24-May-2022

Encompass Health Corp. (EHC)

UBS Global Healthcare Conference

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MANAGEMENT DISCUSSION SECTION

Andrew Mok
Analyst, UBS Securities LLC

Hi. Good morning and welcome back to the UBS Healthcare Conference. My name is Andrew Mok. I'm the US Healthcare Providers Analyst at UBS, and I'm pleased to be joined on stage with Encompass' CEO, Mark Tarr; and Encompass' CFO, Doug Coltharp. Welcome.

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

It's great to be here.

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QUESTION AND ANSWER SECTION

Andrew Mok
Analyst, UBS Securities LLC

Q

To start, Mark, IRF volumes have been very strong in recent quarters, including 8% discharge growth in the first quarter of this year. How should we think about the sustainability of that volume growth?

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

A

Yes. So we do think it's sustainable. If you look at the underlying factors, by the way, first quarter was a very challenging quarter. So, we were very proud of the volume we had and both the IRF and the Home Health and Hospice, but if you think about the longer term growth targets that we put out there, the 6 to 10 new hospitals each year, the 100 to 150 additional beds, and the 6% to 8% CAGR on discharge, that spells really strong growth platform moving forward.

Andrew Mok
Analyst, UBS Securities LLC

Q

And occupancy in the first quarter increased to 73% which is the highest mark dating back over the last five years. Why did we see such a strong improvement there and what's the outlook for occupancy from here?

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

A

So, it wasn't only the volume, there are other things that play into the capacity and occupancy, length of stay being one of the primary ones. So, length of stay ran a little bit higher in Q1 than we saw in pre-pandemic. Other things that can impact that are patient may actually have a higher level of acuity that plays into that. So, capacity is impacted by a number of different factors.

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

A

Over time, we would expect to see the occupancy level actually start to drift a little bit north, and that has a lot to do with just the composition of the hospital base. Within our legacy base, we have many hospitals still, particularly in the northeast part of the United States, that have multiple occupancy rooms. And yet, all of the capacity that we're adding through bed expansions and the de novos are single occupancy rooms. The theoretical occupancy level for a single occupancy room is higher than it is in multi-occupancy, because you don't encounter issues such as gender compatibility or isolation issues. And so, as we continue to add and a higher percentage of our bed mix become single occupancy, we would like to see that occupancy level drift up.

We had anticipated coming out of COVID, and I guess we're not out of it yet, that there might be a couple of silver linings for us that would also contribute to sustainable volume growth over the next several years. We always start with the fact that we've got a strong demographic trend driving the demand for the services in both of our business segments. And obviously, that hasn't been altered. But particularly on the IRF side, we saw a tremendous growth over a multi-quarter period in our Medicare Advantage book of business. And that was only aided by about a quarter – really less than a quarter of the waiver of the pre-authorization requirement, so most of that was gained in a fairly normalized environment.

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And I think it was because the SNFs were in a disadvantaged role, many of them were not able to take patients at all. And we were really able to underscore our value proposition of IRF services with the MA plans themself and with other referral sources. And so, even though we saw a little bit of a retreat in MA volumes in the first quarter, that was against a 37% comp from the first quarter of last year and what we've seen is at the base of MA discharges that we now have is substantially higher than it was in 2019.

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

Andrew, just another comment on that. If you look at what we've done in 2020 and 2021 in light of the COVID and our ability to go in and show that we can take higher acuity patients, our referral sources, either existing referral sources, very much appreciated the role that we played during that time period. And it gave us an opportunity to not only get additional referrals from existing referral sources, but it also opened the door for new referral sources that maybe, historically, had looked at post-acute and just a one size fits all, and that skilled nursing facilities and nursing homes were the same as IRFs. And I think it gave us a real opportunity as an industry, and certainly as a company, to prove our ability dealing with difficult patients that will have some stickiness going forward.

Andrew Mok
Analyst, UBS Securities LLC
Q

Got it. And, Doug, you mentioned that delta or spread between the occupancy levels of the single-bed versus the double-bed. One, what's the breakdown between hospitals that are a single-bed versus double-bed? And where is the occupancy difference, any delta to point to there?

