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Encompass Health Corp. (EHC)

Q2 2022 Earnings Call

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Matt Borsch
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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone, and welcome to Encompass Health's Second Quarter 2022 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 will be a question-and-answer period. [Operator Instructions] 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 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 second quarter 2022 earnings call. With me on the call today are Mark Tarr, President and Chief Executive Officer; Doug Coltharp, Chief Financial Officer; and Patrick Darby, General Counsel and Corporate Secretary.

Before we begin, if you do not already have a copy, the second 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 spinoff of Enhabit, Inc. and

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its impact on our business and stockholder value as well as the magnitude and impact of COVID-19 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, and the Form 10-Q for the quarter ended June 30, 2022, when filed. We encourage you to read them. You are cautioned not to place undue reliance on the estimates, projections, guidance and other forward-looking information presented, which are based on current estimates or 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 any additional questions, please feel free to put yourself back in the queue.

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

Mark J. Tarr

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

Thank you, and good morning, everyone. The strategic review of Encompass Home Health & Hospice business culminated in the spin-off of Enhabit on July 1 to be an independent publicly traded company. Enhabit reported its Q2 results yesterday after the market close and has its earnings call following this call. Accordingly, we will not be commenting on Enhabit's Q2 results.

Q2 was another solid quarter for our inpatient rehabilitation business. Demand for our services continues to grow. Our value proposition is resonating across payers and we are gaining share in what remains an underserved market.

Our de novo and bed addition strategies are increasing availability of the highly specialized services we provide to meet this rising demand. Our commitment of substantial capital to these capacity expansions underscores our confidence in the future prospects of the IRF business.

We open three de novos in Q2, making that six year-to-date. We'll open three more de novos in the second half of 2022, bringing the total to nine openings for the year. We expect a similar number of openings in 2023. We added 38 beds to existing hospitals in the quarter, raising the year-to-date total to 67. We expect to add a total of approximately 90 beds to existing hospitals in 2022 and additional 100 to 150 beds in 2023.

Our total discharges grew 4.9% in the quarter and 1.6% on a same-store basis. This was on top of 18.7% total discharge growth and 16.9% growth on a same store basis in Q2 2021, resulting in an impressive two-year CAGR. As has been the case for the past several quarters, the continued strong demand for our services in a tight labor market for skilled clinicians necessitated elevated utilization of agency staffing and sign-on and shift bonuses.

As we had foreshadowed on our Q1 call, we did see sequential improvement in contract labor costs during Q2 with both the number of contract labor FTEs and the negotiated rates declining. Consistent with our Q1

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comments, we chose to redeploy a portion of the contract labor savings into sign-on and shift bonuses for our internal FTEs.

Contract labor plus sign-on and shift bonuses totaled $56.9 million in Q2 compared to $63 million in Q1 and $28.7 million in Q2 2021. Our Q2 agency rate per FTE was approximately $222,000 compared to approximately $240,000 in Q1 of 2022.

We've responded to the challenging labor market conditions for skilled clinical resources in a number of ways, including adding substantial resources to our talent acquisition team. We have built a centralized recruitment function now comprising over 60 professionals.

This strategy is gaining headway. Same-store net new RN hires were 276 for the first half of 2022 as compared to 117 in the same period last year. For the second half of 2022, we expect sign-on and shift bonuses to remain elevated as we continue to hire more RNs and use existing staff to fill in gaps. This will facilitate a decrease in our utilization of contract labor.

Assuming normalizing industry conditions, we expect agency rates to decline further. However, the pace of the decline remains uncertain as agency rates remain highly variable and the extension of the public health emergency may prolong the duration of elevated rates.

CMS last week issued the 2023 final IRF rule. For IRFs, the final rule will implement a net market basket update of 3.9%. We estimate that taken as a whole, the final rule will result in a net increase of approximately 4% for our Medicare payments beginning October 1, 2022. As a reminder, this increase does not include the impact of sequestration.

While the rate update in the IRF rule is positive relative to current reimbursement rates, it does not adequately compensate for our elevated operating costs. On the regulatory front, on July 1, CMS sent a report to Congress on a prototype for unified post-acute care Prospective Payment System or PAC PPS as required by the IMPACT Act of 2014. CMS did not make legislative recommendations to Congress as to what should happen with the prototype and cautioned that substantially more analysis and research are required. For these and other reasons, it is too early to elevate or evaluate any potential impacts to our business from the PAC PPS.

