02-Aug-2023

Encompass Health Corp. (EHC)

Q2 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone, and welcome to Encompass Health's Second Quarter 2023 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] You will be limited to one question and one follow-up question. Today's conference call is being recorded. If you have any objections, you may disconnect at this time.

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

Mark 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 2023 earnings call.

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 regulatory developments, as well as volume, bad debt, and labor costs 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 the year ended December 31, 2022, and the Form 10-Q for the quarter ended June 30, 2023 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 J. Tarr

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

Thank you, Mark, and good morning, everyone. We're very pleased with our second quarter results, driven by continued strong volume growth and substantial year-over-year improvement in labor costs. Our second quarter

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revenues increased 11.7% and adjusted EBITDA increased 27.1%. Q2 total discharges increased 9.8% with same-store discharges up 6.2%.

Our strong volume growth continues to underscore our value proposition to referral sources, payors and patients. As anticipated, our patient acuity continued to broaden with more normalized patient flows to the health care system. While we continue to show solid growth in stroke discharges, which were up 5.5% year-over-year, knee and hip replacement, fracture of the lower extremity and other orthopedic discharges, each grew approximately [ph] 50% (4:13) year-over-year.

Given the strong demand for in-patient rehabilitation services, we have continued to invest in capacity additions. We opened two de novos in the second quarter, adding 110 beds. This brings us to five de novos and 259 beds added year-to-date. We also added 10 beds to existing hospitals in the second quarter. Over the balance of the year, we plan to open two more de novos and add 31 beds to existing hospitals.

Three of our bed addition projects originally scheduled for 2023 have shifted to 2024, due in each case to local permitting issues. As a result of this shift, we now expect to add approximately 140 beds to existing hospitals in 2024. We continue to build and maintain an active pipeline of de novo projects, both wholly owned and joint ventures with acute care hospitals. We currently have announced 19 de novos with opening dates beyond 2023.

During Q2, we again met the increasing demand for our services, while reducing contract labor and sign-on and shift bonus expenditures. Contract labor was down approximately $13 million or 37% from Q2 of 2022, while sign-on and shift bonuses decreased approximately $8 million or 36% from Q2 of 2022.

Our talent acquisition efforts resulted in over 200 net same-store RN hires. This is a very strong hiring quarter. We want to remind you that hiring results may vary significantly from quarter-to-quarter based on seasonality and other factors.

Last week, CMS issued the 2024 IRF final rule. This included a net market basket update of 3.4%, which we estimate would result in a 3.3% increase for our IRFs beginning October 1st of 2023. Review Choice Demonstration, or RCD, is scheduled to begin August 21 in Alabama. We've been working closely with CMS and Palmetto, the Medicare administrative contractor for the state of Alabama, to prepare for its implementation. While many details have yet to be finalized, we have prepared for its implementation and we are focused on pre-claim review, as we believe that it will allow for a more iterative process and the potential for real-time adjustments.

Moving now to guidance. Based on our first half performance and revised expectations for the balance of the year, we're increasing our 2023 guidance to include net operating revenue of $4.75 billion to $4.81 billion, adjusted EBITDA of $920 million to $950 million, and adjusted earnings per share of $3.31 to $3.53. The key considerations underlying our guidance can be found on page 12 of the supplemental slides.

Finally, I want to remind you that we are hosting an Investor Day in New York City on September 27, 2023. At that meeting, we will provide more detailed insight into key elements of our strategy, including de novo hospitals, clinical technologies and labor management. If you have not already registered, you may do so in our Investor Relations website or contact Mark Miller. We hope to see you there.

Now, I'll turn it over to Doug for further color on the quarter.

Douglas E. Coltharp

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

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Thank you, Mark, and good morning, everyone. I'm going to hit just a few highlights and then we'll open up the floor for questions.

As Mark stated, we are very pleased with our Q2 results. We continue to make significant improvement in year-over-year labor costs. Our Q2 contract labor plus sign-on and shift bonuses of $36.1 million was comprised of $22.1 million in contract labor and $14 million in sign-on and shift bonuses. Contract labor expense in Q2 declined approximately $13 million or 37% from Q2 2022. Agency rates declined year-over-year and were relatively flat sequentially. Our Q2 2023 agency rate per FTE was $186,000, down from $223,000 in Q2 2022.