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

Yeah. So, we're – about between 55% and 60% of our aggregate beds are still multi-occupancy. And by multi-occupancy, either you've got multiple beds in a particular room or you've got shared bathrooms, and they kind of create the same types of issues. And the reason for that is that rehab hospitals didn't exist under the Medicare regulations until about the mid-1980s, and yet we have a lot of physical plan that is older than the 1980s, which means that those facilities were built for a different purpose.

They were also built during a timeframe when the expectation for privacy was significantly different. So, you'll see that for a period of time here, it's reflected in this year, our maintenance CapEx level is actually a bit higher than it has been historically, and a portion of that is devoted towards addressing the multi-occupancy rooms in that older base by, in some cases, reducing capacity to increase the number of single occupancy rooms and others not reducing the capacity, but engaging in a physical reconstruction of the building.

There is an occupancy delta between those. We tend to see occupancy caps start to creep into play depending on where we are with regard to seasonal volume at about an 80% level in the multi-occupancy facilities, depending on specific configuration. And the theoretical occupancy level in a all-private room facility is 100%. Normally, when we get up to about 90%, we're looking hard at bed expansion opportunities there.

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

So, Andrew, you had a recent – you recently had a chance to tour one of our hospitals out in Vegas that was heavy on semi-private rooms, but ran over in 80% occupancy. So, it can be done, it's just more challenging.

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Andrew Mok
Analyst, UBS Securities LLC

Q

Right. Great. And when we look at that strong discharge growth rate that we're talking about earlier and we pair that with 2% to 3% rate increases, it's easy to see this business delivering 8%-plus revenue growth over the next several years. Is that a reasonable growth outlook for that business?

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

A

Yeah, it is. I think, again, we've got to get through the re-implementation of the sequester here in the near term, but I think the math works just the way that you outlined it.

Andrew Mok
Analyst, UBS Securities LLC

Q

Great. And on the margin side, Doug, you recently made a comment that you expect IRF margins to settle in the low-20% range. When we look at the accelerating volume growth, improving labor conditions, presumably better Medicare rates as we get into 2023 and 2024, is it reasonable that margins can drift upwards to that mid-20% range?

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

A

Yeah. It really is so dependent on the relationship between pricing and specifically Medicare pricing because that remains the bulk of our payer mix and the SWB inflation rate. We do think particularly as we get into the back half of this year and specifically once we get past about August of this year when we started to see the spike in wage rate inflation last year that we'll see that start to normalize in kind of the 3% range. And we don't think that that's an unrealistic expectation for Medicare price increases going forward. If we can kind of stay flat against SWB in terms of not de-levering within the P&L, then there are opportunities to leverage expenses such as occupancy expense and some of the administrative costs associated with the hospital that would contribute to margin growth.

Andrew Mok
Analyst, UBS Securities LLC

Q

So, is that a fair way to think about it, 3% will kind of hold your margin steady and anything north of 3% from a rate perspective should lead to improving margins?

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

A

Yeah, I think that's our expectation right now.

Andrew Mok
Analyst, UBS Securities LLC

Q

Got it. That's helpful. And going back to the earlier comments around Medicare Advantage and strong demand there, Mark, last month you mentioned that the spread between fee-for-service and Medicare Advantage has narrowed to 5%. What's driving that lower spread and how far away do you think we might be from achieving rate parity between fee-for-service and Medicare Advantage?

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

A

So for years, we have worked with MA plans and taken what we call our value proposition out which is essentially a data based on our outcomes. And not only our outcomes but we also are able to achieve some comparison with data from CMS where we can show where other providers are in the marketplace. So showing up, providing data helps the value proposition. And I think our outcomes have proven for themselves.

The parity -- and with each successive year, we've made a little progress in terms of negotiating a CMG rate with the MA plans where essentially we are paid the same as fee-for-service. So we're now at 80% of our contracts with MA payers are on a CMG basis. Each year, we've made a little bit more progress on that. So whether or not we get to ultimate parity, we'll see. But we're getting much closer than what we have been ever in the past.

Andrew Mok
Analyst, UBS Securities LLC

Q

Does that strong demand backdrop help in these reimbursement negotiations?