On July 20, we announced that our board of directors declared a quarterly dividend of $0.15 per share to be paid in October. The decline from our recent historical rate is in response to the completion of the spin-off of Enhabit and reflects our continued commitment to a robust de novo hospital strategy. We are affirming our guidance issued on June 7 for 2022 IRF revenue, adjusted EBITDA and adjusted EPS. The key considerations underlying this guidance can be found on page 18 of the supplemental slides.

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. In Q2, our IRF business generated revenues of approximately $1.063 billion and adjusted EBITDA of $196.4 million. Adjusted free cash flow was $166.8 million with year-to-date adjusted free cash flow of $290 million, up approximately 21% over the first six months of 2021.

The key trends we experienced the last several quarters largely continued in the second quarter of 2022. As Mark discussed, we continue to see good volume growth that combined with a modest 1.3% increase in revenue per

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discharge to produce our 6.1% revenue growth in the quarter. As has been the case for the past several quarters, staffing challenges did not limit volume growth, but did result in the continuation of elevated costs.

The Q2 contract labor plus sign-on and shift bonuses of $56.9 million that Mark alluded to was comprised of $35.1 million in contract labor and $21.8 million in sign-on and shift bonuses. Contract labor expense in Q2 declined approximately $6.8 million or 16% from Q1, and we experienced sequential declines in contract labor expense and FTEs for every month in Q2.

Contract labor FTEs, which had peaked at 749 in March, declined to 597 in June, a 20% decline. Contract labor rates also declined during the quarter. The Q2 2022 agency rate per FTE was approximately $222,000 as compared to approximately $240,500 in Q1. Rates also declined sequentially every month in Q2. Agency rates peaked at approximately $243,300 in February and declined 40% to approximately $209,300 in June.

Revenue reserves related to bad debt increased 50 basis points to 2.2%, primarily due to the impact of payer mix shift to Medicare Advantage and managed care, which have longer collection times and higher patient payment responsibility. Medicare contractors have also recently resumed the Targeted Probe and Educate initiative for IRF providers.

The resumption of TPE adds additional uncertainty to our near-term bad debt reserve requirements. As a result, within our affirmed 2022 guidance, we are increasing our expected revenue reserves related to bad debt from 2% to a range of 2% to 2.2%.

I would also like to point out that IRF's year-to-date free cash flow is $290 million and our full year 2022 expectation is for a range of $280 million to $380 million. The large difference between first half and second half free cash flow relates to cash tax payments, changes in working capital and capital expenditures, which are skewed to the second half of the year.

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

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QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question will come from Andrew Mok with UBS.

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

Good morning, Andrew.

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

Good morning, Andrew.

Andrew Mok
Analyst, UBS Securities LLC
Q

Hi. Good morning. I know you've held the full year guidance, but just wanted to better understand how the quarter tracked against internal expectations. And then, I think there is still a meaningful ramp in earnings in the back half of the year. Is there anything that you would call out besides labor as driving that sequential improvement? Thanks.

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

Yeah. So, I would say that – and I think it's evidenced in the fact that we're affirming our guidance that second quarter was very much in line with our expectations pretty much across the board. I think in terms of the puts and the takes that are going to drive improved results in the second half of the year, on the positive side, we expect continued year-over-year discharge growth. You've got the swing in the new store impact, which was a significant drag on EBITDA in the first quarter and turns modestly – or in the first half and turns modestly positive in the second half. We've got the pricing increase that will be implemented in Q4, and then the continuation of improving labor costs given the trend lines that I just outlined in my comments.

Weighing against that are the full implementation of sequestration which began on July 1 and then the anticipated increase or the uncertainty around the bad debt reserve. Andrew, I would suggest that those are the primary considerations.

Andrew Mok
Analyst, UBS Securities LLC
Q

Got it. That's helpful. And then, a lot of hospital operators are now forecasting lower inpatient demand in the back half of 2022. Just wanted to better understand what you're seeing in the market and whether any of that slowing inpatient utilization is having downstream impacts to your discharge growth. Thanks.

