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Encompass Health Corp. (EHC)

Q4 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone, and welcome to Encompass Health's Fourth 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] Today's conference call is being recorded. If you have any objections, you may disconnect at this time.

I'll 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 fourth quarter 2023 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 earnings release and related Form 8-K and the Form 10-K for the year ended December 31, 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 the 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 Miller

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

Thank you, Mark, and good morning, everyone. The fourth quarter was a strong finish to a great 2023 for our company. I'll discuss key highlights for the year and then Doug, will provide details about our Q4 results and 2024 guidance.

Our 2023 revenue increased 10.4%, driven by strong volume growth, with total discharges up 8.7%, inclusive of same-store growth of 4.8%. Our strong volume growth continues to provide evidence that our value proposition is resonating with referral sources, payers and patients.

Our 2023 adjusted EBITDA increased 18.5%, driven by revenue growth and prudent expense management. Persistent vigilance on premium labor utilization facilitated a 32.9% decrease in contract labor plus sign-on and shift bonuses. On a dollar basis, these premium labor expenses decreased \$67.3 million from \$204.3 million in 2022 to \$137 million in 2023. We reduced contract labor FTEs from an average of 547 in 2022 to 425 in 2023 and contract labor FTEs as a percent of total FTEs from an average of 2.2% to 1.6% over the same period. Other operating expenses as a percent of revenue declined by 50 basis points, from 15.3% to 14.8%, owing in part to scale efficiencies. The strong growth in adjusted EBITDA facilitated an adjusted free cash flow increase of 54.6% to \$525.7 million.

We continued to invest in capacity expansions to meet the needs of a significantly underserved and growing market for inpatient rehabilitation services. In 2023, we invested more than \$350 million in growth CapEx, opening eight de novos with a total of 395 beds and adding 46 beds to existing hospitals, a net 4.1% increase in licensed beds.

We also continued to invest in our facility-based technology through initiatives like our Tablo on-site dialysis rollout. We now offer in-house dialysis capabilities in 83 of our hospitals and will continue the rollout to new locations in 2024. We complemented these investments in the growth of our business with the return of approximately \$60 million to our shareholders through cash dividends on our common stock. Our strong free cash

flow generation allowed us to fund these investments and shareholder distributions with internally generated funds, all while reducing our net leverage to 2.7 times at year-end 2023 from 3.4 times at the end of 2022.

Review Choice Demonstration, or RCD, began on August 21st in Alabama. Our company was well-prepared to address the administrative requirements of this program. Recall that under RCD, every Medicare claim is reviewed for documentation and medical necessity. The affirmation rate target set by CMS under RCD is 80% of claims submitted during the first six months of our affirmation rate remains above that level.

Turning to our objectives for 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 expect to open six de novos in 2024, as well as a 40-bed free-standing hospital licensed as a satellite location on an existing hospital that will be accounted for as a bed addition. To date, we've announced an additional 11 de novos with opening dates beyond 2024. We anticipate adding approximately 150 beds to existing hospitals in 2024, including the aforementioned satellite and 80 to 120 beds per year from 2025 through 2027.

We continue to focus on enhancing patient outcomes by investing resources in clinical innovations. One such innovation is our fall prevention model, which combines predictive modeling with our core clinical practice protocols. Our fall prevention model was initiated in 2021, and we have since seen our fall rates per 1,000 patient days improve 24%. We have an array of additional clinical innovations and enhancements underway, which are intended to advance our ability to consistently produce quality outcomes for medically complex, high acuity patients in need of inpatient rehabilitation care.

Now, I'll turn it over to Doug.

Douglas E. Coltharp

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

Thank you, Mark, and good morning, everyone. As Mark stated, Q4 was a strong finish to 2023. Revenue for the quarter increased 9.6% over the prior year, driven primarily by volume growth. Total discharges grew 8.3%, inclusive of 5.3% same-store growth. Volume strength was broad-based across geographies and patient mix and exceeded our expectations. Q4 adjusted EBITDA also increased 9.6% over the prior year as the contribution from increased volume and favorable operating expenses was partially offset by an incremental bad debt reserve.

Our 2023 de novos outperformed in Q4, generating approximately \$1 million in adjusted EBITDA compared to our expectation of approximately \$2.5 million to \$4.5 million of net pre-opening and ramp-up costs. The favorable performance relative to our expectations was driven primarily by the joint venture de novos.