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

A

It does. I think it also helps for what I mentioned earlier just in terms of our ability to separate ourselves from other post-acute providers. It puts us in a much better position to go and negotiate.

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

A

There are two factors that have been contributing to the closing of the gap between Medicare Advantage and Medicare fee-for-service reimbursement. The first, as Mark just mentioned, is that over the last 10 years, we've been successful really on an incremental annual basis of driving up the percentage of the MA contracts that pay on a CMG basis at the Medicare rate. But if you think about that, 80% of your revenues in Medicare Advantage around that rate, there's a discount on the others. How do you get to a 5% aggregate discount?

And the way that you get there is that the average acuity for the Medicare Advantage patients that we treat is higher than it is for fee-for-service. An example there would be about a third of our MA book of business is in stroke which carries a higher reimbursement. I think there may be limitations on how much higher we can drive the average acuity on MA. And so where you'll see the further improvement in that gap – and it's not going to be linear. It's not going to occur every quarter now because we're in this relatively tight zone where you can see some fluctuations from quarter to quarter. It's got to be on converting additional contracts.

Andrew Mok
Analyst, UBS Securities LLC

Q

Got it. And last month when we visited one of your facilities, we saw patients able to dialyze on new Tablo machines. What drove that decision to integrate dialysis into your facilities and how many of your facilities have that capability today?

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

A

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So historically, our hospitals have contracted out to have the dialysis and provide it inside our hospitals. And just what we've seen over time, we can better control both quality and the service by bringing that in-house, and Tablo has allowed us to do that.

We currently have it in 9 of our hospitals. By the end of this year, our plan is to have it in 45 of our hospitals as we roll it out across our platform. But we really saw it as an opportunity to provide better quality, better service, better patient satisfaction. It allows us to provide that in the in-house spaces where it's conducive with better scheduling, their therapy services around the dialysis. So it was kind of a win-win we feel for us and the patients.

Andrew Mok
Analyst, UBS Securities LLC

Q

Got it. And how has that impacted your referral streams for dialysis patients? Are you getting more dialysis patients than you otherwise would have?

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

A

Obviously, there's more dialysis patients out there than – more than ever. And it was a growing need given our demographic and we've seen the increase every year in terms of the number of dialysis patients. And we think this will only solidify yet another opportunity for us to show the level of service that we can provide.

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

A

And, virtually, I think really all of our de novos are being built with a dialysis suite.

Andrew Mok
Analyst, UBS Securities LLC

Q

And what percentage of your patients in the IRFs typically are on dialysis?

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

A

I don't know [indiscernible] (13:11).

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

A

We don't know the exact percent.

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

A

We can follow up on that.

Andrew Mok
Analyst, UBS Securities LLC

Q

Okay. Great. Moving on to labor, top of mind of a lot of investors today. Anecdotally, we're hearing a lot of stories about improving contract labor rates coming down sharply in recent weeks. Can you put that into context for Encompass? Is the market improving in line with expectations?

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

A

So, in our first quarter earnings call, I said that we felt like we've seen the peak of the labor challenge out there, and we continue to believe that. We've seen some loosening up in the markets recently around rate per hour with the agencies. Our hospitals are using less agencies in terms of – look at the FTEs that we are having in-house. We've seen some flexibility on moving away from a 13-week contract or having an out-clause. We sign a 13-week contract, we're going to have an out-clause, say, two weeks or so.

And we've seen applicant flow for full-time staff continue to improve. We've added resources to our talent acquisition team. We now have 62 FTEs based out of Birmingham that their sole purpose is to find nurses to fill our staffing needs in our hospitals in order to accommodate the increased volume that we're receiving. So, we'd like to think and believe that the second half of the year will continue to improve and we'll see a more marked difference in the second half than we saw in the first half.

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

A

You may recall that we made comments in both Q4 and Q1 that we had a very deliberate strategy of not sacrificing any volume in the IRF segment, even if that meant paying up substantially for labor to fill in those gaps. And it was not just contract labor. It was incremental sign-on and shift bonuses that were elevated as well. Those costs reached what we hoped was a peak in aggregate just over $60 million in Q1, about two-thirds of that contract labor and the balance in the sign-on and shift bonuses.

