08-Feb-2023

Encompass Health Corp. (EHC)

Q4 2022 Earnings Call

Copyright © 2001-2023 FactSet CallStreet, LLC

CORPORATE PARTICIPANTS

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

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

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

OTHER PARTICIPANTS

Kevin Fischbeck
Analyst, BofA Securities, Inc.

A.J. Rice
Analyst, Credit Suisse Securities (USA) LLC

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Andrew Mok
Analyst, UBS Securities LLC

Ben Hendrix
Analyst, RBC Capital Markets LLC

Brian Tanquilut
Analyst, Jefferies LLC

Matt Larew
Analyst, William Blair & Co. LLC

Ann Hynes
Analyst, Mizuho Securities USA LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone, and welcome to Encompass Health's Fourth 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 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 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 fourth quarter 2022 earnings call. Before we begin, if you do not already have a copy, the fourth quarter earnings release, supplemental information and related Form 8 -K filed with the SEC are available on our website at encompasshealth.com. On page 2 of the supplemental information, you will find the Safe Harbor statements, which are also set forth in greater detail on the last page of the earnings release.

During the call, we will make forward-looking statements, which are subject to risks and uncertainties, many of which are beyond our control. Certain risks and uncertainties like those relating to regulatory developments as well as volume, bad debt and labor cost trends that could cause actual results to differ materially from our projections, estimates and expectations, are discussed in the company's SEC filings, including the company's

Copyright © 2001-2023 FactSet CallStreet, LLC

earnings release and related Form 8-K and the Form 10-K for the year ended December 31, 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 of future events and speak only as of today. We do not undertake a duty to update these forward-looking statements.

Our supplemental information and discussion on this call will include certain non-GAAP financial measures. For such measures, reconciliation to the most directly comparable GAAP measure is available at the end of the supplemental information, at the end of the earnings release and as part of the Form 8-K filed yesterday with the SEC, all of which are available on our website.

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

With that, I'll turn the call over to Mark Tarr, Encompass Health's President and Chief Executive Officer. Mark?

Mark J. Tarr

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

Thank you and good morning, everyone. Fourth quarter was a very strong finish to 2022, driving our full-year results to the top end of our guidance range. Patient volume remained a particularly bright spot with Q4 discharge growth of 7.3%, contributing to a full-year discharge growth of 6.8%. Continued vigilance on labor management and a solid contribution from our 2022 de novos, facilitated Q4 year-over-year adjusted EBITDA growth of 16.4%.

For fiscal year 2022, we were able to overcome an increase of approximately $70 million in contract labor and sign-on and shift bonuses, $16 million in net pre-opening and new store ramp-up costs at our de novos. And double-digit second half inflation in food and utility costs to generate a year-over-year increase in adjusted EBITDA. And we did so while continuing to strengthen our competitive position. We invested nearly $600 million in CapEx in our business in 2022. This includes upgrades to many of our legacy hospitals, in many instances reducing or eliminating semi-private rooms and shared bathrooms as well as building replacement hospitals in two key strategic markets, Huntsville, Alabama, and Tustin, California.

We also continued to invest in our facility-based technology through initiatives like our Tablo onsite dialysis rollout. We now offer in-house dialysis in 41 of our hospitals and will continue the roll out in 2023. Reducing our reliance on third-party providers in obviating patient transport to receive this service, leads to fewer disruptions to therapy schedules and improved patient outcomes and satisfaction. It also reduces our cost for these services.

A central element of our strategy is investing in capacity expansions to meet the needs of a significantly underpenetrated and growing market for inpatient rehabilitative services. In 2022, we opened nine de novo hospitals, the most ever in a single year for us. These facilities exceeded our expectations by contributing $4 million in four-wall EBITDA in Q4. We also added 87 beds to existing facilities, leading to a net 4.4 increase in licensed beds in 2022.

As we've mentioned previously, we are increasingly utilizing prefabrication alternatives to contain design and construction costs and increase our speed-to-market. Our use of prefabrication has progressed from head walls to bathrooms to exterior walls and in 2022, Uber Modules, which are two-patient rooms adjoined by a corridor. We anticipate piloting full hospital prefabrication beginning in Q3 of this year with anticipated cost savings of almost

Copyright © 2001-2023 FactSet CallStreet, LLC

15% and speed-to-market gains of 25% as compared to conventional construction once the program is fully ramped.

We complemented these investment in our business with the return of nearly $100 million to our shareholders through the cash dividend on our common stock. The strength and consistency of our free cash flow generation allowed us to fund these investments and shareholder distributions, primarily with internally-generated funds. Our leverage in Q4 was 3.4 times, unchanged from Q3 and our liquidity remained strong.

Evidenced by our strong and consistent discharge growth, our value proposition continues to resonate across our constituencies. Within our payor mix, we further consolidated gains made with Medicare Advantage, achieving 4.1% discharge growth in 2022. Our Q4 same-store Medicare Advantage discharges were 41% higher than Q4 of 2019. The normalization of patient flows through healthcare facilitated 8.6% discharge growth in Medicare fee-for-service. We do believe that Q4 volumes benefited from early and aggressive flu season as well.

