluated all the options that were out there and we announced that we're going to be heading down the direction of the spin that would be the transaction day would be July 1. And the goal would be to do what's in the best interest of our shareholders and not do it with the mindset of what's the next 30-day in a very volatile market, but what's in a longer term perspective and the best interests of shareholders. And that's where we are now with the spin.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

Okay. Great. And then when we think about the ERF business kind of ex the home health business, how are you thinking about the growth of that stand-alone business going forward?

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

A

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Yeah, so we're very excited about the growth of that business. So, we mentioned earlier, we brought on. So we've – historically, if we had a two to four new de novo growth opportunity in hospitals, that was kind of our ongoing basis. Couple years ago we announced that we were going to go – double down on that.

And so last year we brought on 8 new de novo hospitals. We'll bring on 9 new de novo hospitals this year, and we have 10 that have been announced for next year. So our growth targets are 6 to 10 new de novo hospitals per year. We'll add somewhere between 100 and 150 bed additions to our existing hospitals every year.

And ultimately the discharge CAGR would be somewhere between 6% and 8%. And so we're very excited about the continued need for services. We really have accelerated the opportunities. If you look at certain states like the state of Florida that abolished their Certificate of Need requirement a couple years ago, that's an example of a state where we already had 12 hospitals in that state. We always knew the other markets that if we just had the opportunity without the CON that we'll quickly move into.

And so we've been aggressively building new hospitals there. We've also built hospitals in some new states up in the Midwest area. And a portion of those are joint ventures with acute care hospital systems. Our portfolio of 147 hospitals right now have – 54 of those are partnered with acute hospital systems, of which that remains part of our strategy. We've done this now for over 30 years with both academic medical systems as well as community-based medical systems.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

And how are you thinking about that pipeline longer term given, to your point, like if we actually look at the numbers, it's not entirely Florida, but this ramp-up has happened when Florida CON happened...

[indiscernible] (20:41)

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

A

Yeah. I just used Florida as an example of a state where we've really accelerated our presence.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

Is it? But so do you think that 6 to 10 is – I mean, obviously, it's the right number for next year or two but like is that the right number for the next five years?

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

A

We think that's sustainable for the next five years. I mean, if you look at the demographic tailwind, our average aged patient is 76 for the next several years. I think the CAGR for Medicare beneficiaries in that age cohort is right at or close to 5%, 4.8%, 5% with the baby boomers entering that age cohort, that drops down afterwards. But we have some really nice track record with the de novo hospitals that we brought on. We have proven that – we've shown nice opportunities to take market share from other providers out there.

I think it's one of the things with COVID, we made the decision early on, working with our clinical teams that we would take COVID patients and not all post-acute providers took COVID patients. I think that was a great benefit

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to our referral sources, taking into consideration about 9% of the admissions into our IRFs come directly from an acute care hospital.

So the acute care hospitals are working for post-acute providers that could work with them during COVID. And we already had a growing reputation for our ability to take on higher acuity patient. And the last two years have really given us an opportunity to continue develop that reputation in marketplace. We've treated over 22,000 COVID patients now between our IRFs and our home health.

I'm very proud of the way that we're able to get great outcomes for that. And I think reputationally, that has – it's going to have some stickiness – has had some stickiness in terms of the referral sources that we either had before COVID [indiscernible] (22:45) more patients from or referral sources that never really recognized this in the past are now using us. So very pleased with the growth.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

And how do you think about margins for that business because margins came down during COVID and so do you expect to get back to pre-COVID level?

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

So, this year, you have two factors on margins. You have not only the labor but you also have sequestration. And so next year that will start to anniversary throughout. And we think that when things start to normalize, that we can get back into that low 20% area on EBITDA margin.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

And this ramp up in de novo oftentimes we hear companies talk about [indiscernible] (23:28) de novos and their startup losses and things like that. So I mean, that's kind of, I guess a fully loaded number that that includes this drag...

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

Yeah. It's...

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

...from this de novo development?

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

So, it's about – it's a little bit over $1 million in startup cost per de novo. So just use that as a proxy.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

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Okay. Perfect. And then I guess the same thing on the home health and hospice side. I mean, how do you think about that business? I think, in particular, once you bought that business, there was a lot of opportunity to kind of bring the referral source from ERF into home health.

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

Yeah.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

How is that going to work post-spin and does it have any impact on the growth of that business?

