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Encompass Health Corp. (EHC)

Q4 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone, and welcome to Encompass Health's Fourth Quarter 2024 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 session. [Operator Instructions] Today's conference call is being recorded. And 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, Encompass Health Corp.

Thank you, operator, and good morning, everyone. Thank you for joining Encompass Health's fourth quarter 2024 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 this call, we will make forward-looking statements such as guidance and growth projections, 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 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, 2024, 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. The fourth quarter was a great finish to a very positive 2024, characterized by strong financial performance, broad-based volume growth and significant advancement of our strategic positioning.

Hitting the highlights for Q4, revenue increased 12.7%, adjusted EBITDA increased 13.6%, adjusted EPS increased 23.2% and adjusted free cash flow increased 103.7%. Total discharge growth for the quarter was 7.8%, once again exhibiting strength across patient mix, payers and geographies. Same-store discharge growth was 5.8%.

Our primary focus remains on serving the Medicare beneficiary population, which for more than a decade has been the fastest growing segment of the US population. It is estimated that by 2030, one in five Americans, more than 70 million people will be aged 65 or older. The 65 or older population has been growing consistently at a CAGR of approximately 3%. And the population in our average Medicare patient age range of 75 to 79 has been growing at approximately 5%, yet the supply of licensed IRF beds in the US has increased only nominally. As a result, the demand for treatment of complex medical conditions, such as stroke, necessitating IRF care intensity, is significantly underserved. [indiscernible] (00:04:46) to many Medicare beneficiaries who would benefit from the clinical services required by law to be administered in an IRF are being denied access to this care.

In addition to the demand supply imbalance of IRF capacity, the access to care issue is exacerbated by ill-informed and lengthy preauthorization requirements by Medicare Advantage plans and faulty assumptions regarding a service equivalence between IRFs and SNFs by some hospital discharge planners and attending physicians.

We are one of very few providers with the means to alter this equation. We have the clinical expertise to successfully treat medically complex patients. Even with the higher acuity of patients we serve, during 2024, our discharge to community rate was 83.6%, up nearly 200 basis points from 2022. We are helping these patients recover and sending them home without subsequent 30-day acute care hospital readmissions.

Acute care hospitals know they can reliably send complex patients to us when the time is right, thereby reducing the number of unnecessary patient days in that relatively expensive acute setting. Our attractiveness as a partner to acute care hospitals is further evidenced by the fact that 65 of our 166 hospitals are operated as joint ventures. There are important benefits attendant to scale that better enable us to serve patients in need of inpatient rehabilitation services.

We treat more patients with IRF appropriate conditions than any other provider. This allows us to develop and refine best-in-class clinical protocols, which are then extrapolated across our hospitals via our continued best practices processes. The identification, development and implementation of these clinical protocols is enhanced by the state-of-the-art information systems we have invested in, including our IRF-specific electronic medical record.

Our scale also contributes significant cost efficiencies, positioning us as a low-cost provider of high-quality IRF services. The right place to be in the value chain.

Finally, we have the financial, administrative and operational resources to add much needed capacity to the IRF industry. We have been deploying capital and talent to extend our services into new geographies and to increase our capacity in existing markets with unmet patient needs for IRF services.

We accelerated our growth efforts beginning in 2020, and importantly and uniquely, our commitment to do so did not waver during the two years of the pandemic, even as we promptly returned the approximately \$240 million of CARES Act funding we received. From 2020 through 2024, we opened 36 new hospitals and added 474 beds to existing hospitals, increasing our total bed supply by 1,845 beds or approximately 20%.

During 2024, we invested more than \$450 million into capacity expansions, opening seven new hospitals and adding 107 beds to existing hospitals. In aggregate, we added 427 beds last year. In 2025, we expect to open seven new de novo hospitals with 340 beds, one satellite hospital with 50 beds and add approximately 100 beds to existing hospitals.

Included in our 2025 openings are five hospitals in the state of Florida. Prior to Florida eliminating its Certificate of Need requirement in July of 2021, we operated 13 hospitals in the state. With the CON revocation then pending, we announced that we had identified and prioritized 15 markets for new hospital activity in Florida.

By this time next year, we expect to have opened 13 new hospitals in the state of Florida since the revocation of the CON requirement, and we have additional Florida opportunities in our active development pipeline. We have already added beds to one of our new Florida hospitals and plan to do so at another in 2025.

We have continued to expand beyond Florida as well. Since 2020, we've added five new states to our map and will add another Connecticut in 2025. We now operate IRFs in 38 states in Puerto Rico and still the market for IRF services remains substantially underserved.