For the full year of 2023, our de novo net pre-opening and ramp-up costs were \$6.6 million. Within our 2024 guidance considerations, we are anticipating \$15 million to \$18 million of de novo net pre-opening and ramp-up costs. The year-over-year difference is largely attributable to the timing of new hospital openings and the balance between joint venture and wholly owned de novos.

We continue to see improvement in year-over-year premium labor costs. Q4 contract labor plus sign-on and shift bonuses totaled \$30.6 million compared to \$35.4 million last year. Within premium labor costs, Q4 contract labor was \$17.7 million and sign-on and shift bonuses were \$12.9 million as compared to \$19.7 million and \$15.7 million in Q4 of 2022. On a sequential basis, premium labor decreased by \$2.7 million.

Our Q4 adjusted EBITDA included approximately \$6.8 million in favorable reserve adjustments for workers' comp and general professional liability insurance. On a full year basis, 2023 included approximately \$11.2 million in

favorable reserve adjustments for these self-insured programs. These reserve adjustments are out-of-period as they relate to claims prior to 2023. Our Q4 adjusted EBITDA also benefited from favorable trends in group medical claims under our self-insured program.

Q4 revenue reserves related to bad debt as a percent of revenue increased 170 basis points to 4.1% as a result of an approximately \$22 million reserve related to appeals pending before the Departmental Appeals Board in various federal district courts. These appeals relate to claims denied primarily prior to 2018 and under review programs that are different from TPE and RCD. We now have a full year of experience at the Departmental Appeals Board and have updated our reserve assumptions given our experience to-date. After giving effect to minority interest, the Q4 adjusted EBITDA impact of this incremental bad debt reserve was approximately \$16 million.

Adjusted free cash flow for the quarter increased 103.3% to \$93.5 million due to higher adjusted EBITDA, lower maintenance CapEx and favorable changes in working capital.

Moving on to guidance. Our 2024 guidance includes net operating revenue of \$5.2 billion to \$5.3 billion, adjusted EBITDA of \$1.015 billion to \$1.055 billion, and adjusted earnings per share of \$3.77 to \$4.06. The key considerations underlying our guidance can be found on page 13 of the supplemental slides.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And we'll take our first question today from Kevin Fischbeck with Bank of America.

Mark J. Tarr

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

Hello, Kevin.

A

Joanna Gajuk

Analyst, BofA Securities, Inc.

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

Q

Mark J. Tarr

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

Hi, Joanna.

A

Joanna Gajuk

Analyst, BofA Securities, Inc.

Thanks for taking the questions. Yeah, there's too many going on at the same time. So, we got to do this way, but thank you for question. So, I guess my question around volumes, because clearly you highlighted volumes also came in better than your internal expectations and obviously, very robust growth year-over-year. So, I guess the question is, is that sustainable? What do you assume for same-store volumes growth in 2024 guidance?

Q

And I guess, I understand you mentioned that the strength was broad-based geographically, but can you talk about maybe whether there was any category that stood out or maybe the payer as well, and flu I guess, or any impacts, kind of seasonal in Q4? Thank you.

Mark J. Tarr

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

A

Hey, Joanna. So, this is Mark, I'll take a shot at this first. As you know, we saw nice volume growth across all eight of our geographic regions, and I think it was a number of things. One, we continue to see where we've taken market share from nursing homes. I think that going back to the last two or three years, we've proven ourselves very capable of taking a higher acuity patient and having great outcomes with them. So that has been a primary driver to us. I think that it's no secret that the acute care hospitals have seen to have had strong volumes, which we get the downstream impact from that.

Relative to program mix, it was another quarter of continued growth in our stroke program and other neurologic conditions. We did see some pickup on a small base in our orthopedic categories, but nonetheless, we did see a percentage increase in lower extremity joint replacements and other orthopedic as well. So, it was very broad-based in terms of our overall growth and we're confident that we're building a good foundation.

Douglas E. Coltharp

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

A

Just to add a couple of other things to round out your question. In terms of the expectations for volume growth in 2024, if you kind of parse through the guidance considerations, you get a range of the discharge growth that is kind of in line with our long-term target of 6% to 8%. Obviously, coming off a number of strong years, the low end of the range would be slightly above that, but the rest of the range is solidly within that.