None of this success has been accomplished without more than 30,000 dedicated associates. The past three years have been complicated with a lingering pandemic, tightening labor market, burgeoning inflation and the strategic alternatives view for our home health & hospice business. Our team has consistently risen to meet these challenges and to seize opportunities. Our value proposition and our operating strategy have been further validated and we remain highly optimistic about the long-term prospects of our business.

As is our custom, today we are also providing our initial guidance for 2023. Our revenue guidance reflects our expectations of continued high-single digit growth, driven this year by both volume and pricing gains. We also expect solid adjusted EBITDA growth. Given continued uncertainty around the trajectory of further labor cost improvements and the impact of the inflation elsewhere in our cost structure, we believe it is prudent to exercise some caution in establishing our initial guidance range.

Our 2023 guidance includes revenue of $4.68 billion to $4.76 billion, adjusted EBITDA of $860 million to $900 million, and adjusted EPS $2.87 to $3.16. A list of considerations underpinning these guidance ranges can be found on page 13 of the supplemental slides.

I also want to note that we are planning to host an Investor Day in New York City on September 27, 2023. At that meeting, we'll provide more detailed insight into key elements of our strategy, including de novo hospitals, clinical technologies, and labor management. We'll also provide investors with the opportunity to hear from an array of our teammates within the senior management ranks. Please mark your calendars for September 27. Details will follow in the days ahead and we hope to see you there.

With that, I'll turn it over to Doug to provide some further details on our operating results.

Douglas E. Coltharp

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

Thank you, Mark, and good morning, everyone. As Mark stated, we are very pleased with our Q4 results. Revenue for the quarter increased 9.1% over the prior year to $1.14 billion, and adjusted EBITDA increased 16.4% to $232.7 million.

We continued to see strong volume growth in Q4. Discharges grew 7.3%, which combined with a 2.2% increase in revenue per discharge to drive 9.6% inpatient revenue growth. On a same-store basis, discharges grew 4.2%. For the full year, 2022 discharges increased 6.8%, and that was on top of 8.7% growth in 2021.

Copyright © 2001-2023 FactSet CallStreet, LLC

In 2021, when the clinical labor market began tightening and contract labor and shift bonuses started to rise, we made the strategic decision to continue to admit IRF-appropriate patients, regardless of the financial burden to our company. This allowed our hospitals to provide value to our patients, referral sources, and payors. As a result, we are experiencing gains in market share. We made further progress on reducing labor cost in Q4. Our Q4 contract labor plus sign-on and shift bonuses of $35.4 million was comprised of $19.7 million in contract labor and $15.7 million in sign-on and shift bonuses.

Contract labor expense in Q4 declined approximately $5.1 million or 20.6% from Q3, $10.3 million or 34.3% from Q4 2021 and $22.2 million or 53% from the peak in Q1 2022. We experienced sequential declines in contract labor expense and FTEs for every month in Q4 and in fact for every month since last March. Contract labor FTEs for December were 325 compared to 749 in March. Our contract labor expense is fairly concentrated with approximately 50% of the spend occurring in 20 hospitals.

Agency rates ticked up in Q4 versus Q3. This was due in part to the premium pay associated with holiday shifts. The Q4 agency rate per FTE was $211,000 compared to $205,000 in Q3. Agency rates remain market-specific and highly variable. Reducing contract labor spend remains a key focus for us, and we expect year-over-year improvement in 2023 albeit with some uncertainty around the trajectory of these costs.

Our December contract labor FTEs of 325 was in the range of 300 to 350 we had estimated in our Q3 earnings call as an exit level for 2022. The seasonality of our business and capacity growth via new hospital openings and bed expansions may lead to some incremental needs for contract labor FTEs.

Sign-on and shift bonuses decreased $8.5 million sequentially to $15.7 million in Q4 from $24.2 million in Q3. This represents a decline of $5.7 million from Q4 of 2021. Sign-on bonuses declined by approximately $700,000 from Q3. Much of the Q4 sign-on bonus spend was tied to new hires in Q3 and prior.

We saw an approximately $8 million decline in shift bonuses sequentially. You will recall that in Q3, sift bonuses were elevated to cover periods of unexpectedly high clinical staff PTO usage during the summer. We have also made significant progress standardizing the process around shift bonus utilization and rate.

We expect year-over-year improvement in sign-on and shift bonuses in 2023 as well, but there remains a trade-off between our utilization of these bonuses and our objectives for reducing contract labor FTEs. Specifically, shift bonuses pay to existing associates and sign-on bonuses pay to new hires provide a positive arbitrage against current contract labor rates. As such, we expect the year-over-year improvement in sign-on and shift bonuses in 2023 to be less pronounced than the anticipated improvement in contract labor. Our efforts in hiring and retaining clinical staff remain our best option for mitigating contract labor and shift bonuses.