Utilization also declined year-over-year and remained essentially level sequentially. Q2 2023, contract labor FTEs of 476 represented a 25% decline from Q2 2022. Contract labor FTEs as a percent of total FTEs was 1.8%, an 80-basis-point decline from Q2 of last year and flat sequentially. We expect contract labor FTEs as a percent of total FTEs to remain relatively consistent but we will continue to seek improvement.

Sign-on and shift bonuses decreased $7.8 million or 36% from Q2 2022, and decreased by $2.3 million or 14% sequentially. The improvements we are experiencing in sign-on and shift bonuses are the result of the processes we have implemented and, we believe, an easing in market conditions.

Revenue reserves related to bad debt decreased 30 basis points to 1.9%. Supplemental Medical Review Contractor, or SMRC, audit results trended favorably in Q2 compared to our previously established reserves. Our aging-based reserves also benefited from strong collections in the quarter. EPOB for the quarter was 3.38, an increase from 3.37 in Q2 of last year and from 3.32 in Q1 of this year. Our guidance assumes EPOB to be approximately 3.40 for Q3 and Q4.

Q2 de novo net pre-opening and ramp-up cost totaled $4.3 million, bringing the year-to-date total to $8.5 million. We continue to expect $10 million to $12 million of these costs for the full year. Finally, we ended Q2 with a net leverage ratio of 2.9 times, down from 3.1 times at the end of Q1 of this year and from 3.4 times at the end of 2022.

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

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QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] You will be limited to one question and one follow-up. Your first question comes from Kevin Fischbeck of Bank of America.

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. Thanks. So, I guess maybe just to start off on the labor side of things. I guess, obviously, making some progress there in a number of areas, but just interested in the comments about the contract labor expected to be relatively stable sequentially. So why is the progress kind of plateauing here? And what do you need to see to make additional progress on that?

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

Yeah. So, Kevin, this is Doug, and I think it's relatively consistent with the comments we made at the end of the first quarter, where we felt like we had hit what at least for now is a run rate, both in terms of the rates per FTE and the percentage of our total FTEs are made up of contract labor. The rate is kind of stabilized in the mid-180s. And as a percentage of total FTEs, we're hovering around that 1.8%, and that compares to roughly 0.9% pre-pandemic.

We don't know that this represents a permanent level, and we're anticipating that there will be further improvements perhaps as we move into 2024. There are signs on the horizon that the labor market for skilled clinicians is getting a little bit better, but we continue to see it move around in pockets. Our contract labor in the second quarter was still fairly concentrated. It was less concentrated than it was in Q1, but we still had 20 of our hospitals comprise more than 50% of the spend during the quarter. And it's not consistent in terms of which hospitals are experiencing those kinds of trends.

So until we get greater visibility, we think it's prudent to anticipate relatively consistent spend based on those factors from quarter-to-quarter for the balance of the year. Again, that doesn't suggest that we're not continuing our efforts, as you saw evidenced in our recruitment of more than 200 RNs during the quarter to reduce the reliance on this premium labor.

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

Kevin, one more point I would add, and this is Mark, is we've guided our operators that if they have the volume, they need to just go out and get the labor even if it's contract labor. So we've been very fortunate to continue to grow our volumes, and they've been accommodating in certain marketplaces because of the availability of contract labor.

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Kevin Fischbeck
Analyst, BofA Securities, Inc.

Q

Okay. And then I guess that leads me to the second question, which is, on the volume side, I guess there's been a lot of talk about the volume strength in the industry to start the year. And I'd just love to kind of hear your thoughts about – because your volumes came in higher than we were expecting, sounds like maybe you were expecting. Is there anything in here that makes you look at this and say, hey, this is a bolus of utilization that would moderate in the future? Or is this kind of a good way to think about the base and the growth from here? Thanks.