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

So we refer to that as clinical collaboration. Clinical collaboration dealt with the patients that we discharge from our hospitals to home health and what we called our [ph] overall out (24:21) markets, where we had both the hospital and home health representation. We collaborated on the processes of everything that goes into clinical collaboration for a patient. So that's a smooth transition from the hospitals to home health.

What we've seen is that we could replicate much of that in marketplaces where we had willing home health providers but we didn't have an Encompass home health provider. So we know that that can continue with home health provider that is not owned by us. There are certain things with [ph] care flows (24:59). Since we won't own that company, there are HIPAA rules and compliance rules that we'll have to comply with it, will put us in a position to do certain things differently.

But the one thing that we think will stick are the relationships, the referral relationships and the service accountability that our home health has provided for our hospital discharges. So even though they'll be called Enhabit, they'll be a separate company. Many of these relationships and these referral relationships will continue. And of course, patient choice is what drives that. But we think that we can have a higher quality with an organization that we can work well with and that will be Enhabit.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

Okay. That's helpful. And I guess, when you think about capital deployment on the IRF side stand-alone, with all these de novos is that basically the free cash flow of that side of the business that's going to be used there?

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

That's the focus right now in terms of we like to own our real estate and own about 70% of our real estate. So, reinvesting in our growth and on our opportunity to continue on with the de novo and also I mean, we'd love the bed addition strategy. That is a really good return there. So, that 100 to 150 beds of bed additions to our existing chassis is also a really great way for us to invest in our capital.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

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And then on the home health side, I guess deals is still going to be there. I mean how are you thinking about the deal pipeline there, multiples [indiscernible] (26:42)?

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

So, it's still continued to look at all opportunities that are out there. Historically, we have used $50 million to $100 million worth of acquisitions and I know it's kind of a marker for – that was our growth marker on that. After July 1, they will clearly move on to a freestanding company, of which they will be reviewing the opportunities they have for acquisitions. But I think they'll be well-positioned to take advantage of this fragmented marketplace. I do think that when [indiscernible] (27:16) a lot of the stimulus dollars that are working their way through the system go, I think they're going to be a lot of some of the small agencies that are going to be looking for opportunities to be acquired.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

Okay. And then, I guess, when we think about the home health asset, it appears that the company, during COVID, broadly grew a bit more slowly than where the peers were growing. So can you talk a bit about why that was the case and if there's a reason [ph] that should be accelerating (27:51)?

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

On the home health...

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

On the health side, yeah.

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

Yeah, I think that if you go back, a lot of that growth [indiscernible] (27:59) more specifically from the MA plans and that was one of the reasons that we've added resources that Mark mentioned earlier and gives us a better chance to go out and have a greater presence in terms of negotiating with the MA plans and being a provider and being part of their profile that care for their beneficiaries.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

All right. And then I guess, when we think about the overall margin profile for that business. I mean, is that business underearning today versus where you think it should be? I mean, the labor problems are here. The volumes have been impacted. It feels like there's opportunity there, but I don't know how you guys are thinking about that.

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

We think the long-term prospects for home health are very strong, and that being for Enhabit. Certainly, between COVID, the last two years, and having an impact on volumes and now you bring the labor component into that, this is going to normalize out. And so the longer-term prospects for Enhabit and the industry, I think will be very

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strong. We're just in a period of transition right now that is putting a damper on some of the results that we see from an earnings perspective.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

And then maybe just last question. On the ERF side, you mentioned that the de novo pipeline, you're increasingly doing JVs. Can you talk a bit about what the benefit is of doing one with the JV versus doing it on your own? How do you think about that?

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

A

Yeah. So if you look at our pipeline right now for de novos, it's about – about half of them involve joint ventures. We evaluate marketplaces, whether we should go into a wholly-owned versus a partnership. Some of the hospitals that we're building are with partnerships. We already have one existing hospital, and they have expanded their presence, and we're doing a second hospital with them. So we take it market by market. We have a great reputation as being a great partner. And in certain markets, it's just strategically more important for us to consider partnering than going into and building wholly-owned, or they've reached out to us, they have a small unit within their hospital and want to have a bigger footprint and are looking for both expertise and operations and a capital partner.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

I guess, what is the benefit to you for doing [indiscernible] (30:27) having 100% of the economics and having [indiscernible] (30:29)?

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

A

So you're in a marketplace where they have a higher profile name and some marketplaces. They have a strong presence there. They have an existing referral pattern. And you can go in and you can be part of that existing brand without having to start from scratch and developing your own brand in a marketplace.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

All right. Great. That's all we have time for. Thank you very much.

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

Thank you.

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