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

Andrew, this is Mark. We've not seen a negative impact. I think that given our ability to have the growth that we did in the second quarter, particularly compared against the very difficult prior-year comp, I think if anything we've seen in – more of the marketplaces are resuming to – from a acute care standpoint, kind of resuming to a more

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normalized business pattern with referral patterns looking similar to 2019 versus the last couple of years with COVID. Certainly, elective procedures have come back in place nicely as well. So, we're not really seeing anything that we would see that would impact negatively in the second half of the year.

Andrew Mok
Analyst, UBS Securities LLC

Q

Great. Thanks for the color.

Operator: Thank you. Our next question will come from Kevin Fischbeck with Bank of America.

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

A

Good morning.

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

A

Hi, Kevin.

Joanna Gajuk
Analyst, BofA Securities, Inc.

Q

Good morning. Actually, this is Joanna Gajuk filling in for Kevin.

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

A

Hi, Joanna.

Joanna Gajuk
Analyst, BofA Securities, Inc.

Q

Thanks so much for the taking the questions. How are you? So, I guess, on the contract labor, [ph] so first a (00:17:17) follow-up and then a question, but a follow-up on the contract labor, you said you assume will continue to decline [ph] and you've seen it (00:17:25). So, do you expect this level to return all the way back to 2019 or you think, as you exit the year, it's still going to be – continue to be elevated? How should we think structurally about, is the business model changing here or should we assume that there should be normalization into next year?

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

A

I don't think anybody really knows the answer to that, Joanna. There is certainly a lot of uncertainty about it. As we pointed out and provided some very tangible evidence, we do see that both based on market conditions and the proactive steps that we've been taking to address staffing that the utilization, the cost of contract labor is improving. I don't believe that we'll get back to 2019 levels by the time that we exit 2022. How long it takes to get back to those levels, assuming that we ever do, remains to be seen. But we do expect continued sequential improvement through the back half of the year.

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

A

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As we noted, the net new RN hires of 276 for the first half versus the 117 the prior year, I mean that shows the progress that we're making right now with our ability to hire nurses, which plays very favorable into the contract labor reduction story.

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

And bear in mind that 276 is same store. So on top of that, we were able to recruit sufficient nursing staff to address all of our new hospital openings in the first half.

Joanna Gajuk
Analyst, BofA Securities, Inc.
Q

Yeah, because actually that was my second question because it sounds like you keep opening and you keep start getting more both de novos, but also additional beds. So, it sounds like there are no really major issues in terms of staffing these new beds and new buildings. Is that the way to think about it?

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

That's correct. Staffing constraints have not impacted the timing with which we're bringing new capacity on board, and as we referenced in our remarks, nor have staff constraints in any way limited our volume as a whole.

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

We've been very pleased with the new de novo hospitals, in the new markets we're entering with the receptivity of the staff towards having a new hospital and, in some cases, a rehabilitation environment that did not previously exist.

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

We did experience some modest delays in bringing on a couple of the de novos and that was 100% attributable to actually constraints within the agencies that are required to provide approvals on a state and local basis. And they were experiencing some of their own staffing shortages. But nothing on our end was delaying the opening of new capacity.

Joanna Gajuk
Analyst, BofA Securities, Inc.
Q

Great. Thank you so much.

Operator: Thank you. Our next question will come from Brian Tanquilut with Jefferies.

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

Hey, Brian.

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

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Good morning, Brian.

Brian Tanquilut
Analyst, Jefferies LLC

Q

Hey. Good morning. I guess just to follow-up on the questions on contract labor. So maybe, Doug, as I think about the sign-on or shift bonuses that you've paid, I mean, it kind of flattened out from Q4 to Q2. How should we be thinking about that trend for the back half of the year and into next year?

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

A

Yeah. We would expect that to improve from the current run rate as well, but at a much more modest level than contract labor.

Brian Tanquilut
Analyst, Jefferies LLC

Q

[indiscernible] (00:20:59).

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

A

So, you really don't have an opportunity much there for rate reduction and it's really just then about the value that you're utilizing. And we think it's a pretty good trade right now to increase that number of net RN hires.