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

A

Well, this is Mark. I mean, we obviously are very pleased with the volume we saw in the second quarter. We think that our value proposition with our outcomes continue to help us to grow our volumes. And clearly, I think referral sources and patients and payors are recognizing the differences in the various post-acute settings. So I think there's a lot of momentum behind our volume gains that are sustainable and our ability to continue to perform.

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

A

The volume growth was strong across virtually all categories. So if we look at it, for instance, first within patient mix, and Mark mentioned some of this in his comments, our top acuity categories, stroke was up about 5.5% and neurological was up about 2.5%. So we're still seeing growth in those categories. But based on what we believe are largely normalized flows and then gains in market share throughout the health care system, we saw double-digit growth in every other major RIC category for the quarter, so across the patient mix was very strong.

We should also acknowledge that that growth was coming even as, on a year-over-year basis, the number of COVID patients that we were treating declined by about 43%. It was strong across the payor mix as well. Our fee-for-service was up about 9.5% on a year-over-year basis. Medicare Advantage was up 20%. And we really saw the broadening in the patient mix that we had been anticipating within that Medicare Advantage book of business as well. And then geographically, it was very strong on a broad basis as well. If we look at the 35 states plus Puerto Rico, which are included in our same-store calculation, 78% of those geographies had same-store growth during the quarter that was greater than 5%.

Now having said all of that, on a year-to-date basis, our discharges are up 9.5% and same-store is up roughly 6%. And we just don't know, particularly as we've got more challenging comps in the second half of the year, that it's prudent to expect volume growth on a year-over-year basis at the same levels. So our guidance includes some moderation in volume growth for the second half. It doesn't mean that we're – that's what we're seeking. We just think it's prudent to plan the business that way.

Operator: Your next question comes from Andrew Mok of UBS.

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

A

Good morning, Andrew.

Andrew Mok
Analyst, UBS Securities LLC

Q

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Hi. Good morning. With the recent positive indicators around the early de novo performance, I was hoping you could provide updated views on total start-up losses incurred in year one and time it takes to reach breakeven and mature EBITDA margins? Thanks.

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

A

Yeah. So we haven't changed our estimate for what the ramp-up and start-up costs will be for this year. But remember, even as those new doors come online, it takes them for a while to ramp up, which I think is an appropriate segue into your second question. Generally speaking, we're seeing most of our new units start to hit a maturity level somewhere between year three and year four, but they're getting to positive four-wall EBITDA typically within a 9- to 18-month time period, and that's been relatively consistent.

Andrew Mok
Analyst, UBS Securities LLC

Q

Got it. And then I just wanted to follow up on some of the volume discussion. You called out orthopedic procedures. I think you said up 15%, driving incremental volume strength in the quarter. As you speak to your referral partners in July, August, what's your sense of the durability of the elevated orthopedic procedures for the balance of the year? Thanks.

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

A

It certainly feels like maybe some of this is a result of pent-up demand. As we've talked about before, we do believe that over the intermediate or long run, the conditions that are treated in our facilities are nondiscretionary in nature. But there was the ability for some of these orthopedic conditions to be deferred for a period of time. And so that's part of the reason that it's contributing to our expectation that volumes might moderate a little bit in the second half. Having said that, again, seeing the strength that we are across geographies, across the payor mix and so forth, we feel like some of it is sustainable and is attributable to market share gains.

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

A

And one final comment on the orthopedic mix that we see. Just as a reminder, I mean these patients are typically in their late 70s, multiple comorbidities. All of our patients still have to meet that medical necessity threshold. So they – in many cases, they aren't your typical knee replacement patient.

Operator: Your next question comes from A.J. Rice of Credit Suisse.

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

A

Hey. Good morning, A.J.

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

A

Hello there, A.J.

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

Q

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Thanks. Hi, everybody. So first question on the – obviously, the 202 new hires on a same-store basis, that's the highest it looks like in years, and it's happening as sign-on bonuses are down. I guess, that suggests there's a more plentiful supply of nurses that you're seeing available or therapists.

I wonder what would that number potentially be? Or do you have a lot of open positions that you still might see further step-up? Or are you hiring pretty much who you need to hire and want to hire at this point? It looks like this quarter was quite a bit different than the last couple of quarters.