The peak month that we've experienced thus far was March. From a contract labor perspective, we had 750 FTEs in the IRF segment that were provided through contract labor, and the average rate for those on an annualized basis per FTE was about $240,000. That compares to $96,000 for an internal FTE. Based on the timing of those contracts, we were hoping that we would start to see some improvement in the number of FTEs under those contracts by the time we reached the end of April, and that we'd also start to see that the renegotiation on contracts that were renewed came in on a lower rate, and we saw some evidence of that in April. The number of FTEs came down, and we saw some improvement on contracts. It's a very market-specific thing.

From a normalized perspective, we would expect – if we were not dealing with all of these current disruptions in the labor market, that we'd have a base of about 250 contract labor FTEs in the business. And that's because you don't necessarily want to staff internally with FTEs to accommodate fluctuations in volume. There's an inefficiency in that. And we believe that we can be down to about that 250 contract labor FTEs by the time we exit this year.

Additionally, we're optimistic that the rate environment will continue to improve. In a normalized environment, contract labor runs between 125% and 150% of the internal cost versus this 240% that I referenced earlier. And so, don't know that we'll get all the way down low end of that range, but I think 150% as an exit point for the year is a reasonable objective, if you will.

In the second quarter, in addition to the fact that the contract labor FTEs are coming down rather modestly but improving, what you're likely to witness is that we're continuing to reinvest some of those dollars in the sign-on and shift bonuses. That, again, is a deliberate strategy. We would rather be paying more to the full-time equivalents who are internal than going outside.

And so, the aggregate improvement in the second quarter labor expense between those three categories is likely to be a little bit more modest, but there'll be some evidence of it in there. And then, as Mark suggested, we do

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expect the improvement to ramp up in the second half of the year based not only on the trend line, but based on the fact that we'd begin anniversarying the spike that we'd be – that we first encountered once we hit August.

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

We're hopeful that inflation's going push people back into the workhorse.

Andrew Mok
Analyst, UBS Securities LLC
Q

Doug, I want to follow up on a few of those comments there. So, one, it sounded like you prioritized referrals and volumes and long-term market share over short-term profits. So is it fair to assume that your contracted premium labor costs spiked more than the market and may fall sharper than the market as things start to normalize?

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

I think that's not unreasonable. Yeah, it was – we definitely had a significant portion of that that was driven by that substantial increase in demand for our business that you referenced earlier when you mentioned some of the discharge growth numbers we've seen here in recent quarters.

Andrew Mok
Analyst, UBS Securities LLC
Q

Got it. And the 13-week contracts, presumably most of your contract labors are on 13 weeks, that will give you an opportunity to renegotiate them throughout the second quarter. Where do we stand in terms of how a percentage of contracts have been renegotiated today?

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

So relatively small percentage in the back end of April. And really that was just due to the fact that if you think about how Omicron was moving through, we were really in a position where we had to re-up some of those contracts in February. So those -- that tail really starts to run off in mid-May. And so we're optimistic again that we'll see incremental improvement in the number of contract labor FTEs and the contract rate on renegotiation in each month during the second quarter.

Andrew Mok
Analyst, UBS Securities LLC
Q

Got it. And are there any numbers you can provide just in terms of recent negotiations? Just order of magnitude of those lower contract labor rates?

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

I don't have anything at my disposal. But we can certainly follow up on that as well.

Andrew Mok
Analyst, UBS Securities LLC
Q

Okay. That's helpful. And the labor dynamics on the home health side are a bit different than they are on the in-patient rehab side. It certainly seems like the home health performance was more resilient in the first quarter than

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a lot of the post-acute providers and other facilities. Has that been your experience just seeing a larger supply of home health nurses and how have labor trends in home health developed in recent months?

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

A

So, our home health team have had some nice trends here recently in terms of what we call the net new nursing hires. And if you think about the home health and the differences between home health and IRF around COVID, home health was definitely more impacted by having staff out on quarantine which did not allow them to handle the volume of referrals. They're still getting referrals in first quarter. It was just they couldn't service those referrals because they had as high as 1,300 FTEs out at one point on quarantine, and it was just a challenge for them.