For the full year of 2022, we had net same-store RN hires of 427. As we have discussed previously, we have made significant investments in our in-house recruiting capabilities. This includes the establishment of a centralized recruiting function and a significant expansion of dedicated resources. Our centralized talent acquisition team is now comprised of 73 associates. We have also increased our investment in marketing support for our recruiting efforts. As a result, recruiting and relocation costs in Q4 increased to $7.8 million from $3.2 million in Q4 2021. And for the full year 2022, this investment increased to $24.5 million as compared to $12.7 million in 2021. These expenses are included in our other operating expenses.

Food cost per patient day increased 15.9% from Q4 2021 and 0.7% from Q3 2022. Utilities cost per patient day increased 16.1% from Q4 2021 and declined 11% from Q3 of 2022. Sequential decline in utilities cost per patient

Copyright © 2001-2023 FactSet CallStreet, LLC

day was primarily attributable to seasonal weather patterns. We anticipate continued inflationary pressures in the first half of 2023 before lapping the larger increases in the second half of the year.

Our de novo and bed addition strategy continues to generate solid growth and contribute to share gains. Our de novos performed exceptionally well in Q4, contributing $4.2 million in adjusted EBITDA. Recall that we had expected the de novos to breakeven in the fourth quarter after experiencing administrative delays in openings and hurricane-related disruptions in Q3. Much of the overachievement in Q4 was attributable to our Naples and Cape Coral de novos, which rebounded from Hurricane Ian much faster than anticipated.

We plan to open eight new hospitals in 2023 and add approximately 80 to 100 beds to existing hospitals. Three de novos, totaling 149 beds are scheduled to open in March with an additional 50-bed hospital scheduled to open in April. As such, a significant portion of the estimated $10 million to $12 million in net pre-opening and ramp-up costs for 2023 is expected to be incurred in the first quarter.

As you may have noted on page 18 of our supplemental materials, we have changed our expectation for annual bed additions from a range of 100 to 150 to a range of 80 to 120. There are two reasons for this revision. First, we have been increasing the initial bed count in our de novos. The average number of initial beds in our de novos opened in 2018 to 2020 was 42. That average increased to 44 for the 2021 de novos and 46 for the 2022 class. The average number of beds in the de novos we expect to open from 2023 to 2025 is 49.

The larger initial footprint creates incremental leverage on the core infrastructure of the hospitals, thus serving as a partial litigant to higher construction costs and effectively front-end loads future period bed growth. You may recall that I spoke about this in response to a question on our third quarter earnings call. The increase in the initial size of new hospitals has effectively boosted the number of beds associated with our de novo strategy by an average of approximately 56 per annum.

Our market density strategy is also a factor here. In certain large and growing markets, we have chosen to open an additional hospital instead of adding beds to an existing hospital. This allows us to better serve the market by overcoming geographic barriers and traffic patterns, and placing the new beds closer to incremental referral sources. We have successfully deployed this strategy in markets like Dallas and Houston, and are now doing so in certain other markets, including most recently Tampa and Orlando.

I'll also note that our 2022 maintenance capital expenditures of $238.4 million was higher than the estimate of $195 million to $215 million cited in our Q3 earnings report. Relief of supply chain bottlenecks and mild weather in many northern markets allowed us to proceed with several projects that we had assumed would be delayed.

As you can see on pages 14 and 15 of the supplemental materials, we expect both maintenance and discretionary CapEx in 2023 to be consistent with 2022.

With that, we'll open the lines for Q&A.

Copyright © 2001-2023 FactSet CallStreet, LLC

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And we will take our first question from Kevin Fischbeck with Bank of America. Please go ahead.

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

Hey. Good morning, Kevin.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

Good morning. Great. Thanks.

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

Good morning.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

I guess the main question I had was around labor costs. I guess the actual wage inflation itself looked a little bit low, and I guess when we – in one of your [indiscernible] (22:32) you have the number of net same-store nurses added. The figure was negative in the quarter after some pretty strong hires in the first three quarters of the year. So would love to get a little more color about, I guess, maybe what happened in Q4. And if you're still talking about sign-on, shift bonuses, why does the core wage growth kind of drop down to 3%?

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

Yeah. So, Kevin, I think in terms of the internal SW per FTE, that has been running right about 3%. And some of that has to do with the fact that we made a series of market adjustments really beginning in the latter part of 2020 that have now anniversaried. So we think that that for internal SW per FTE is a good estimate. We do note that benefits, which typically make up about 10% of SWB, is expected to increase by about 5% in 2023. And that's just the cost that we're seeing, the inflation that we're seeing in group medical expense.

With regard to the hiring in Q4, your observation is correct. We did take a step back. The good news is it wasn't on the hiring front. So if you look at Q4 of 2022, our hires – gross hires for our RNs was 530. And that compares to 310 in Q4 of last year, so an increase of 220. Unfortunately, it was more than offset by terminations during the quarter which were 562 as compared to 264 of – Q4 of 2021, so an increase of 298.