Brian Tanquilut
Analyst, Jefferies LLC

Q

Got it. Okay. And then maybe, Mark, as I think about the in-patient rehab growth target that you set out, 6% to 8% discharge figure through 2026, without the noise of Enhabit in the background anymore, maybe just any thoughts on how [ph] should we think (00:21:31) about makeup of that. I know you're obviously adding a lot of de novos, a lot of JVs. So, just maybe any color on how to get to that 6% to 8% over the next four years?

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

A

I mean, we're very enthusiastic about the runway there with the demographic tailwind. We know we brought on eight de novos last year, which previously that was the high. This year, we'll be bringing on nine. We've already set that up for next year as well. The bed addition strategy on top of the de novo strategy, I think, plays very favorable in our ability to grow this business and take advantage of the opportunities [ph] they have (00:22:14) in the marketplace. So between the continued demand and our ability to go out and add capacity to meet that demand, we've got a really nice runway ahead of us.

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

A

It will be a little uneven, as you saw, for instance, in this quarter depending on the comps that you're up against. But generally speaking, if you smooth it out over time, you expect something in the 2.5% to 3% range to come from same store with the balance being contributed by new store.

Brian Tanquilut
Analyst, Jefferies LLC

Q

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Awesome. Thanks, guys.

Operator: Thank you. Our next question will come from John Ransom with Raymond James.

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

Good morning, John.

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

Hey, John.

John W. Ransom
Analyst, Raymond James & Associates, Inc.
Q

Hey. Good morning. So, Doug, you won't like this question, I'd tell you, but it's the one I'm getting, so I got to ask it. So, the whole Enhabit process, I think, has – kind of at least at this point look a little disappointing. And so within the bounds of what you can tell us, how is it that the vanilla spin ended up being plan A and some type of spin/merger/sale couldn't have resulted? I mean, I think it's around 8.5 times EBITDA now and numbers have come down a couple of times, as you know. So, just what can you tell us to say, hey, this really was the best option and other things either weren't forthcoming or we just – for tax reasons or other reasons, we decided to go the route we did. Thank you.

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

No, John, it's a very fair question. And I know the process took a lot longer than most folks had anticipated. Let me tell you, it took a lot longer than we had anticipated at the outset as well. And the length of time that the process took was really a result of two factors. One is we had pretty volatile market conditions that occurred during the course of that process, and they shifted a couple of times, some of those COVID-related and some of those more just generally market-oriented.

The other thing is that our board wanted to make sure that we conducted an extremely thorough evaluation and that we looked at every one of those alternatives, and you enumerated a number of them, to choose the one that was going to generate the best long-term value for our shareholders. And the board is confident in the decision they made.

They also recognize that based on prevailing market conditions and just the way that spins work that this wasn't going to be something where the efficacy of the chosen transaction should be judged in a one-month or two-month or even a six-month period, but it will stand the test of time. And so, yes, it looks like Enhabit is off to a challenging start. Their call follows this one. They can address their operating results separately, but this is not done yet.

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

John, I'll add. This is Mark. I mean, a number of us are shareholders and we continue to have a great deal of confidence in that team at Enhabit. So, look forward to the future.

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

John, does that address your question sufficiently?

John W. Ransom
Analyst, Raymond James & Associates, Inc.
Q

I mean, I think that's all you can say, so I think that's fine. Now, my other question, let's say, the happier question is, you guys have been bogged down in this process, a lot of drama, a lot of time. And so, now that you're not – if we're sitting here a year from now, two years from now, what is different with legacy EHC that might not otherwise have been the case if you were still wrestling with Enhabit?

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

Well, I think we've articulated some of it here, we're very excited about what the future holds, about the opportunity for us to continue to grow in the IRF business. As you know, John, it's an area that we know quite well. We have a team here that's been built to contribute and develop that growth. And so, I think we're very excited about what the future holds.

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

Yeah. I think it just becomes a more focused story, John, maybe one that is a bit easier for those on the outside to understand and we'll be able to highlight the great returns that we're getting on invested capital, the superiority of our clinical results, the efficiency of our operating model and maybe really highlight some of the additional capabilities we're bringing to bear to the benefit of our patients and the caregivers who are involved with regard to new technologies and new clinical protocols.