What we have seen now with the numbers of COVID drop, we've certainly seen our quarantine levels go down into at a low-double-digit number now, and we've been able to hire new staff. They, too, have added resources for their talent acquisition. So I think that similar to the IRF, you've seen some like green shoots on the labor side of our home health group as well.

Andrew Mok
Analyst, UBS Securities LLC

Q

And when you source labor on the home health side, where have you found success, where have you been met with resistance just in terms of sourcing the supply of labor?

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

A

Right. I think there's really not one easy fix on this. You go out and you find it wherever you can. So it can be from former employees that we're reaching out to, to see if they want to come back. It is using indeed and reaching out to new candidates that are new to the organization. It is getting the word out, word of mouth, referral bonuses for existing staff to refer friends and family. So it's an all-out force to do whatever you can to find referrals for new nurses.

Andrew Mok
Analyst, UBS Securities LLC

Q

Got it. And let's talk a little bit about the volume side of home health and the demand there. As we enter an endemic state, how would you describe the demand backdrop for home health? How have volumes been trending exiting Q1? Yeah, let's start there. And has labor been a constraint to your volume growth here?

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

A

Let's say that labor – there have been certain parts of the US where we still have some agencies that have been challenged with staffing that impact labor. But we're starting to see some better trends in those parts, geographic areas as well. If you think about just the elective procedures in acute care hospitals starting to rebound and that plays in our favor, we've seen that as well. So I think the more that things resume back to a endemic platform instead of pandemic with COVID, the continued demand for home health will have a bright future.

Andrew Mok
Analyst, UBS Securities LLC

Q

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Got it. And early on in the pandemic, home health agencies took a lot of market share from the SNF industry. What are the latest trends you're seeing there in terms of SNF occupancy and impact to the home health business?

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

Our home health group had a past history of taking some very challenging, chronically ill patients. And I think that really played in their favor in terms of being there and having the capability clinically to take patients that historically may have gone to a skilled nursing facility. So I think that will still work in our favor going forward as we go out and obtain the staff to care for those additional patients.

Andrew Mok
Analyst, UBS Securities LLC
Q

Got it. Just continuing on the home health volumes, I think about 30% of your Medicare Advantage business is episodic today. How should we expect that number to trend over the next several years? Has that hit a status quo point or should we see that number continue to decline?

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

I think it will increase. So, the single biggest impact on that percentage over the last year plus has been the national contract with United which is on a per visit basis and not on episodic. I think you're hearing from all of the home health providers right now that this rate differential that has historically existed between Medicare Advantage and fee-for-service and home health which is substantially wider than what we experience on the IRF side to the tune of about 40% is simply not sustainable, and that really the way to address that is through more episodic models sometimes with risk-sharing arrangements between them. And I think the MA plans are going to have to demonstrate an openness to that or providers are going to turn away from those patients and there's going to be a real access to care issue for the MA beneficiaries.

Andrew Mok
Analyst, UBS Securities LLC
Q

Got it. So you think we're actually at a low point on the episodic admissions and now the industry is going to be pushing back and pushing more of those arrangements into episodic payment models?

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

We would expect trends – we're a decade ahead in this movement on the IRF side than we are on home health, but we would expect for our business and for the industry in general that the payment percentage within MA creeps up more in episodic and that the rate differential between MA and fee-for-service closes.

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

They have the same value proposition opportunity that we've done on the IRF and it is -- have the data to go out and sell your outcomes and the trends that you have, the ability to keep patients in home and not return back to acute care hospitals.

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Andrew Mok
Analyst, UBS Securities LLC

Q

Got it. And what's the economic difference between a per visit and episodic payment in Medicare Advantage?

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

A

It's about a 40% delta, yeah.

Andrew Mok
Analyst, UBS Securities LLC

Q

40%. Got it. That's helpful. Let's shift to the Hospice side.

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

A

With no change in the cost, right?