In terms of the breakdown between same-store and new store, we obviously have the eight units that we opened this year that'll be a new store. And so that's a bit of a tailwind there. And it's worth recognizing that if you look at the full year CAGR and same-store growth that extends from 2019 to 2023, that's north of 5%. So, we continue to demonstrate very positive numbers there, but it's not to suggest that we're going to be in a position to generate 5% same-store growth on a year-over-year basis. There will be some fluctuations from year to year. The patient mix was very broad based. As Mark mentioned, we did continue to see outsized growth in some of the smaller categories like ortho, but saw in excess of 5% growth in neurological and just about 5% growth in stroke. So those are good numbers.

And then finally, as it relates to payer mix, on a year-over-year basis, we saw the Medicare Advantage payer mix increase by 90 basis points. But importantly, about 50 basis points of that growth came out of general managed care and another 20 basis points or 30 basis points came out of Medicaid. So, those were both representing a positive trade out of our lowest reimbursement categories into a higher reimbursement category.

Joanna Gajuk

Analyst, BofA Securities, Inc.

Q

Thank you for the call. I appreciate it.

Operator: Next, we'll hear from Pito Chickering with Deutsche Bank.

Mark J. Tarr

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

A

Hello, Pito.

Douglas E. Coltharp

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

A

Morning, Pito.

Kieran Ryan

Analyst, Deutsche Bank Securities, Inc.

Q

Hi there. You actually got Kieran Ryan on here for Pito. Same idea as Joanna earlier, lots of calls, but appreciate you taking the question.

Mark J. Tarr

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

A

Sure.

Kieran Ryan

Analyst, Deutsche Bank Securities, Inc.

Q

I wanted to ask on margins, it looks like the guidance is implying about 50 bps of year-over-year contraction on your reported 2023 figures, maybe a little bit less than that when adjusting for the reserve benefits and the de novo outperformance. But just broadly, when we think about what could drive margins lower year-over-year, how should we think about these headwinds from labor and the de novos compared to the fixed cost leverage that you should get on this very strong volume growth you're seeing?

Douglas E. Coltharp

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

A

Well, Kieran, I think you hit exactly on it, which is we've got all-in and assumed 4% to 5% increase in SWB per FTE. And so, what's driving that is an assumed 4% to 5% increase in general internal SW per FTE. And then the benefits of getting some leverage with volume growth across assumed relatively constant premium labor cost is being offset by an increase in benefits cost, which is largely attributable to the fact that we had such a favorable outcome this year. And so that nets to the 4% to 5% for an SWB increase.

And then it's a pretty significant swing going from a little over \$6 million in net pre-opening costs for 2023 to an assumed \$15 million to \$18 million in 2024. And that's got a number of factors implied in it. In 2023, we had a much heavier weighting towards the first half of the year in terms of openings than we're anticipating for 2024, and five of the eight facilities that opened in 2023 were joint ventures including a couple of those that were with existing joint venture partners. So, those ramped faster and the balance that we're anticipating in 2024. But those are the two primary factors that could create a little bit of rub on the margin.

And as we have said repeatedly, we are an EBITDA and EBITDA growth story. We are not necessarily a margin story. We'll always seek to gain leverage as we're growing volume, but the most important thing that we can do is get out there and provide extremely high-quality care to more patients who are in need of in-patient rehabilitative services. And we continue to believe that the market is underserved.

Kieran Ryan

Analyst, Deutsche Bank Securities, Inc.

Q

Appreciate that. And then just a quick follow-up on the labor side, 55 net RN hires in the 4Q. Solid, obviously down a bit from the last two quarters where you were up in the 200 range. But should we think about this as kind of the right pace as to what you're targeting heading into 2024, given where volumes are running and that you've already cut down contract labor down to that 1.5%, 1.4% of FTEs, or do you see it accelerating further from here?

Mark J. Tarr

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

A

No, we're actually very pleased with that number in Q4. If you look back at prior year that was that was a negative net. And if you think about the period of the year, that's extremely difficult to hire new staff, it's around the holidays particularly in Q4. So, our talent acquisition team has been very successful in helping to support the hospitals as well as the new ramp-ups and finding and hiring nurses. We've talked about in past calls too that we have a real focus on retention in our hospitals to retain the nurses that we already employ with particular focus on those that have been hired in the last year or so. So, we're very pleased with the progress that we've made and our hiring of RNs and would [ph] accept (00:23:22) this year to be another strong year with that.