During 2024, we complemented our investments in growth with a return of approximately \$63 million to our shareholders through cash dividends on our common stock and repurchased more than 350,000 shares of our common stock. Our strong free cash flow generation allowed us to fund these investments and shareholder distributions while still reducing our net leverage to 2.2 times at year-end 2024.

Our investments in clinical innovations continue to advance our ability to consistently produce quality outcomes for medically complex, high-acuity patients in need of inpatient rehabilitation care. For example, we have further enhanced 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 improved by more than 30%, including an approximately 8% decline in 2024.

We also continue to refine our ReACT predictive tool, which measures a patient's risk of being transferred back to an acute care hospital. Our ReACT 2.0 was implemented in January 2023, and through year-end 2024, we experienced a more than 100 basis point decline in our acute care transfer rate. Our clinical interventions and experience continue to distinguish us from our peers.

Now, I'll turn it over to Doug to provide details about our Q4 and full year results as well as our 2025 guidance.

Douglas E. Coltharp

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

Thank you, Mark, and good morning, everyone. Revenue for the quarter increased 12.7% to \$1.4 billion and adjusted EBITDA increased 13.6% to \$289.6 million. The revenue increase was comprised of 7.8% discharge growth and a 4.2% increase in net revenue per discharge. As Mark stated, volume strength was broad-based across geographies and patient and payer mix.

Adding a bit of color on discharge growth, for the quarter, Medicare increased 6.8%, Medicare Advantage 14.7% and managed care 8.9%. Within patient mix, stroke discharges increased 12.6% and neurological disorders 7.7%. Net revenue per discharge for Q4 benefited from a decrease of 200 basis points in bad debt expense to 2.1%. Recall that Q4 2023 bad debt included an approximately \$22 million reserve related primarily to claims denied prior to 2018.

SWB per FTE for Q4 increased 6.4%. Within this, salaries and wages per FTE, excluding contract labor and sign-on and shift bonuses, increased 4.8%, resulting from merit increases, market adjustments and a change in our clinical license mix. This latter factor is related to our implementation of nursing and therapy career ladders, which encourage our clinicians to seek incremental accreditations, which are then accompanied by compensation increases.

We believe these career ladders are contributing to our improved turnover results. For 2024, our RN turnover was 20.4% compared to 23.1% in 2023 and therapist turnover was 7.7% compared to 7.8% in the prior year.

Our Q4 benefits expense per FTE increased 30.6%. Please recall that in Q4 of 2023, benefits per FTE decreased 9.6%. So some of this year's increase is attributable to the lower base.

Similar to Q3 of this year, within our group medical, we continued to experience a higher incidence of large dollar claims and an increase in utilization of high specialty – high-cost specialty drugs. While the incurrence of large dollar claims is sporadic and the frequency of such claims tends to be mean-reverting, we expect group medical prescription drug cost growth to remain elevated at least through the first half of 2025 when we anniversary the increase in utilization of these specialty drugs.

For 2024, our benefits expense per FTE increased 12.4%. This increase comes off of two very good years, as in 2022, benefits expense per FTE decline 0.8%; and in 2023, the increase of this lower base was only 0.2%.

Premium labor costs, comprised of contract labor and sign-on and shift bonuses, were \$29.7 million in Q4, a decrease from \$30.9 million in Q4 2023. During Q4, contract labor FTEs comprised 1.4% of total FTEs. Net preopening and ramp-up costs were \$1.3 million in Q4 2024 as compared to an adjusted EBITDA contribution of \$1 million from the 2023 openings in Q4 2023.

Our Q4 adjusted EBITDA included approximately \$7.7 million in favorable reserve adjustments for workers' comp and general professional liability insurance. On a full year basis, 2024 included approximately \$13 million in favorable reserve adjustments for these self-insured programs.

We continue to generate significant free cash flow. Q4 adjusted free cash flow increased 103.7% to \$190.5 million, bringing our 2024 full year total to approximately \$690 million, a 31.3% increase from 2023. Our leverage and liquidity remain very favorable. As Mark cited, net leverage at year-end was 2.2 times.

Moving on to guidance. Our 2025 guidance includes net operating revenue of \$5.8 billion to \$5.9 billion, adjusted EBITDA of \$1.16 billion to \$1.20 billion and adjusted earnings per share of \$4.67 to \$4.96. The key considerations underlying our guidance can be found on page 11 of the supplemental slides.