Andrew Mok
Analyst, UBS Securities LLC

Q

Let's shift to the Hospice side. Hospice admissions on an organic basis have been pressured in recent quarters, declining about 14% to 15%. Can you speak to the drivers of that pressure and how has Hospice earnings held up during that decline in volumes?

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

A

What we saw in Hospice, particularly on the volume side, is that they were definitely impacted by having staff out. The inability to staff certain agencies and certain agencies that historically had a large portion of our hospice volume were particularly challenged. So I think we saw in the first quarter that was probably the largest single driver impact on our volume is just the number of staff that were out, the openings that we had and the challenge of trying to staff the volumes that we had.

Andrew Mok
Analyst, UBS Securities LLC

Q

And how has average length of stay trended in the hospice business, any comments there or visibility into average length of stay?

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

A

Yeah. It's certainly moved up from the low point that were achieved kind of in the fall of 2020, where mortality rates particularly tied to COVID drove length of stay down pretty substantially.

Andrew Mok
Analyst, UBS Securities LLC

Q

Has that been trending up in recent quarters?

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

It has. Chrissy, do you recall where we're kind of landing on that?

Crissy Buchanan Carlisle
Chief Financial Officer-Home Health & Hospice, Encompass Health Corp.
A

It's close to 1.08 [indiscernible] (27:18) right now.

Andrew Mok
Analyst, UBS Securities LLC
Q

Got it. That's helpful. On the spin dynamics, it sounds like you're still waiting for a private letter ruling from the IRS. Once the tax free spin is effectuated, can you remind us what the tax considerations are for subsequent transactions?

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

It's very situational-specific. And so, some of the kind of underlying principles there will be outlined in the Form 10 when that is publicly filed, and we expect that that's going to happen in the very near term here. So, we would refer you to the language that's included in the Form 10, but it's very situational-specific. When we separate the businesses, there will be a tax matters agreement that extends between the two business. That is very customary. And I will tell you that there will not be anything about the Tax Matters Agreement that we put in place that will not appear to be a market term for precedent transactions.

Andrew Mok
Analyst, UBS Securities LLC
Q

Got it. And once that spin occurs, you're going to have greater flexibility from a capital deployment perspective. What changes should we expect from that greater flexibility?

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

I think it's going to open up incremental growth opportunities for the Home Health and Hospice business. With regard to kind of capacity for larger acquisitions – and particularly at some point in time as we think the stock trades at an appropriate level to potentially use the equity as a currency for larger business combinations as well. I think it creates a lot more flexibility for how you deploy capital on the IRF side. We've been extremely pleased with the returns that we're getting from our de novos and from our bed expansions, and we anticipate that we'll continue to deploy a meaningful amount of capital towards those initiatives in the foreseeable future.

And this is the case for both – both of these businesses generate a lot of free cash flow. And when you look at the IRF business, you not only have the strong free cash flow generation, but you've got an extremely strong balance sheet driven by, amongst other things, the substantial amount of unencumbered real estate on the balance sheet. And so, that's a business that opportunistically could live with somewhat higher leverage levels, if only on an intermediate basis. And so thinking about how we might complement the deployment of cash flow and the utilization of the balance sheet for capacity additions with things like share repurchase programs is something that will certainly be on the table for us.

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Andrew Mok
Analyst, UBS Securities LLC

Q

Right. And can you remind us what percentage of the real estate is owned by Encompass?

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

A

About 70%.

Andrew Mok
Analyst, UBS Securities LLC

Q

70%.

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

A

Yeah.

Andrew Mok
Analyst, UBS Securities LLC

Q

And on the spin itself, will the spinco be making a cash distribution back to the parentco, so will that give you extra capital for which to deploy?

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

A

Yeah. So as we mentioned, we anticipate that we're going to be out of the gate [ph] with Enhabit (30:15) leverage of kind of 3 to 3.25 times which implies they'll be somewhere between $550 million and $600 million of funded debt on that business. The proceeds from raising that debt, which is a process that is under way right now, will be distributed upstream a dividend to the parent company. And those proceeds will likely be used to pay down debt that is currently there. And that would give us the resulting leverage that we're anticipating for Encompass Health post-spin of somewhere inside 3.5 times.