Douglas E. Coltharp

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

A

Yeah, we can't necessarily assume the run rate that we saw on new hires in Q4 is going to stay steady across all four quarters in 2024, because there will be some seasonality to that. But as Mark said, we're very pleased there. And with some specifics on turnover, our RN turnover for all of 2023 was down 500 basis points from 2022, and therapy, which has always been best-of-class and low from turnover perspective, was down 130 basis points on a year-over-year basis. So, a combination of new hires and reducing turnover rate is really allowing us to manage those premium labor costs better.

Now, frankly, the 1.4% that we saw in terms of contract labor FTEs as a percentage of total FTEs in the fourth quarter was better than we had anticipated. We have assumed that we'd hit kind of a stabilization point around 1.5%. As we've noted previously, we had run just below 1% pre the Q3 of 2021, when the spike occurred for the overall industry. We'd like to see continued progress towards that number, but it's just very hard to predict.

Embedded in our guidance assumptions for 2024 is that from a total dollar perspective, premium labor costs in 2024 remain relatively consistent with the run rate that we established in Q4, which was down an aggregate of \$2.7 million sequentially from Q3.

Kieran Ryan

Analyst, Deutsche Bank Securities, Inc.

Q

Thank you so much.

Operator: Our next question will come from Ben Hendrix with RBC Capital Markets.

Douglas E. Coltharp

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

A

Good Morning.

Mark J. Tarr

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

A

Hello, Ben.



Hi. This is [indiscernible] (00:25:21) for Ben. Thanks for taking the question. So, it sounds like internal SWB per FTE growth is expected to moderate in 2024 after a few years of acceleration. Just broadly, can you talk a little bit more about the labor market and what you're seeing for wage inflation? And do you think this will continue to moderate moving forward?

Douglas E. Coltharp

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



As I said, [ph] Mike (00:25:49), we've got it. The internal SW per FTE assumption is an increase to 4% to 5%. And frankly, that's probably a point higher on both ends of the range than I was thinking about at the end of Q3. What we are seeing is that although overall labor market conditions are improving, it's important to really stay on top of market adjustments. And as we're bringing in these larger number of new hires, if they're coming in at a market rate that is different than what we're paying the [ph] external (00:26:20) workforce, we've got to make sure that there's parity across that.

Again, across all of the metrics that we've cited, we're seeing improving labor market conditions. We're optimistic that that will improve, particularly as we progress into the second half of 2024. But it's difficult to bank on that. So, we went with a set of assumptions I think reflect the current environment and no further improvement as we progress through the year.

Mark J. Tarr

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



[ph] Mike (00:26:46), we've tried to make sure that our hospitals have stayed at the mark in terms of their rates with what the market analysis we have. Once you get behind market, it's awfully difficult to catch up and it typically costs you more once you get behind that if you had stayed at the market level all along through market adjustments. If you look at between the market adjustments we've done in the last year and a half and the new staff that we brought on, there's a pretty high percentage of our overall staff that had some adjustment or another. So, that's part of the logic that we took going into the assumptions for this year.

Douglas E. Coltharp

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



And I think it's all proving to be a very good trade. I mean, you tie together a bunch of these metrics, look at the volume growth. At no point during 2023 did we find ourselves constrained in being able to take volume and to take it safely into the best interest of the patient because of labor constraints. Our turnover rates, as I cited before, are down markedly for both RNs and therapists on a year-over-year basis, and our salaries are competitive enough that we're continuing to have made great progress in recruiting new clinicians into our workforce.

Mark J. Tarr

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



One final note on labor, it should be noted that our talent acquisition team has helped us open up the vast majority of the de novos for last couple of years with zero contract labor at the time of opening. So, it's been a huge support in terms of our ability to take the volume that Doug alluded to and just start off in these markets, some of them new markets on a good solid footing.

Douglas E. Coltharp

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

A

And the efficacy of that centralized talent recruiting function also comes with an efficiency, and to their credit our HR team has been very creative in looking at the ways that we were spending dollars across the recruiting function to find out where those were having the greatest impact and then concentrating the dollars in those areas. So, even with the success we had on new hires during the course of 2023, we actually did that with a year-over-year decrease in recruiting costs.

Q

Okay. That's very helpful. Just shifting gears a little bit, I know you're working at moving more contracts towards case mix, just wanted to see how this is progressing. Thanks.

Douglas E. Coltharp

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

A

Yeah, we continue to make great progress there. We're at just about 90% of our MA contracts are on an episodic versus a per diem basis. And the rate differential, even as we continue to grow Medicare Advantage at a rate greater than our other payer categories as compared to fee-for-service, remains less than 5%.

Q

Thank you.