John W. Ransom
Analyst, Raymond James & Associates, Inc.
Q

Thanks so much.

Operator: Thank you. Our next question will come from Pito Chickering with Deutsche Bank.

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

Hey, Pito.

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

Morning, Pito

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.
Q

Hi. Good morning, guys. Thanks for taking the questions. Labor spend is pretty volatile right now with all the moving pieces here. And this may be an exercise in futility, as you're [ph] stepping out of (00:26:59) contract labor costs, the sing-on bonuses and shift bonuses. But if we exclude contract labor and exclude signing bonuses and

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exclude shift bonuses, what are the hourly full-time employee rates in 2Q? How that compare sequentially versus first quarter? And where are you still seeing pressure or relief in those hourly rates?

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

A

Those are kind of interesting because we really began pretty aggressively in Q3 of last year making market adjustments for the internal FTEs to remain competitive. And so, as we move into back half of the year, we really expect that on that base of internal FTEs, we're going to see pretty normalized level of increase. So, call it, something in the 3.5% to 4% range.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Because there's so many moving parts year-over-year, I guess, [ph] exiting (00:27:55) sequentially 1Q, 2Q, are the average hourly full-time employee rate, is that stable?

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

A

Yeah. So, it was a little bit elevated in the second half because you weren't anniversarying that yet. But as we move into the second half, the comparisons get more favorable and we've really done what we needed to do with regard to market adjustments. And now, you're looking at just a more normalized merit cycle, which is slightly elevated over where it was, say, pre-2021, but not significantly.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Perfect. And then sort of two more sets of questions on that, on contract labor, you did give the number of FTEs in June. I guess, any color that you can give us on how much that costs in June or the run rate.

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

A

I did mention the rate in June. So, the rate was down to $209,300 in June. I don't want to give you a – we're not going to give a number on a monthly basis. We don't want to get into that habit, and continue to report it on a quarterly basis.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah. All right. Fair enough. Two more quick ones here. The [ph] accounting (00:28:59) for sign-on bonuses, is that realized over time or is it all upfront?

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

A

It's all upfront.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

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All right. Perfect. And then the last question is, as you track the ROIC sort of in the last 18 months for the bad add-ons versus, say, 2017, 2019, do you find that the ROIC in the bad add-ons on the new projects as they ramp is identical or similar to what it was sort of previous to 2019? Thanks so much.

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

A

Yeah. And it does depend on which vintage you're looking at. I will say that one of the things that we're experiencing right now is, as we evaluate new projects, we've got elevated construction costs, so the investment is going up, and right now, labor costs are elevated. So, that does impact particularly the early years of the P&L.

I will say that as a result, within our aggregate pipeline, there have been a couple of projects because of specifically difficult conditions in a particular market where construction labor costs may be impacted that we decided to stand down – not cancel, but to stand down on a couple of projects. It's been a very limited number. Out of a total pipeline that is typically comprised of about 50 projects, I think we're talking about less than a handful.

By and large, what we're able to see is even when we model in the elevated construction costs and assumptions about the trajectory and labor costs, we're still seeing projected returns that exceed by a pretty good margin our weighted average cost of capital, and that's why we're continuing to move forward with the capacity additions. Then, of course, any time we can add a better addition to either an existing facility or a recent de novo, that just serves to turbo-charge the return.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Great. Thanks so much, guys.

Operator: Thank you. [Operator Instructions] Our next question will come from Matthew Borsch with BMO Capital Markets.

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

A

Good morning, Matt.

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

A

Hello, Matt.

Matt Borsch
Analyst, BMO Capital Markets Corp.

Q

Thank you. Could I just ask about now that you're operating with a very strong focus on the in-patient rehab area, and I realize that, ultimately, you reached a conclusion that Home Health was not strongly synergistic enough to make it make sense to hold on to that, are there other areas that you might look at that you could see as synergistic that you'd be willing to share? And are you thinking about acquisitions at this stage? And if so, what types of things would you look at?

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

So, Matt, we're constantly scanning the landscape to decide if there are any compelling businesses that ought to be added to our portfolio, either because there is a gap in our existing model or because a new capability is required to take us to the next level.