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

So as I noted, A.J., in my comments, there's quite a bit of variability from quarter-to-quarter, some that's affected by seasonality and other points. I think that, A, we are seeing some nurses come back into the marketplace. I think that there's starting to be some softening in the markets in general. But I also think we've just gotten better too in terms of our own strategies and tactics that we use to recruit.

Two years ago, we centralized the talent acquisition functions around our nursing recruitment, which has really paid dividends for us. And then we've just looked at everything that we could to make ourselves a better employer, particularly for nurses, whether that is through scholarships to support nurses that may want to go back in for their RN degree. We've been reviewing opportunities for improvement on our clinical ladders. We've taken a real strong look at our orientation process, clinical education, flexible scheduling.

So I think it's the combination of marketplaces externally and internally, the things we've done, to make sure that we are an attractive opportunity for RNs and also to retain RNs once we get them.

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

So, A.J., obviously, we're very pleased by the more than 200 net RN hires during the quarter. To maybe get to your question about how far do you have to go, what kind of openings you have out there, you can kind of triangulate on it using a number of data points. First, we referenced the 476 contract labor FTEs that are out there. So that suggests if you were going to go to zero usage of contract labor, you've got roughly 476 FTEs that would need to be replaced in the existing system.

In addition to that, our RN turnover has been improving on a year-to-date basis and it's currently running at about 22%. So you've got at any point in time, 22% that needs to be backfilled. And then finally, not included in that 200 because that's a same-store basis, but we are utilizing our recruiting efforts for the de novos as well. And I'll remind you that a 50-bed de novo has stabilized staffing at about 97 FTEs. It typically opens kind of 12 less than that and that you're going to have somewhere, I think, about 35% of those FTEs are going to be in nursing.

So it's all those pieces together...

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

Okay.

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

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...and that's what our recruitment team is attempting to tackle on a quarter-by-quarter basis. And not only did they do that with an improvement year-over-year in sign-on and shift bonuses in Q1, but we did it with a reduction in our overall recruiting and related marketing costs, and that is because we have standardized procedures for using sign-on and shift bonuses and we have also really honed and gained efficiencies in our recruiting and related marketing efforts.

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

Q

Okay. Maybe if I could get my follow-up, you're calling out 2% to 3% managed care contracting rate increases. That seems pretty consistent. We hear a lot from the MCOs about wanting to shore up their post-acute networks, et cetera. I wonder if any of that activity on the value-based side is creating any incremental opportunities for you that you're looking at.

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

A

We're not really seeing any movement to, say, risk-bearing or value-based contractors. As we've suggested before, we actually think we're well positioned to do that. And we've had some discussions with some of the major managed care companies. And for whatever reason, it just hasn't been a priority for them. What we have seen is that we continue to be able to increase the percentage of our contracts that are paid on a case rate basis versus a per diem basis. And that tends to move up to a payment rate that is very close to the fee-for-service rate.

If you look and get into the details, the discount from fee-for-service to Medicare Advantage expanded a little bit in Q2. And again, that was expected and something that we foreshadowed previously. That was related not to our contracting efforts, but specifically to the broadening of acuity within the MA book of business, which, as I alluded to earlier, grew 20% on a year-over-year basis.

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

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

A

Good morning, Brian.

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

A

Hey, Brian.

Brian Tanquilut
Analyst, Jefferies LLC

Q

Hey. Good morning, guys. Yeah. I guess, Mark, as I think about it, I mean, you've obviously had a lot of success and you're still adding beds, de novos and beds additions to existing facilities. As we look forward, I mean, I've seen more announcements about JVs. Maybe anything you can share with us in terms of what those conversations are like and what that pipeline is like with hospitals versus doing your stand-alone de novo builds?

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

A

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Yeah. So our pipeline is a nice complement of both wholly owned and JV opportunities. I think kind of the themes that we hear back from potential joint venture partners and our existing joint venture partners is that we bring something relative to the knowledge of running and operating an IRF that they don't have in-house, particularly around all the regulatory and the processes that are different from the acute care hospitals. They're looking at opportunities to grow their IRF business. Typically, the units that they may have are in a less than desirable portion of their acute care hospital that can't be expanded and they're looking to grow that with the partner.