So that took us from a Q4 2021 net positive of 46 to a decrease of 32 in Q4 of 2022. Virtually all of that was attributable to increased terminations within first year RNs. That rate rose to 45.3% this year versus 36.6% in the 2021 quarter. We think that was a bit of an aberration because for the full year, our termination rate for first year hires actually improved year-over-year from 45% to 41%. So a lot of detail in there, Kevin. We did take a step back. We don't think that necessarily portends that we'll have a higher termination rate moving into 2023. Frankly, some of that appeared to be tied to bonus [ph] topping (25:08) based on increased volumes tied to flu volumes in some of the acute care hospitals and again, we don't necessarily think that that's going to be a persistent trend.

Copyright © 2001-2023 FactSet CallStreet, LLC

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

A

So, Kevin, clearly, we have a focus not only on the recruitment of nurses, but also on the retention. We've put in things in place this year in terms of bonus structure. Our CEOs will be having a very strong focus on making sure that we retain the nurses that we've hired in the past. Especially those within that first year, we've seen kind of a spike in nurses that turn over within the first year that we hire them. So it's an all hands on deck to make sure that we are putting forth a very solid orientation, that we bring these new nurses into our hospitals, have them orient with mentors, with folks that are seasoned in our hospitals, that they have a comfort level in caring for the rehabilitation patients that we have and so that they want to be there for a long time. So it's both recruitment and retention.

As Doug noted, I'm not taking anything away from the Q4 drop-off as being alarming. I think that our strategy of having a centralized recruitment function and talent acquisition continues to be a good move. It took a lot of the pressure off of our hospitals to keep up with this function. We aren't staffed at the hospitals to take on this task with the same degree that we have here from a centralized function in Birmingham. So we are very focused on both the recruitment and retention of nursing staff.

Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

All right. That's helpful. I guess second question then just being, I guess in your prepared remarks, you guys said that you thought it was prudent to have some conservatism in the guidance. Is there anything in particular in here where you say, this is where we kind of decided to put our finger on the scale a little bit in the area of being prudent, or is it just broad-based?

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

A

I would probably point to a couple of things that just really reflects some of the uncertainty. We put in an assumption of 2.5% to 3% Medicare price increase in Q4. If you look at where the input factors have been over the last couple of years, it would certainly point you and justify a higher increase. But the nice increase that we saw in the existing fiscal year notwithstanding, we really reflect it back on what we'd seen over the 10 years prior, and so put that assumption in. We've also put in what I think is a pretty reasonable assumption with regard to the increase that we're getting from other payors.

The other factor that's in on our guidance that may not appear immediately available to you is that we are anticipating that we will see some normalization as we move from 2022 to 2023 in both our length of stay and our EPOB. And so just to give you some specifics there, for fiscal year 2022, our length of stay was 12.7. It was actually 12.5 in Q4 of 2022. And the EBITDA flow-through is very sensitive to small changes in this metric. In fact, moving that metric by just 0.05 can have an impact of approximately $8 million to $10 million on EBITDA.

We think that the 12.5 is not something that is necessarily sustainable, particularly given the acuity that we've been running. CMI has been hanging in there right in the kind of 1.44, 1.45 range. We're also expecting further normalization in our EPOB. Fiscal year 2022 EPOB ran at 3.35. It was 3.38 in Q4. And you've probably seen in our guidance assumptions that our expectation for 2023 is 3.4. Some of that is attributable to the cumulative effect of opening 17 hospitals over two years. This, again, is a very sensitive metric, and every 0.05 increase in EPOB translates to about $6 million to $8 million in EBITDA depending on where you are in the guidance ranges.

Copyright © 2001-2023 FactSet CallStreet, LLC

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

And it's worth noting that 3.4 EPOB is the same EPOB levels we were running pre-pandemic in our hospitals.

Kevin Fischbeck
Analyst, BofA Securities, Inc.
Q

Okay. That's great. Thank you.

Operator: And we'll take our next question from A.J. Rice with Credit Suisse. Please go ahead.

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

Good morning, A.J.

[indiscernible] (30:01)

A.J. Rice
Analyst, Credit Suisse Securities (USA) LLC
Q

Hi, everybody. Thanks. Maybe first just a little bit more on the pricing assumptions and where you see things evolving at this point. I guess Medicare Advantage and managed care together are about 26% at least of your fourth quarter revenue. Are you seeing – I mean, you've got a step-up in the underlying rate normalizing for sequestration for Medicare fee-for-service? Are you seeing a little pickup in the rate from your managed care, either MA or straight managed care or any move to some of this value-based type of stuff? Is that becoming more a part of what you're contracting for?

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

You've got to break the Medicare Advantage to that which is paid on a CMG basis and that which is paid on a per diem basis. And as we've talked about a lot in the past, we've made great progress over the last five years plus of moving more of our contracts to the CMG bases, which are tied specifically to the Medicare rate. So, right now, about 88% of our Medicare Advantage revenues are paid on CMG basis, and those move in lockstep with Medicare.