There are a number of factors to keep in mind as you contemplate quarterly and year-over-year comparisons. Recall that Q1 2024 discharge growth benefited from an extra day due to leap year and because the quarter ended on Easter Sunday. We are anticipating \$18 million to \$22 million of hospital net preopening and ramp-up costs. We expect these costs to be heavily weighted towards the second half of the year because five of our eight hospitals are expected to open between September and year-end. This estimate also includes costs related to openings in early 2026.

2024 included approximately \$13 million in favorable reserve adjustments for workers' comp and general professional liability insurance. Our second half 2024 adjusted EBITDA included approximately \$2.3 million in

Oracle Fusion implementation cost and approximately \$3.2 million in NCI expense related to the addition of our Augusta Hospital to the Piedmont joint venture.

2025 will include a full year impact of these, which we expect to be \$5.5 million to \$6.5 million for Oracle Fusion implementation cost and \$6 million to \$7 million in NCI expense related to the Augusta joint venture.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] We'll take our first question this morning from Whit Mayo at Leerink Partners.

Douglas E. Coltharp

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

A

Morning, Whit.

Mark J. Tarr

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

A

Hello there, Whit.

Whit Mayo

Analyst, Leerink Partners LLC

Q

Morning, guys. Thank you. My question first just on the MA growth. This has been outpacing other payer classes for some obvious reasons with all the health plan scrutiny, the fewer denials and such. But is the growth you're seeing more apparent in certain states or certain markets versus other? Is it more broad-based as a trend across the portfolio? I'm just trying to get a sense of sort of when you unpack the business where we're seeing that level of growth come from.

Douglas E. Coltharp

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

A

Yeah. Whit, it's been a little bit of both. We are seeing same-store growth in Medicare Advantage as well, but it's definitely being assisted by our movement into new markets. We continue to believe that there's a lot of upside within the Medicare Advantage book of business, both because of the enrollment trends and also due to the fact that our admissions to referral rate remains substantially lower within Medicare Advantage than it does within fee-for-service, and there's really no reason for that discrepancy to exist.

But if we just kind of look at some of the discharge growth patterns, for the quarter, Medicare Advantage was up 14.7%, up 12% on a year-to-date basis. The same-store growth within that for the full year of 2024 was 9.9%, and we're looking at a five-year CAGR in the Medicare Advantage discharge growth of 11.6%. So we really do feel like we're making substantial inroads there.

Mark J. Tarr

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

A

Whit, as you know, it's been a multiyear process for us in terms of making sure that we are loaded with data to show our outcomes and our value proposition. So that's what we lead with whenever we go in and meet with the

plans, and make sure that they're aware of the outcomes we're able to get in our facilities. So we continue to refine that process and would expect to continue to see growth in Medicare Advantage going forward.

Douglas E. Coltharp

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

A

And I think it is also important to note that it doesn't mean that Medicare fee-for-service is not growing. Again, Medicare discharges in the quarter up 6.8% year-to-date, which is the full year of 2024, 8.6%, same-store for 2024, up 5.7%, and the five-year CAGR there is a little bit lower, but still impressive at 3.4%.

Whit Mayo

Analyst, Leerink Partners LLC

Q

No, that's helpful. Just my follow-up on free cash flow and priorities here. I mean, the cash flows hit an inflection the last two years with presumably a lot of the earnings from the prior year investments now overcoming the incremental capital investments, which you've made, which is nice. But I just want to hear any views on buybacks as a larger priority going forward. And Doug, if you could just maybe comment on total CapEx expectations for the year? I don't know if I caught that number. Thanks.

Douglas E. Coltharp

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

A

Yeah. So, CapEx is going to be up this year. It's probably going to be up on the order of about \$100 million. Most of that is in growth-related CapEx, specifically related to our continued capacity expansions. It's going to be a big year, we expect, both this year and next year with regard to bed additions, which, as you know, is our highest returning form of capital deployment. So we're excited about the opportunities to bring more beds on. And we've got – also got an increased spend in de novo activity. Some of that is related to the fact that we're opening one additional hospital this year, but it also gets to the timing of the 2026 opening. So that number will be up and is probably approaching what we think will be a run rate for the next several years.

With regard to deploying cash flow beyond that, we did increase and begin utilizing the share repurchase authorization mid-year of 2024, and we would expect continued and probably more consistent utilization of that program with excess free cash flow going forward. And we do have the cash dividend. That gets adjusted from time to time at the discretion of the board. It's not specifically policy or formulaic driven. But I think once you move beyond our spend on growth-related discretionary capital expenditures, the most likely utilization of excess free cash flow, given where we sit from a leverage perspective, is going to continue to be shareholder distributions.