And then last thing I want to point out is that we've been doing this business model with partnerships now for over 34 years. And so we know how to be a really good partner. And it gives us an opportunity to go out and grow with the acute care hospital systems that are looking to expand their post-acute.

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

A

We like having both arrows in our quiver, and we think we use them effectively. And some of what determines whether or not we'll prioritize like a JV relationship has to do with the market that we're entering. There are certain states where aligning yourself with an acute care hospital that already has a presence in that state or in that market can be useful in securing CON, in others where it really doesn't matter as much.

If you look at our portfolio today, those hospitals that are already opened were just below 40% in terms of the number of those that are JVs. When we look at our broader pipeline, not just the 19 that had been announced beyond 2023, but the total pipeline of active projects, which is closer to about 50, it's running at about 40% that we currently have identified as potential or likely JV partners. So I think we'll continue to utilize both effectively. And as a result, I wouldn't expect that we'll see a significant change in the composition of our portfolio in terms of JVs versus non-JVs.

Brian Tanquilut
Analyst, Jefferies LLC

Q

That's awesome. And then Doug, maybe any color you can share with us on early reads on RCD?

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

A

As Mark alluded to in his comments, we think we've been having some very productive discussions with both CMS and with Palmetto, who is our MAC for Alabama. We think, not surprisingly, we're ahead of the curve in terms of our competition and even for the administrator. Not all of the details have been provided. We've been asking a lot of probing questions to make sure that there's a practical application when this starts up. We believe, based on our resources and our system's capabilities that we're going to be in a great position to provide all of the appropriate documentation to the MAC to satisfy them that these are appropriate admissions and to proceed with the claims processing.

And that's really why we've chosen to go on a pre-claims review. As Mark again added in his comments, that's going to be an iterative process, and we think we'll be very effective at engaging in that back and forth on any patients where there are questions with Palmetto. So we think that in terms of any kind of impact, could there be some delays in claims processing that would really be more of a working capital issue than a long-term bad debt expense issue? Sitting here today and not knowing what implementation will look like, that's our best guess.

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

A

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Brian, I've been pleasantly surprised at the amount of dialogue that both CMS and Palmetto has had with the providers. We've been very involved with that opportunity, including a meeting yesterday in Columbia, South Carolina, where Palmetto is based. So, if nothing else, that has been a learning process both for Palmetto, hearing feedback from providers like us, as well as us hearing from Palmetto and CMS. So it's – from that perspective, I would say it's gone about as well as expected, although there's still some process-oriented type of questions to be answered.

Operator: Your next question comes from Pito Chickering of Deutsche Bank.

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

A

Hey. Good morning, Pito.

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

A

Good morning, Pito.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Hey, good morning, guys. Thanks for taking my question here. Versus your last guidance, you have increased your labor inflation assumptions, which is offset with tailwinds from better Medicare pricing for the fourth quarter. 2Q was very strong. You're still implying 2Q margin expansion relative to Street estimates today despite the increase of inflationary pressures on the labor side.

So I was curious if you can talk about OpEx leverage, what you're seeing. Is it getting better than you had assumed for last quarter or at the beginning of the year in order to offset these labor inflationary pressures? And is there any reason why this OpEx leverage shouldn't continue into 2024?

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

A

It's a great question, Pito, and it's – the answer is yes and no, right? So if you go – if you parse into some of those expense categories where we saw a lot of leverage, there are some of those categories that we feel will be sustainable even if volume growth moderates a bit. So we have been anticipating through the course of this year, as we anniversary some of the more significant increases from the prior year and as market conditions stabilize, that we would see improvement in areas like utilities expense per day and food expense per day. And we believe that will be the case, and that will drive incremental leverage into the second half of the year.

I mentioned earlier that we made some improvements year-over-year in our recruiting and related marketing expenses. And we certainly believe that based on our revised procedures and some of the efficiencies that we gained, that that will be a source of leverage even as we continue to expand significant efforts on recruiting and retaining nurses and other clinicians in the second half.