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

Mark J. Tarr

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

A

Good morning, Brian.

Taji Phillips

Analyst, Jefferies LLC

Q

This is Taji on for Brian. But thank you for taking my question and congrats on the quarter. So unfortunately, just one more question about labor. Currently, are you able to fill all the demand that you are seeing in the market, and if not, how much more of labor would you need to see you upsize, like that volume growth?

Douglas E. Coltharp

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

A

Yeah, as I just mentioned, at no point in 2023 were we unable to take volume because of labor constraints.

Taji Phillips

Analyst, Jefferies LLC

Q

Okay, great.

Douglas E. Coltharp

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

A

And we continue to prioritize. We are going to serve all of the patients who are in need of inpatient rehabilitative care in the markets in which we are in, even if it means paying premium labor.

Taji Phillips

Analyst, Jefferies LLC

Q

Okay. And then this is a slight follow-up from Joanna's question. I know you had called out differences you're seeing in different condition categories. Just wanted to follow-up and see if there are any specialties where you see as an incremental opportunity in terms of volume growth or revenue yield? I know you called out increasing investment and like expansion of your in-house dialysis, but wanted to see if there's anything else you're thinking about?

Mark J. Tarr

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

A

So, we've put a big focus on the neurological categories as a whole for the past several years. We called out stroke, because we think we have a particular strong outcomes and we feel like there's a huge demand for stroke rehabilitation. We think we do a really good job in getting these patients back to the community. And we partner with the American Stroke Association nationally to help promote the need in education for stroke patients. So, we call it stroke specifically. As Doug noted, we had almost a 5% growth in that last year. And it remains one of our top categories in terms of percentage of total discharges. So, between stroke and other neurological, I would call those out as areas that we see continued opportunities to grow.

Douglas E. Coltharp

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

A

I think the other one that I would point to and perhaps one that we don't count enough and maybe don't get enough credit for in a forum like this, is dealing with brain injury patients. And so, brain injury particularly runs between 10% and 12% of our overall patient mix, and it was up 10.5% in the quarter. Obviously, that's a very medically complex patient and so, they can't be treated effectively in too many settings.

Operator: Thank you. [Operator Instructions] We'll now hear from Jared Haase with William Blair.

Douglas E. Coltharp

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

A

Good morning.

Jared Haase

Analyst, William Blair & Co. LLC

Q

Hey, good morning and thanks for taking the questions. Appreciate all the detailed commentary thus far. Maybe I'll just take a step back and ask a bigger picture question. I'm curious to hear your perspective just around the outlook for Medicare Advantage environment in general. Obviously, there's been a lot of focus lately just around rates for the plans and the broader utilization that those guys are experiencing. We'd just love to get your perspective on the group in a general sense, and then how you're sort of thinking maybe potential leverage in terms of rate negotiations or just your general value proposition in partnering with MA plans?

Douglas E. Coltharp

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

A

Yes. So again, we think with this – there continues to be significant upside in Medicare Advantage for us. Although the growth rate over the last several years has been very impressive, if you look again at the four-year CAGR, same-store CAGR for Medicare Advantage extending from 2019 and I picked 2019 specifically to go back before COVID and run that through 2023, our Medicare Advantage same-store is up 15.2%. So, it's our fastest growing category. But we've been able to grow that while maintaining or increasing the number of those contracts that are paid on a case rate basis versus a per diem, and keeping that narrowing and then keeping that payment differential versus fee-per-service at less than 5%.

I think the real opportunity is that we continue to see conversion rates in Medicare Advantage and that means the number of admix as a percentage of referrals that is lower, significantly lower than Medicare fee-for-service. And some of the pressures or some of the focus that you're now seeing from CMS on the MA plans is about denial of access to care and utilizing internal metrics and algorithms to authorize care for [ph] Medicare Advantage (00:34:57) patients, which is not necessarily directing those patients to the place where they can expect the best outcome.

We think that those trends will bode well for us in the future, just based the quality of outcomes that we're producing and the complexity of the patients that we're able to treat effectively.

Jared Haase

Analyst, William Blair & Co. LLC

Q

Got it. That makes a lot of sense. And then maybe I'll just ask a quick follow-up. Thinking about specifically any priorities you guys would call out in 2024 just around technology investments or other workflow improvements? I think you alluded to some of the things around predictive analytics and obviously of the dialysis technology that you're rolling out as well. But just would be curious to hear of anything new or incremental on the road map this year that's focused kind of on driving clinical or operational improvement?