The per diem contracts layer and virtually all of the managed care are one off contracts that have to be negotiated, most of them on an annual basis. And that's – frankly, that's a guerrilla warfare around those and it'll take getting into this year to see what kind of increases we're able to wrestle from those payors.

With regard to the movement towards more value-based care and risk sharing arrangements, we feel like we have been more ready than the payors to enter into those types of arrangements. But I would say that little traction has been made to date.

[indiscernible] (31:51)

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

Copyright © 2001-2023 FactSet CallStreet, LLC

...providing our hospitals, though, A.J. I would say that if we had the opportunity to work with payors and as Doug noted, we've certainly reached out to them in terms of including a value-based component. It's just been – it's been difficult for them to think about how to administer that.

A.J. Rice
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. And maybe just as a follow-up on the labor. You talked a lot about the RN side of it. Anything new or different? What kind of an increases for physical therapist and therapist generally? Is it similar to last year or is there anything changing there? And maybe just to remind us what percent of your labor is RNs versus therapists?

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

A

So just in general, on the marketplace for therapists, we've seen some limited number of markets that have had a little bit more pressure on therapists, not just PTs, but it's OTs and speech therapists as well. But that's been pretty much isolated on certain markets where there's been pressures, nothing near what we've seen relative to nursing. But we've had to respond in those markets the same way we've responded in markets for nursing. But keep in mind, I mean, our turnover on therapy is around 8% for licensed therapists. So it is nowhere near the degree of turnover that we have in nursing.

A.J. Rice
Analyst, Credit Suisse Securities (USA) LLC

Q

[ph] Got you (33:20)

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

A

And, A.J., to your second question in terms of our hospital staffing and this is based on the number of FTEs, about 37% of the staff is comprised of nursing, 21% is therapy. And the balance would be administrative and support personnel.

A.J. Rice
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay, great. Thanks a lot.

Operator: We will take our next question from Pito Chickering with Deutsche. Please go ahead.

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

A

Hey, Pito.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Hey, good morning, guys. Thanks for taking my questions. First one here is how should we think about fixed cost leverage from OpEx in GA and 8.5% revenue growth throughout the midpoint of the guidance? Any color on what percent of these expenses are fixed versus variable?

Copyright © 2001-2023 FactSet CallStreet, LLC

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

A

Now that's a good question. There's a little bit more influx right now because of the inflationary rates that we're seeing around food and utilities. And again, we've got to go through the first half of the year before we anniversary those. And just because of the volatility in contract labor sign-on and shift bonuses. The other variable that I would point you that's changing that equation a little bit and really should be just a onetime adjustment in 2023, is that normalization in the length of stay and the EPOB hat I referenced previously.

If you think just about that EPOB adjustment going from where we were this year with the 3.38 to 3.40, if in fact, we go all the way there, even though you're getting good leverage on total SWB with it growing about 1.5% on a year-over-year basis, 1.5 to 2% based on the improvement in contract labor and sign-on and shift bonuses, you're increasing your FTE count by about 8% and so that's causing some leverage in there. So you've got kind of both puts and takes with regard to our 2023 assumptions around the composition of fixed costs.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. But I mean...

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

A

[indiscernible] (35:17) exactly to a breakdown of the percentage, but there is a little bit more influx this year.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah, so I get it on EPOB. But specifically, if I think about OpEx and G&A, I mean, on the OpEx side, I guess, besides food cost, what in there is really variable and same in G&A, kind of what there was actually variable versus fixed?

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

A

So, first of all, I think you're seeing really good leverage within G&A. About the only category that we don't expect to lever in 2023 is that we are going to annualize some of the second half of the year staffing additions in the recruiting function. And so you'll see an increase is probably a little bit on the higher side in that category, but really not enough to move the needle. And that's included in OOE within the hospitals.

Corporate G&A, we should see some continuing leverage on. Within the kind of the operating segment P&L, obviously, the most leverageable portion of that expense is occupancy costs. And then, as you move further up the P&L, we get good leverage off of the administrative staff as well. And then you're getting into a whole lot of variable costs, remembering again that almost 55% of every revenue dollar is consumed by labor.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. And then sort of a quick follow-up here on the new denials you saw in the fourth quarter. How should we think about sort of the system denials sort of in 2023, you're also changing bad debt guidance of sort of 2%, 2.2%, but just how [ph] should we be thinking of (36:50) denials sort of accelerating in 2023?

Copyright © 2001-2023 FactSet CallStreet, LLC

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

So activity is definitely up across the board. We had enjoyed some cessation, some relief during – really starting with March of 2020. And then, even as the switch got turned back on, it was kind of slow to ramp up. But, basically, all of the MACs are engaged in some form of audits before.

We continue to be frustrated by misinterpretations and misunderstandings of the Medicare guidelines in the claims denial process. We have had some success, including recent success, in being able to educate certain over the MACs about the requirements and about how we were meeting those requirements. And those resulted in denied claims being reversed. But with many other MACs, it is a slow process and sometimes can even take years and multiple layers of appeal to reverse.