With regard to moving into an adjacent space in the provider universe, there is nothing on our radar screen right now to suggest that it would be compelling. If you think, we've already made a decision and have separated out Home Health & Hospice, so the remaining adjacencies in the post-acute space would be LTACHs and SNFs. And as we've stated before, we think that there is going to be a gradual, but an ultimate progression towards some site neutrality with regard to post-acute inpatient facilities. And we think the best way to prepare for that is to continue to invest in freestanding IRFs.

And we say that because even if there is no change in the patient criteria and even if the evolution is very slow, the demand for inpatient rehabilitation services in this country remains very high and very underpenetrated. We again use as a prima facie estimate of that the fact that if you just look at the CMS 13 eligible discharges coming out of acute care hospitals in the US on an annual basis, less than 15% of those find their way into an IRF bed. So, there is a tremendous whitespace for us to grow into.

Moreover, if we do eventually move towards site neutrality [ph] for EQ4 (00:33:20) inpatient post-acute, it is our belief that the physical construction, the clinical expertise and the staffing complement that exist in the IRF model today are better positioned than either an LTACH or SNF to adjust to those changing conditions. So, that kind of addresses our thoughts on the provider community.

With regard to other services that we think could either enhance our value proposition or make us a more efficient operator, that's a constant evaluation. And when we evaluate those, we're trying to think about, A, what does it really do to position us more competitively? And B, is it something that we need to own or is it something we can replicate internally or buy as a vendor? So, that evaluation will remain open. And I can't point to any specific service line right now that we think is a must add-on for us.

Matt Borsch
Analyst, BMO Capital Markets Corp.
Q

Okay. Thank you for all that.

Operator: Thank you. Our next question will come from Sarah James with Barclays.

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

Hi, Sarah.

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

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Hi. Good morning. Can you help us understand what portion of your contract labor is related to permanent staff that is just on quarantine for testing positive? And then, as we move into the phases of COVID where spread rate is higher, but symptoms are lower, is there any discussion with the CDC or internally around testing frequency and quarantine length?

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

A

So let me take – this is Mark. I'll take the first portion of your question. Right now, given the current rates of COVID, as we see in the marketplace, we're not experiencing staffing difficulties where we would be bringing in contract labor to offset quarantined staff at this point. So it has pretty much neutralized out there in the marketplace versus where it might have been in the peak periods from last year or even prior year to that.

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

A

And then second part of your questions, Sarah, is yes, there is flexibility within the CDC guidelines for a member of our clinical staff who receives an exposure to COVID to still be able to work providing that they meet certain – that they're able to pass the test.

Sarah E. James
Analyst, Barclays Capital, Inc.

Q

Great. And then, just wanted to circle back on capital deployment. I know, part of your strategy has always been to buy property or build footprints that are larger than you initially need to give you the flexibility to build out more space. Can you give us an idea of where you guys are in that process? Like how many of your facilities have that capacity to add rooms or add therapeutic space within existing footprint?

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

A

Yeah. So, I would say, almost without exception, every de novo that we have brought on board in the last 10 years still has room for – there may be one or two that are exceptions, but still has room for additional capacity growth. Typically, we are buying 5 to 7 acres of usable land to house a de novo. We're building a single-storey facility that can be expanded without disruption to the existing capacity that's there as well.

It's much more of a mixed bag within our legacy hospitals. You've got a greater variety in terms of the physical construction of those, and location, and CON requirements, and so forth. But we remain very confident in that, an ability to add 100 to 150 beds per annum to the existing base.

Now, some of that's going to be a little bit lumpy just based on timing. As an example, Mark alluded in his comments to the fact that we now think just based on timing where one project has moved from late in Q4 to early in Q1 of next year that we're going to open up 90 beds this year, and we will probably be towards the high end of the range next year.

Sarah E. James
Analyst, Barclays Capital, Inc.

Q

Great. Thank you.

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Operator: Thank you. At this time, there are no further questions. So, I would like to turn the call back over to Mark Miller for any additional or closing remarks.

Mark Miller

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

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

Operator: Thank you, ladies and gentlemen. This concludes today's conference and we appreciate your participation. You may disconnect at any time.

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