Weighing against that to some extent or a couple of things to consider, maybe three or four. One is, we just had an incredible performance within our self-insured group medical program in the first half of the year, both in terms of the overall utilization rates and the number of higher dollar claims. Our experience tells us that that is mean reverting. And so we don't expect that to sustain, and would actually anticipate that that's going to be a source of a little bit of margin pressure in the second half, and that's built into our guidance assumptions.

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We had a very favorable bad debt experience in the second quarter. Again, that really related to the SMRCs as much as anything else. With little experience with regard to the SMRCs and with that being a very targeted audit in the first quarter, we put up some incremental reserves based on the information that was at hand. And ultimately, we prevailed at a higher rate in the second quarter, and that came back down. We've assumed more of a normalization of that for the balance of the year.

And then two things that I know can sound like they're a little esoteric, but are really important to consider is, again, we're anticipating that that EPOB is going to continue to move up towards 3.40 and that the length of stay is going to increase from its current level, which was at 12.3 days in the second quarter. So I know I've thrown a lot into the mix there. There are some expense categories that we absolutely anticipate further leverage on. There are a few countervailing forces that just need to be considered here in the near term.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Okay, great. And then the follow-up on the 20% growth of Medicare Advantage, just hard as you saw in the quarter. I'm just curious if you're seeing any different behavior from Medicare Advantage maybe at the end of the quarter or in July, trying to curb the days or be more stringent with prior authorizations as you're absorbing that spike at utilization?

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

A

We really aren't. And I think the good news with the MA growth is that it also has been brought across geographies. Again, how we deal with MA plans with regard to prior authorization and their admission procedures and so forth can vary pretty significantly from payor to payor, and even within those payors from market to market. But generally speaking, and as evidenced by the 20% growth on a year-over-year basis, it's getting better.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Great. Thanks so much.

Operator: Your next question comes from Steven Valiquette of Barclays.

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

A

Hey. Good morning, Steve.

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

A

Hey, Steve.

Steven J. Valiquette
Analyst, Barclays Capital, Inc.

Q

Hey. Thanks. Good morning, guys. You touched on this a little bit, just talking about some of the patient referral sources. The Medicare Advantage payors obviously talked about elevated utilization more in the outpatient setting

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versus inpatient in the second quarter. So I guess just kind of tied into that, I was curious regarding your incoming patient flow in the quarter and patient referral sources into you.

Can you just remind all of us just on the mix of your patients that are referred into you from the inpatient setting versus other sources? And did that mix shift at all really during the quarter to a greater amount of patients coming in from outside of the hospital in patient setting? Just trying to marry up your trends with some of the comments from managed care companies. Thanks.

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

So, close to 90% of our admissions come directly from an acute care hospital. We didn't see a significant change in that in Q2 from past quarters. So, kind of goes back to the point that all of our patients have to meet medical necessity. They typically have multiple comorbidities. They're sick. So outpatient is not really an option for them because they need 24-hour nursing care. So we haven't really seen anything that stood out in the second quarter from our past trends.

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

Yeah. I think the point we're trying to make there is that those patients who are receiving orthopedic surgeries and then ultimately finding their way into our facilities are getting those on an inpatient basis at the acute care level and not on an outpatient basis because of their comorbidities.

Steven J. Valiquette
Analyst, Barclays Capital, Inc.
Q

Okay. That's helpful just to get some color on that. Appreciate it. Thanks.

Operator: Your next question comes from Matt Larew of William Blair.

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

Hello, Matt.

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

Good morning, Matt.

Matt Larew
Analyst, William Blair & Co. LLC
Q

Hey. Hey, good morning, Mark, Mark and Doug. Last quarter, you touched briefly on occupancy rate long-term target, reflecting the higher skew towards private rooms. Occupancy rates again was very high this quarter. So perhaps I was thinking about that theoretical long-term target. Maybe could you help us think about some more near- or medium-term targets as to how you expect occupancy rate to trend over the next year or two, given the shift of de novo builds towards private rooms?