When we look at the appeals process, whether it's the ALJ or the DAB, one of the frustrating parts is kind of these blanket denials of claims, which of course indicate to us that they are not making a review of each claim upon its individual merits, which is required by law. So, that's another element that we're battling. We put in what we think is the most realistic estimate of how we will see bad debt trending. I don't know that there's anything on the horizon that would suggest a spike above that, nor do we necessarily expect any kind of immediate improvement.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.
Q

Great. Thanks so much.

Operator: And we'll take our next question from Andrew Mok with UBS. Please go ahead.

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

Hello, Andrew.

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

Good morning, Andrew.

Andrew Mok
Analyst, UBS Securities LLC
Q

Yeah. Hi. Good morning. Wanted to follow up on guidance of – by my estimates the 4Q EBITDA run rate annualized is above the high-end of the guidance range even after considering the de novo outperformance in Q4 and incremental start-up losses for 2023. You called out normalization in length of stay and EPOB as potential headwinds. But it sounds like the assumptions embedded in the 2023 guidance are close to what you experienced in Q4 length of stay, finished the quarter at 12.5 days, and EPOB finished at 3.39. So, one, do I have that right with respect to assumptions for 2023? And are there any other specific headwinds that you would call out that bridge just back to the midpoint of the guide? Thanks.

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

Yeah. So actually Q4 length of stay was 12.5. And as I mentioned earlier, each05 movement in that metric can translate to $8 million to $10 million in EBITDA. Now Q4 EPOB was 3.38 but the expectations we've laid out there

Copyright © 2001-2023 FactSet CallStreet, LLC

is 3.4, and every.05 increase in EPOB translates to about $6 million to $8 million of EBITDA. So I think those two assumptions alone would kind of bridge you from your Q4 run rate once you've normalized the de novo impact to something that looks like the midpoint of our guidance range.

Andrew Mok
Analyst, UBS Securities LLC

Q

Got it. Okay. That's helpful. And then it sounds like the de novos drove $4 million of outperformance in Q4. One, can you help us understand what drove that outperformance? And if is there any reason to think that that outperformance would continue into 2023? It seems like a faster de novo ramp would have a positive follow through for 2023 as well. Thanks.

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

A

I think that's a very good point. And really, we didn't factor that into 2023 simply because it's not something that we have a lot of visibility into. As I mentioned in my prepared comments, when we set the expectation for Q4 that de novos would breakeven, it was because we had experienced really just on the front-end of our Q3 earnings call, we'd seen some administrative delays that pushed the opening dates on a number of our de novos out further, which meant that the time that they were really starting to ramp-up had been delayed.

And we saw some pretty significant disruptions to our Cape Coral and our Naples hospitals from Hurricane Ian. And we had expected that those would linger and impact Q4 as well. Naples and Cape Coral rebounded remarkably quickly. A real credit to our teams down there in Q4 and contributed nicely, and the hospitals that we had assumed that had other administrative delays that would kind of lag a little bit in Q4, also contributed above our expectations.

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

A

I think also you're seeing a bit of – we mentioned this market density and where we've built de novos, where we have strong number of other hospitals, we have other resources there, staffing expertise, you're starting to see where staff can move from one hospital to the next, that you're starting de novos up with at least a portion of the senior team at the de novo hospital, is a seasoned, experienced Encompass Health staff member. So they can work their way up the learning curve very quickly.

And I think that is exactly what we saw at Naples and Cape Coral, both of those hospitals had existing CEOs from other hospitals transfer in to do those startup. I do want to throw out my compliments to that group too, in terms of working through the hurricane and working through the startup process.

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

A

And some of what impacts the ramp-up of a new hospital, there are two important factors to consider. One that Mark just touched upon, which is if we're proximate to an existing market because the payers are known to us, because the referral sources are known to us, because we can leverage the existing staff, the ramp-up tends to be faster than when we go into a brand new market. And when we have a JV partner, the ramp-up tends to be a bit faster as well, because we can leverage some of the relationships they have also.

And you've got a bit of a mixed bag on those if you look at the 2023 class. Looking specifically at the first quarter, Eau Claire, Wisconsin is going to be a brand new market for us as is Knoxville, Tennessee, Owasso, Oklahoma.

Copyright © 2001-2023 FactSet CallStreet, LLC

We're going to be able to leverage Clermont. We're going to be able to [indiscernible] (43:32). So there's a little bit of each of those included in that class.

Andrew Mok
Analyst, UBS Securities LLC

Q

Great. Thanks for the color.

Operator: And we'll take our next question from Ben Hendrix with RBC Capital Markets. Please go ahead.

Ben Hendrix
Analyst, RBC Capital Markets LLC

Q

Hey. Thanks, guys.

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

A

Hey Ben.

Ben Hendrix
Analyst, RBC Capital Markets LLC

Q

Good morning. How are you all?