Whit Mayo

Analyst, Leerink Partners LLC

Q

Okay. Thanks, guys.

Operator: Next, we'll hear from the line of Matthew Gillmor at KeyBanc.

Douglas E. Coltharp

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

A

Morning, Matt.

Mark J. Tarr

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

A

Hello, Matt.

Matthew Dale Gillmor

Analyst, KeyBanc Capital Markets, Inc.

Q

Hey. Good morning. Hey. I wanted to ask about the pace of the bed additions in 2025. Seems like that's accelerated a little bit this year compared to last year, and I appreciate Mark's comments at the top of the call about the supply and demand imbalance. Should we think about 2025, [ph] and is this (00:26:00) in terms of the pacing, more of just a timing issue, it happens be a good year? Or is there anything more to discuss in terms of your ability to move projects forward and meet the demand and maybe even accelerate sort of the pace of bed additions over time?

Mark J. Tarr

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

A

Hey, Matt. So we're adding one more hospital in 2025 than we did last year. We have seven de novos and one satellite coming on this year. We're also adding 100 beds. So both of those, it's one additional hospital and it's a higher number of total bed additions, too. You're just going to see some fluctuations from one year to the next on that. I think we've done a really nice job in showing our ability to meet our growth target in terms of bringing on new hospitals.

As we said, we are bringing on five in the state of Florida this year, which certainly has some benefit when we see that market density in terms of staffing and having experienced members of senior management teams maybe float from one hospital over to a new hospital to help that startup process. But we feel pretty good about the pace that we're bringing them on. And yes, this year is a little bit higher pace than what we had last year.

Douglas E. Coltharp

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

A

And Matt, if I could elaborate on that, we have more hospitals today that are candidates for bed expansions than we've had in recent history. And that is largely due to the fact that we are coming off of two years, really three years, of very strong total discharge growth, if you roll all the way back to 2022 up 6.8%, 2023 up 8.7% and 2024 up 8.3%. And as a result, our occupancy level has been increasing. Now, some of that is also attributable to the fact that we continue to push the percentage of our overall portfolio comprised of private beds up, but this has started to create more opportunities, more hospitals that are on our list for future period bed expansions.

Our ability to move quickly on those has two primary constraints or limitations. One is a significant number of those bed expansion opportunities are subject to CON permit. That CON hurdle is a lot lower than it is for a new hospital, but it still exists and it takes some time to navigate. And the second, quite frankly, is that the number of projects that is on our plate somewhat limited the capacity within our design and construction department. We're adding resources there. This is a high-class problem to have. But that's why some of what you're starting to see in this year's number and in what we're anticipating for 2026 as well.

Matthew Dale Gillmor

Analyst, KeyBanc Capital Markets, Inc.

Q

That's great. And then, Doug, maybe asking about the SWB per FTE assumption in the guide. I know you've got a little bit, I think, of a deceleration in growth, down to 3.5% at the midpoint. I was hoping maybe you could unpack that a little bit. It sounds like you've got a really easy comp on the benefit side. But is there anything you can call out in terms of what you're seeing in terms of other factors, whether that's wage growth or turnover that's helping to explain that modest deceleration?

Douglas E. Coltharp

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

A

I think all of that gets tossed in. And so that SWB inflation range that we have of 3.25% to 3.75% is on total SWB. So that also includes those premium labor categories. And we're making an assumption that our spend in those premium labor categories will still stay relatively constant as in terms of total dollars. So that's going to give us a point of leverage in the inflation rate as well.

Your comment on benefits is appropriate. As I noted in my comments just a moment ago, we do expect that group medical inflation to continue through the first half of this year, but then you're going to anniversary it in the second half of the year. And we do expect to see some benefits related to the lower turnover rates. So all of that kind of in the mix.

I will note that the – that range is just slightly higher than what I had alluded to as a potential range in our Q3 call, but it's really just based on the trends that we witnessed in Q4 that are carrying into 2025.

Matthew Dale Gillmor

Analyst, KeyBanc Capital Markets, Inc.

Q

All right. Thanks a lot.

Operator: Our next question today comes from A.J. Rice with UBS. Please go ahead.

Mark J. Tarr

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

A

Hey, A.J.