Andrew Mok
Analyst, UBS Securities LLC

Q

Got it. And do you anticipate any discretionary cash left over after you repay down that debt or will the vast majority be your market for that repaid down?

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

A

Cash is fungible, so even if there was any excess cash would pay down a revolver balance and then you just have the ability to draw down. So I think probably the cleanest way to think about it is just assume that it all pays down debt on day one but obviously then you're creating additional capacity in the balance sheet.

Andrew Mok
Analyst, UBS Securities LLC

Q

Got it. That's helpful. I want to move on and talk about some of the transactions in the market. After UnitedHealth finalizes its acquisition of LHC Group, two of the largest home health companies will be owned by Medicare

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Advantage plans, what was your reaction to that deal and how does that impact the competitive landscape of the home health business?

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

A

We don't think it's necessarily going to a negative impact on Enhabit and we think that the number of patients and the coverage necessary to provide care for the home health marketplace is going to be very substantial going forward, and we see this as a bit of a transition in terms of those acquisitions, and we'll see longer term what those companies do with the home health agencies that they acquired. But in the near term, we don't see it initially as a negative impact on our business.

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

A

So first and foremost, the fact that both of those businesses have chosen to establish a large presence in home health really underscores the value proposition of the business as well. And so I think that's great for all of the providers in the space on a longer term basis.

If you listen to how each one of those two companies have described the strategy and the strategic rationale for getting into the home health business, it's specifically targeted at addressing the medical loss ratio that they have for their Medicare Advantage book of business and not to improving the profitability of the home health platforms.

And so what that means is that they're likely to redirect those limited clinical resources to more preventive-type and maintenance-type of activities versus which would be on the intended to keep patients out of acute care hospitals on the front-end as opposed to addressing patients with a post-acute need which is where our clinical resources have been focused and particularly within the fee-for-service business. So we think that dynamic could actually free up the market share for us and would be a good thing over the long term.

Andrew Mok
Analyst, UBS Securities LLC

Q

Got it. And any learnings from your overlap markets with Kindred's home health business? Any takeaways there on the experiences?

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

A

No impact, slightly positive.

Andrew Mok
Analyst, UBS Securities LLC

Q

Got it. That's helpful. Last question here that I want to get through, there's been a growing concern in the investment community that CMS may implement behavioral rate adjustment in home health to keep PDGM budget-neutral particularly after the agency proposed a similar rate cut to the SNF industry in April. What was your reaction to that preliminary rate update and is it fair to compare that to the home health industry?

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

A

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Well, the – first of all, the home health industry through trade associations are absolutely arguing the fact that it does not warrant that type of impact. If you think about the data that's being collected, it's being collected during a public health emergency. It certainly goes countered to a lot of communication from the administration in terms of the importance of having home care for the Medicare beneficiaries, how important it is in terms of influencing future healthcare spending, and the controlling of the escalating cost of care for patients. So it's – it would not make sense to have an impact of that magnitude at this point.

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

A

There are a couple of important distinctions between the SNF position in the home health. The most significant one that we would point out is that with the implementation of PDGM, home health took a significant rate cut. With the implementation of PDPM, the SNFs did not. And so there may be a little bit of an element of catch-up here that may not be applicable to the home health business. That said, it's hard to divine the motivations of CMS and underlying rationale at any particular point in time.

Andrew Mok
Analyst, UBS Securities LLC

Q

Got it. That's helpful. All right. Well, any last or final comments that you want to leave the audience here today?

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

A

Well, yeah, very pleased with Q1 particularly on the volume side and think that shows the resiliency of the sustainability and the need for the services we provide. So we look forward to a bright future.

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

A

Yeah. The labor conditions will eventually moderate and normalize. I know it seems like it's going to take forever to get there. It's really not going to do that. The strength and the demand for both of our businesses is extremely strong. And we are really, really optimistic about the long-term prospects for each of these two businesses as independent public companies.

Andrew Mok
Analyst, UBS Securities LLC

Great. Well, thank you so much for your time. Enjoy the rest of the conference.

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

Thanks, Andrew. Appreciate it.

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

Thank you.

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