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

A

We're good.

Ben Hendrix
Analyst, RBC Capital Markets LLC

Q

Good. A quick question on case mix. Most of my questions have been answered, but you've stressed focusing on stroke and neurological volume in the past and having a higher than industry mix of that higher acuity volume and differentiated capabilities around stroke and neuros. Just want to see how that's progressing, if there's anything to call out in terms of case mix in general and how you see that evolving in the 2023? Thanks.

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

A

Yeah, I think – well, our case mix has been relatively flat. If you look at our program mix with stroke, we continue to be strong performer there with a little bit over 18%. You add another 20-some percent in neurological. So what we've said over the last couple of years now is we've built up our expertise in just neurologically-based conditions, stroke in others, and accounts for almost – a little over 40% of our discharges. If you look at our ability at the time of discharge to get patients back to home, that's an area that we continue to excel, almost 83% of our total discharges this last quarter went back to the community.

So the association with our ability to have better outcomes with stroke population, I would say, the relationship that we have with American Heart – American Stroke Association in terms of co-branding this, has helped to continue to put our name out in the forefront in our markets in terms of caring for stroke patients and those patients suffering from neurological conditions.

Copyright © 2001-2023 FactSet CallStreet, LLC

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

Both stroke and neurological showed growth on a year-over-year basis in Q4. But as a percentage of payor – patient mix actually declined slightly. And that was because we have pretty significant increase in debility and that is directly attributable to the flu season that was very prevalent in Q4.

Ben Hendrix
Analyst, RBC Capital Markets LLC
Q

Great. Thanks for the color, guys.

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

You're welcome.

Operator: And we'll go next to Brian Tanquilut with Jefferies. Please go ahead.

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

Good morning, Brian

Brian Tanquilut
Analyst, Jefferies LLC
Q

Hey, good morning, guys. Good morning, congrats on the quarter. I guess, Doug, just as I think about modeling, anything you would call out from a seasonality perspective or just how we should be thinking about the cadence of EBITDA over the course of the year?

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

I would expect this to be kind of a normal year with regards to seasonal trend. The timing of the de novos has some impact, but otherwise the normal factors with regards to seasonality that go from quarter-to-quarter should be prevalent.

Brian Tanquilut
Analyst, Jefferies LLC
Q

Got it. And then, I know in your prepared remarks you called out that 20 markets where you're seeing some contract labor tightness – or labor tightness and high use of contract labor, anything you can share with us on maybe which those markets are and any improvement or anything, any color on rate trends in those specific markets that we should be thinking about?

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

Yes. The Northeast remains the most challenging market both in terms of the number of contract FTEs and the rates as well. I would say that our team has been really focused. The regional team there has been really focused on that through the course of the year, and they've made great sequential progress. But there are a couple of

Copyright © 2001-2023 FactSet CallStreet, LLC

markets in and around the Boston area is one that I would cite that have remained a bit in transit with regard to progress. But the team is really focused on it.

Brian Tanquilut
Analyst, Jefferies LLC

Q

All right, got it. Thanks.

Operator: [Operator Instructions] We'll go next to Matt Larew with William Blair. Please go ahead.

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

Hey, there, Matt.

Matt Larew
Analyst, William Blair & Co. LLC

Q

Yeah. Hey. Good morning. Just wanted to follow-up a bit on the share taking and just get a sense for if you kind of dial back the last 24 months, how much of a sense you have for that coming from specific payors or payor categories, perhaps from competitive IRFs relative to eligible patients at site of care shifts from other post-acute settings? Just anything you can help us out with for a little more color on share taking.

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

A

Yeah. I think in [ph] general (48:23), you've heard us talk about this in the past, but I absolutely think during the pandemic, our ability to take COVID patients and show that we can take a very challenging, high acute patient with medical complexities and do a really good job in getting them back to community, has continued to pay dividends as we move forward into a more normalized operating environment.

I think that referral sources have recognized that not all post-acute settings are created equal, particularly between skilled nursing facilities, nursing homes and IRFs. I think that clearly IRFs and LTACHs stood out in terms of their ability to take challenging patients. And so, I think that we've seen – certainly have taken market share in those communities, particularly where there were nursing homes that were trying to pattern themselves and claim to be rehabilitation facilities and probably over-extended a bit in terms of their ability to take rehab-oriented patients.

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

A

Matt, the strength has really been very prevalent in the two major payor categories for us, which are fee-for-service and Medicare Advantage. If we look at same-store discharge growth in the Q4 of this year, Medicare fee-for-service was up 5.9%, for the full year 2022 it was up 3.9%. We've had seven consecutive quarters now of fee-for-service discharge growth.

Copyright © 2001-2023 FactSet CallStreet, LLC

We had mentioned relatively early in the pandemic back in 2020, when we were seeing a pretty dramatic increase in Medicare Advantage, that we felt that our ability to demonstrate our value proposition through difficult times like that was really going to have some staying power with regard to Medicare Advantage. And in fact that's proven to be true, because our Medicare Advantage discharges increased by 34.3% in 2020. We consolidated that gain with a 5.8% increase in same-store Medicare Advantage discharges in 2021, and we added another 1.5% in 2022.