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

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Yeah. It's a very fair question. And to be honest, Matt, I haven't mapped it out, but we would expect it to continue to increase. In the near term though, I think it's fair to say that it will move from the low-70s up into the mid-70s. I think that's reasonable. I don't know how I would define the near term. And you've got a little bit of this push me/pull me that goes on as well because as we see the occupancy increase in recently opened facilities or bed additions that are all private room, you're getting downward pressure on the occupancy rate from the de novo activity and the more recent bed expansions.

But if we stay at kind of the current build level that we've been at, which is roughly, call it, 850-bed de novos per year and some – and call it, 100 beds, so adding 600 beds to a larger base. That should start to result in opportunities for company-wide occupancy levels to trend up. Where the theoretical limit gets, it really depends on that ongoing ratio between new capacity coming on in any particular year against the base.

To the extent that new capacity becomes an increasingly smaller part of the base, then I think you have continued upward opportunity within occupancy. It will take a while just because of the legacy base. Even where we're addressing that through remodels to try to create more private rooms, it's going to take a while to get it north of 80%, but definitely see upside.

Matt Larew
Analyst, William Blair & Co. LLC

Q

Okay. And then for years, obviously, occupancy rate has company-wide been around 70%, give or take. And so I'm curious, as that moves up, obviously, in theory, there would be benefits from a margin perspective. But I presume that you've sort of staffed facilities and thought about flex staffing around that sort of 70% level.

And so just curious, do you have any experience with facilities that – within your network that have always perhaps run at higher rates and thus, maybe have a framework to think about how you'll add staffing and sort of management as necessary as that activity level shifts up over time?

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

A

You definitely get a benefit there from EPOB because you've just got a whole lot of efficiency when you're running at really high staffing. The dynamic that can work against you a little bit on that, and so you'll get margin expansion. If you're taking a facility that's running in the low-70s and you're pushing it up, perhaps all the way to about 90%, you're getting margin gain opportunities all the way through there. I'm leaving the pricing environment out of the equation for right now.

When you get north of 90%, though, unless the – and let's assume that that facility is tapped out, there's no opportunity for a bed expansion, you're going to see margin pressure go the other way. And that is because, in many instances, you're going to be capped on growing your volume any further. Your revenue increase on an annual basis, therefore, will be limited to pricing increases and you may have inflationary pressures, SWB and elsewhere in the P&L that are growing greater than the annual pricing increase.

Matt Larew
Analyst, William Blair & Co. LLC

Q

Okay. Thanks, Doug.

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

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

Morning, Scott.

Scott J. Fidel
Analyst, Stephens, Inc.
Q

Hi. Thanks. Good morning, good morning. Wanted to circle back just on the Medicare Advantage discussion. And I know that often you'll give us actually where those MA reimbursement rates are relative to fee-for-service. Would be interested if you had the updated stat there. And then maybe how you're thinking about that trending, I guess, over the balance of the year and into 2024.

And I guess what I'm thinking about here is the push and pull between – you talked about some of the shifts and the broadening of the utilization backdrop are affecting that. At the same time, you also talked about growing your market share, which I would assume could benefit that. So trying to think about, I guess, how those sort of friction points net out against each other. Thanks.

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

Yeah, absolutely. So in the first quarter, the rate differential between MA and fee-for-service was 4.7%. That broadened by 120 basis points to 5.9% in the second quarter, and it was really solely attributable to the lowering of acuity, which was based on the patient mix. That's a positive trade-off for us. I mean we like getting that additional volume gain and we like the fact that our value proposition beyond stroke, where it's been evident for a long period of time, and complex neurological disorders is now resonating with those MA plans.

The two countervailing forces that you'll have that will impact that discount on a go-forward basis are what we believe will be the continuing broadening of acuity within MA, which we believe will continue in aggregate to grow faster than fee-for-service. But at the same time, our success in contracting with those MA plans to move more and more of those, we already added about 80% of the revenues into a per diem basis. Put all of that into the mix and our assumption is that that gap that existed in the second quarter widens a bit in the second half of the year.

Scott J. Fidel
Analyst, Stephens, Inc.
Q

Okay. Thank you.

Operator: Your next question comes from John Ransom of Raymond James.

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

Hey, John.

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

Good Morning, John.