Mark J. Tarr

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

A

Yeah, you've named a couple of them. We always look at innovations that are out there, whether that is through the utilization of this huge amount of data that we've been able to collect from our clinical information system over the years and working with our clinical team on predictive analytics and driving our clinical outcomes. We look at the new technologies that are out there, particularly on the clinical aspects either for nursing or therapies that will help us to assist in treating our patients. There are a number of them that were working in full this year around dysphagia and helping the patients on their swallowing difficulties, which is a common issue with stroke patients.

We have weight-assisted devices in our gyms that can help our patients in ambulation around. So there, on any given year, including 2024, we take access to innovation in a number of different settings, particularly if it enables our staff to get better outcomes or helps them become more efficient.

Douglas E. Coltharp

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

A

We believe our competitive advantage in this regard is self-perpetuating, providing that we operate under a philosophy of continuous improvement. And by that I mean if you look at the common conditions that are treated in the IRF setting, just based on our scale and our market share, we see far more of those patients than any of our competitors by a very wide margin. And we utilize the data that comes from seeing that vast number of

patients to get smarter about the clinical protocols and the outcomes that they produce. And our clinical leaders have been really, really focused. They never rest on our laurels and they're focused on just continuously getting better at what we do, analyzing the data that comes through on almost every patients, saying how do we refine our models, how do we refine the protocols that we're using to become even more effective in treating these patients?

Operator: Our next question will come from Scott Fidel with Stephens.

Douglas E. Coltharp

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

Good morning. We'd say Scott, but we don't want to be presumptuous.

Scott J. Fidel

Analyst, Stephens, Inc.

Hi. Good morning, and it's actually Scott here for the real...

[indiscernible] (00:38:23)

Mark J. Tarr

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

Hi, Scott.

Douglas E. Coltharp

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

Which is not in any way to express disappointment regarding any of the others.

Scott J. Fidel

Analyst, Stephens, Inc.

Understood. Understood. I want to ask you just about balance sheet capacity here, just given how you did end up with leverage down below the long-term target range, obviously high interest rate environment. So that's not necessarily a terrible thing. But it does seem like you still have a lot of capacity incrementally here, right? Just how you're thinking about that for 2024 and whether that would influence thinking about potentially ramping up capital returns, such as the buyback more or further accelerating some of your growth investments? Or are you just comfortable keeping leverage below target here, just given the cost to capital environment?

Douglas E. Coltharp

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

Yeah. So, Scott, if you go back to 2022, we were running just about \$600 million in total CapEx and we were essentially a breakeven from a cash flow perspective. As a matter of fact, I think we, beyond funding almost all of that plus the dividend with internally generated funds. I think our debt increased modestly, maybe \$25 million or \$50 million.

As it came into 2023 with a CapEx budget that was in aggregate pretty similar and with an assumption that the dividend would be relatively constant, based on our initial guidance, we were assuming that we would once again be essentially breakeven in 2023. And we didn't necessarily, at that time think that it would be prudent, given that

we were starting the year with a 3.4 times net leverage to start deploying capital towards other potential utilizations like further shareholder distributions.

While through the course of 2023, we under-spent a bit, mostly based on timing with regard to CapEx and we over-performed with regard to EBITDA and adjusted cash flow. So that not only brought the leverage down but created more capacity for us earlier than we had anticipated to start really thinking about some of these additional uses of capital allocation. And shareholder distributions is one that comes immediately to mind once we get beyond funding our discretionary CapEx.

So, it is certainly something that the board is going to be considering through the course of this year. We frankly got in a position to be able to have that consideration sooner than we had anticipated.

Scott J. Fidel

Analyst, Stephens, Inc.

Q

Okay, great. So, we'll certainly keep an eye out for that. And then just a follow-up question just around modeling for seasonality, anything you'd want to call out just from either EBITDA or cash flow from the sort of the quarterly modeling progression that would be different than normal patterns, or should we think about it sort of consistent with typical patterns? Thanks.

Douglas E. Coltharp

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

A

It really feels like, after a period of some normalization being required that we've kind of gotten back into our regular seasonal pattern in terms of volume flows. And so, the biggest difference year-over-year is going to be the timing and the impact of de novos.

Scott J. Fidel

Analyst, Stephens, Inc.

Q

Okay. Thank you.

Operator: Our next question will come from Parker Snure with Raymond James.

Mark J. Tarr

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

A

Well, Parker...