So, we definitely feel like A, the market is very substantial for the services that we provide and the conversion rate remains low, and that we are resonating with our value proposition to payors, to referral sources and to caregivers.

Matt Larew
Analyst, William Blair & Co. LLC

Q

Okay. Thank you.

[indiscernible] (51:11)

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

A

...all of that is strong demographic tailwind.

Matt Larew
Analyst, William Blair & Co. LLC

Q

Yes, understood. And then Doug, on the thought process in existing markets about that expansions relative to adding a new hospital. I know in the past you've talked about that expansion as being the highest ROI use of capital that you have. I imagine that your ability to use prefab and that's bringing down new-build costs and timeline maybe changes some of that math. But I'm curious once the hospital is built down the road or a few minutes away or a few miles away, can you still get any labor – or just any leverage from an admin or labor perspective where you might be able to deploy – employ nurses and therapists to one or both hospitals depending on demand? Just curious once that new build is in place, how it would compare to adding a 10 or 20 bed addition [ph] on your existing (52:13) hospital?

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

A

Yeah, that's absolute case. In markets where we have a cluster of hospitals that are reasonably proximate, we're able to leverage things like the marketing staff, the regional administration staff, and we do share resources between hospitals.

Matt Larew
Analyst, William Blair & Co. LLC

Q

All right.

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

A

But back to your earlier point, Matt, bed expansion on an existing hospital remains the highest return that we get on capital. When we look to add a new hospital, many times because we look at the market we see that it's

Copyright © 2001-2023 FactSet CallStreet, LLC

growing in a particular direction that is currently underserved, we do a bed needs analysis there and say, this is not going to be solved by adding 10 or 20 beds to the existing hospital. This is really a 50 or 60 bed need over the near term, let's go ahead and construct a new facility and try to take advantage of that demand in advance of other competitors entering that particular market.

Matt Larew
Analyst, William Blair & Co. LLC

Q

All right. Thanks, Doug. Thanks, Mark.

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

A

Thank you.

Operator: And we'll go next to Ann Hynes with Mizuho Securities. Please go ahead.

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

A

Good morning, Ann.

Ann Hynes
Analyst, Mizuho Securities USA LLC

Q

Hi, Good morning. So just being on the Washington front, is there anything that's on your radar on the regulatory or legislative outlook over the next 12 to 24 months? And then secondly, maybe on your Investor Day, I know before COVID, you had some long-term targets for EBITDA and free cash flow, is that something we should expect to be reinstated at Investor Day? Thanks.

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

A

Well, I'll take the Washington question first, Ann. So we have a number of new members of Congress that we have prioritized, going out and making sure they know about our rehabilitation hospital, having opportunity for them to do a tour so that when we talk about our patients or the process, they are much more familiar with it. So that has been a big focus. We have plans for a CEO fly-in this year. We will take a subset of our CEOs in the hospitals and have them come to Washington and we'll do a multi-visit members of Congress from each one of our marketplaces and that's coordinated with our team there in Washington.

Relative to the regulatory front, it's been fairly quiet. RCD remains a topic out there that we have continued dialogue with our trade associations and CMS. CMS has not provided any timelines or any additional details about implementation of RCD, but that is something that we've kept in front of mind and continue to have dialogue with CMS.

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

A

So, Ann, just back on the longer term outlook, our last Investor Day was March 4th of 2020 and at that Investor Day we issued longer-term targets, five-year targets for discharge growth, bed additions and for number of de novos to be opened per annum. And then we had comparable measures for home health & hospice. We didn't issue any specific long range targets with regard to EBITDA or cash flow or EPS at that time.

Copyright © 2001-2023 FactSet CallStreet, LLC

Obviously, the world shut down about two weeks later and everybody lost visibility, so we had to suspend those targets for a period of time. We introduced those for the IRF business, I think just about a year ago, I have to go back and check specifically, and those are the targets that you see included in the supplemental materials today, albeit with the change that I've explained earlier with regard to the annual bed additions. In terms of what specific metrics we will provide a longer term outlook on in September that is something that we're still discussing internally. I would say, everything is on the table and it's just going to be something that we will discuss and socialize with individuals such as yourself, between now and September.

Ann Hynes

Analyst, Mizuho Securities USA LLC

Q

All right. Thanks. I was just looking at the − I thought you had some EBITDA targets out for each segment back then. All right. Thanks.

Douglas E. Coltharp

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

A

Now, there was a time in our history we did that, but I forget when we dropped it. I feel like it was sometime around 2018 or so.

Operator: And there are no further questions at this time. I'll turn the call back over to Mark Miller for closing remarks.

Mark Miller

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

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

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

Copyright © 2001-2023 FactSet CallStreet, LLC

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

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

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2023 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.