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

Q

Hey, good morning. Doug, aren't you glad we aren't talking about a complicated health spinout?

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

A

What a difference a year makes.

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

A

I can tell you I am, John.

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

Q

So this is an unfair question, but is there any indication at all that CMS is unhappy with the current payment structure? It just strikes us that they're not happy with home health ever, they are not happy with hospice length of stay, but they've left you guys alone since the 60% rule. It used to be the 70% rule. But is there any kind of inklings on the horizon they may look to tweak how you're paid?

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

A

John, first of all, we might challenge you on we've been left alone since the 60% rule. We've had sequestration along with everybody else, and we've had Section GG and more quality indicators and all of that other kind of stuff that have not always been easy to digest but we hear you...

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

Q

Well, I mean it's like a big structural change of – yeah, but like a big structural change, we want to pay you now on per hour divided by 12 minutes or some such thing. So do you think the current structure stays in place [indiscernible] (45:52)

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

A

Yeah. We're not hearing anything to the contrary, John. As a matter of fact...

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

Q

Okay.

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

A

...if you look at the combined rhetoric out there between CMS and MedPAC and then even some of the things that have been considered through, for instance, the residue of the IMPACT Act, it seems to be going the other way, which is a recognition that significant improvement has been made in areas like quality reporting and so forth, and

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that trying to make a more substantive revision would have very significant complexities to it without necessarily accomplishing anything.

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

So I think the impact to that was certainly an indicator that of what direction they were going to head X number of years ago in creating this common assessment instrument. And now I think they saw the complexities of looking across the various settings in post-acute and that was – they presented their prototype as required. But I think everybody agreed that that was not ready for prime time and very difficult to implement. But to go back to your initial question, we're not seeing any major structural changes that would be indicated or hinted at, at this point, from CMS or any other regulatory body.

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

John, that doesn't mean we have enough hubris that we feel like we're immune to it, but we're not aware of anything on the horizon.

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

And so my follow-up would be, I think you just said 80% of your MA rates are per day, right?

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

No, sorry, John.

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

[ph] If you could be Doug. (47:29) Did you – did I miss that? Did I hear that right?

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

Yeah. 88% of our current MA revenues are on a case rate basis.

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

Okay. Got you. So if you could be Dougadamus, not a Nostradamus, again, do you think any indication, as you talk to these MA payers, if they want to change how you're paid? Or do you think that will also stay in place?

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

I think we're making progress pushing that 88% up north, so...

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

Okay.

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

...it's a ground game. So it's small increments. But right now, I think the trend line suggests that we're going to be able to not only grow our MA revenues significantly, but continue to push the percentage of those revenues that are on an attractive case rate basis north.

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

Got you. Thanks so much.

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

Thank you, John.

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

Thank you, John.

Operator: Your next question comes from Ben Hendrix of RBC Capital Markets.

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

Good morning, Ben.

Ben Hendrix
Analyst, RBC Capital Markets LLC
Q

Good morning. Thanks, guys. I just wanted to follow up on John's first question there, specifically pertaining to the final rule for Medicare. It looks like your rate update is kind of in line with the industry. But is there anything else, any other observations to call out from the final rule, whether they be with the quality reporting program, or specifically any implications from the rebasing of the market basket given that it's kind of rebased to a COVID laden year? Thanks.

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

There's really no major takeaways that we saw. We thought it was a pretty benign final rule. It was very much in line with the initial rule that came out. And yes, they continue to have quality reporting and we're in full compliance with that. So we're not seeing anything major that indicated in the final rule that would change our thoughts on that.

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

And to some extent, it may be the case that CMS was cognizant of the fact that we do have RCD rolling out this month and didn't want to overly complicate things for either the MACs by injecting something into the payment system or for the providers as well. But as Mark said, the final rule was really consistent almost wholly with the proposed rule, which is a good thing.

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Ben Hendrix
Analyst, RBC Capital Markets LLC

Q

Thank you.

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

A

Thanks, Ben.

Operator: This concludes the question-and-answer session for today. I'd be happy to return the call to Mark Miller for closing comments.

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: This does conclude today's conference.

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