Parker Snure

Analyst, Raymond James & Associates, Inc.

Q

Hey, good morning, and this is Parker.

Douglas E. Coltharp

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

A

Hey, good morning.

Parker Snure

Analyst, Raymond James & Associates, Inc.

Q

Yeah, this is Parker on for John Ransom. I just want to shift over to the 2024 guidance. So, yeah, if I look at the guidance or if I just look at your fourth quarter 2023 EBITDA, you did \$255 million of EBITDA. If I normalize that for the bad debt charge, that's \$271 million. If you annualize that, you get \$1.080 billion. Maybe there's some added de novo costs in there, so maybe let's say \$1.065 billion is kind of the run rate, but your guidance is \$1.035 billion. So, maybe just talk about why would there be a difference there? Is there a reason? Were there certain items in the fourth quarter that were kind of more one-time in nature? And why wouldn't the fourth quarter run rate be a good kind of jumping off point as we look into 2024?

Douglas E. Coltharp

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

A

Yeah. So first you back out of that to \$9 million in workers comp and GPL prior period reserve adjustments, then you normalize for a favorable group medical expense. Then as you suggested, the de novos for 2023 contributed \$1 million in EBITDA in Q4. The assumption for all of 2024 is that you're going to have \$15 million to \$18 million, some portion of that attributable to Q4. So, you've got a swing there. And then again, our core assumption is that you got 4% to 5% labor inflation, which is going to de-lever to some extent against the pricing. On top of that, you've got more nuanced items. We continue to believe that EPOB will normalize towards 3.4 rate. We're pretty close there right now at 3.38 for fiscal year 2023 in aggregate, that's a highly sensitive ratio. So even if you just moved up from 3.38 to 3.4, which is two one-hundredths of an impact, that's about a \$40 million to \$50 million impact on year-over-year EBITDA.

So, I think it's a combination of all those things. And we're here, we're a month into 2024. And so, what we have demonstrated consistently is particularly with regard to guidance is, we call balls and strikes very consistent. So, the guidance that we're providing right now is according to a philosophy that we have consistently applied. If the business is out there and if the environment is better, we'll deliver better results. But we think that this is a reasonable set of assumptions starting the year.

Parker Snure

Analyst, Raymond James & Associates, Inc.

Q

Okay. Yes, that's fair. And if I can just squeeze in one more just related to the bad debt charge. I know you guys said you changed some of your reserving practices as you move into next year, is there any chance that there could be another one of these kind of one-off reserve charges, or is it kind of the expectation that this was a one-off and shouldn't recur?

Douglas E. Coltharp

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

A

It's really the latter. We didn't necessarily change our reserve methodology, right, because the reserve methodology that's in place right now is really looking specifically at TPE, which had been suspended for a while and then came back on. But the activity there is a lot lower than it ever was under the widespread probes that stopped in 2018. The write off that we took this quarter, the \$16 million EBITDA impact, related to those older claims that originated, 97% of them were prior to 2018. And it related specifically to the fact that when we started appealing these things up to the DAB level, I mean to the federal district courts, we didn't have any experience on which to base specific reserve methodology. We're a year into it right now.

And unfortunately, what we found is that the claims denials that were essentially rubber-stamped as the ALJ ramped up, its number of judges in an attempt to clear the backlog is dictated by the federal court ruling that they were getting rubber-stamped at the higher levels as well. So, it's frustrating. We look back at that backlog of claims which has now been largely resolved, the balance is still out there on our balance sheet is essentially fully

reserved. We look back at those claims and say, we did the right things, we admitted the right patients and we treated them effectively. And yet, we're going to take these write offs and move on.

Parker Snure

Analyst, Raymond James & Associates, Inc.



All right. Thank you so much.

Operator: We have a follow-up question from Kevin Fischbeck with Bank of America.

Joanna Gajuk

Analyst, BofA Securities, Inc.



Hi. This is Joanna. Yes, thanks. So, I guess a little bit different topic, but I guess the proposed regulation cycle also creeping up on us. So, kind of your expectations for 2025 proposed rule, what do you expect there when it comes to rate out there or anything else? And I guess specifically, the home health trust for policy change that I guess was lax prior to 2024 cycles, so do you expect this to show up in 2025 or would you expect this to kind of die down? Because I guess when you think about it, if you would be [indiscernible] (00:47:18), like why should consumers just do this, because I guess the hospitals have the same transit policy. So why would the [ph] IRF see the front part (00:47:26), but any thoughts in terms of expectations for that? Thank you.

Mark J. Tarr

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



Hi, Joanna, this is Mark. Let me take the latter point. We've not heard any feedback relative to the home health transfer rule any anymore from CMS other than what was discussed last year as they did the RFI. I think at that time. the industry made a pretty good case why the home health transfer rule is a little bit different when you think about IRFs and the primary point being is that home health for an IRF patient is not a substitution version of care and it's actually a normal progression of care for rehabilitation patient. And I think it was also pointed out that the average length of stay for IRF patients across CMGs has been remarkably consistent. In other words, they've not seen it from a perspective that there was a financial motive to reduce average length of stay. And those are all different aspects. And if you've looked at other sectors in healthcare where there have been a transfer rule.

So, we've not heard anything. If there is information or an act included within the proposed rule or make it through the final rule, we'll do what we've done with all the other regulatory changes in our history. We'll evaluate it. We'll digest the new rule. We'll understand it. And we will adjust accordingly, just like we've done historically with other major changes.

Douglas E. Coltharp

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



Yeah, not to beat our chest, but I don't know that you can point to another provider that over its history has demonstrated greater adeptness and agility at responding to regulatory changes. And underlying all of this is the fact that the demand for inpatient rehabilitative services in this country is currently underserved and is only going to continue to grow based on the underlying demographic. Those patients need to be treated by somebody, and we are the most effective at treating those patients in need of those services and expanding the capacity to do that.

So regardless of what comes down the pipe from a regulatory perspective, we will adjust to it with alacrity and we will continue to grow our business.

Joanna Gajuk

Analyst, BofA Securities, Inc.

Q

Thank you. I appreciate the commentary.

Operator: Our final question will come from A.J. Rice with UBS.

Douglas E. Coltharp

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

A

Good morning, AJ.

A.J. Rice

Analyst, UBS

Q

Hi, everybody. Couple quick things here. I know you were saying in the deck that you're looking for a 2% to 3% increase in your managed care, and that's a small piece of the overall business. But I was curious if any updated commentary or discussions about value-based arrangements, incentive type of programs, any discussion along those lines?

Douglas E. Coltharp

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

A

You know AJ and I know it's going to sound redundant with what we said previously. We really just don't see much of that dialogue with the MA plan. A, it's complex and I think in terms of their overall book of business, we're still relatively small. So, the emphasis – now, if we get any inquiries from an MA plan about our willingness and our ability to participate in those types of models, we express great desire to do so.

Most of the discussions are really centering on the efficacy of our outcomes, the overall value proposition and the benefits to all parties involved in moving to a case rate structure where we're able to manage the MA patients to what we believe is the greatest clinical efficiency.

A.J. Rice

Analyst, UBS

Q

Okay. And then, I know you said your affirmation rates on the demonstration projects is hitting the – above the 80%, which is the target. I think that was supposed to be a six-month project, if I have it right. Any sense of where we go from here? If everyone, the major players, are hitting the targets, does it just get dropped? Do you think they're going to make a change on any of this? Do we have any idea?

Mark J. Tarr

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

A

AJ, it's Mark. As it laid out now, I mean the initial six months will end at the end of February and so it's projected to go from 80% to 85% and then ultimately up to 90%. So, we would expect it to go up to 85%. I think certainly given the affirmation rate that the industry has seen and CMS is seeing, we'll see where that goes from here. As it's noted, the five-year demonstration, so if they take the entire five years, we're not sure. But as you note, as the entire industry is performing quite well, you'd wonder why they would continue on with it.

Douglas E. Coltharp

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

A

You know, they had identified some of the states that they wanted go to next following the initiation in Alabama, Pennsylvania, Texas, and then I think Florida were on that list, not surprising given the number of IRFs in those states. It's our understanding that they have given, they being CMS, has given notice to the MAC Novitas about ultimately starting up this project without a date certain this demonstration, excuse me, in Pennsylvania.

We have nine hospitals in Pennsylvania, but all of our nine hospitals are with a different MAC that is [ph] Palmetto(00:53:27). And so, as it stands right now, our hospitals in Pennsylvania would not be subject to the extension of that demonstration into Pennsylvania.

A.J. Rice

Analyst, UBS

Q

Okay. All right. Thanks a lot.

Mark J. Tarr

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

A

Thank you.

Operator: That will conclude the question-and-answer session. I will now turn the call over to Mark Miller, for any additional closing remarks.

Mark Miller

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

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

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