A.J. Rice

Analyst, UBS Securities LLC

Q

Hi, everybody. First of all, maybe just to ask about your – Florida has been a great opportunity for you. How has – are you the primary person adding IRF beds in that state? How's the overall market look now? Is it running any risk of being somewhat over-bedded and people overshoot the target or is – do you feel like relative to your other markets, the beds per 1,000 and so forth is still in a good spot there?

Mark J. Tarr

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

A

Yeah.

A.J. Rice

Analyst, UBS Securities LLC

Q

[indiscernible] (00:31:18) how much of your overall – once you get these all up and running will be part of this, if I could ask?

Mark J. Tarr

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

A

So, let me take your first question, A.J. It's Mark. So, we feel good about our growth in Florida. We are the – we've taken the lead, have been in the lead in terms of adding beds there. And that was by design. When we

stated we had 15 marketplaces that we were prioritizing for future growth, we went out and bought the real estate, and were first to market, which was an important part of our strategy in the state of Florida. As we said, we already had 12 hospitals that were legacy hospitals there. So we knew exactly what markets we wanted to go into and where we would add beds to. So it's been very intentional our accelerated pace in the state of Florida.

As you know, the demographics for the state of Florida play into our line of business. There continue to be strong growth in the markets that we're entering. And so we don't see that state as being over-bedded. If anything, as I noted, we have additional opportunities in the state of Florida, whether that's through new hospitals or adding beds our existing hospitals.

Douglas E. Coltharp

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

A

Yeah. And A.J., maybe just to piggyback on that a little bit. First of all, because the CON was in place until 2021, there was an artificial cap on the number of IRF beds in the state of Florida. And as the population continued to grow, even during that period preceding 2021, particularly amongst the senior population, the supply-demand gap really opened up pretty significantly. So they were starting in a very significant deficit.

As Mark noted in his comments as well, and I think it's important to go back to that 2020 timeframe, obviously, when the pandemic hit, most operators in the business kind of lost visibility into the near-term operating trends of their business. But as we've recounted previously, we made the decision in April of 2020, even in the midst of all of that, to begin pushing forward with this accelerated de novo program and doing things like purchasing land in the state of Florida for de novos because we had identified those markets previously. That had the effect of creating a first-mover advantage and frankly, made a lot of our competitors shy away from adding capacity because they weren't in a position to do so.

The final thing that I would add is if you just look at the current rate environment versus what it was several years ago, for those IRF operators that are owned by private equity sponsors that have been heavily reliant on levered transactions with refinancing, the economics have just become a lot less palatable. If you combine elevated construction costs with higher cap rate costs embedded in those leases, it's just difficult, particularly without enjoying the same economies of scale that we do, to make the numbers work.

A.J. Rice

Analyst, UBS Securities LLC

Q

Okay, great. Maybe just my follow-up, obviously, there's a lot of focus across healthcare services on the new administration, the new Congress and what they might do. It seems like you're fairly insulated from the laundry list of Medicaid reforms and so forth, but are there any areas where you're watching that are a particular area of focus? And then as well on the – you mentioned in prior authorization, there's been some chatter about that. Are you advocating for some relief relative to MA and other health plans on prior authorizations and what's the prospects for that?

Mark J. Tarr

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

A

So, A.J., as you know, there's not a lot of specifics coming out relative to policy from D.C. right now until the confirmation of HHS and CMS or RFK Jr. and Dr. Oz, but we've spent some time up there. We've had a chance to meet some of the incoming senior staffers for CMS and otherwise. And we made the point of wanting to make sure that there is not regulatory overreach and those are unnecessary expenditures and have no positive benefits for the patients.

And so we're watching it closely. We're not hearing anything of concern right now that are specific policy changes or regulatory changes facing the IRF industry, but we will absolutely remain active and involved in D.C. and want to be on the front edge of – meaning the new incoming leaders of CMS.

Douglas E. Coltharp

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

A

And A.J., I would say that with regard to conversations that we have with CMS and then also with our elected representatives on the subject of Medicare Advantage, our two primary focus points are improvements in preauthorization processes and philosophies. And then the second is, as we've discussed before, right now, there is no requirement for Medicare Advantage plans to include IRFs in their definition of network adequacy and we think that that is simply an oversight that should be corrected.

A.J. Rice

Analyst, UBS Securities LLC

Q

Okay. Thanks.

Operator: Andrew Mok with Barclays, you have our next question.

Mark J. Tarr

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

A

Hello there, Andrew.

Douglas E. Coltharp

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

A

Morning, Andrew.

Andrew Mok

Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. You noted that group medical prescription drug costs are expected to continue to increase through the first half of 2025 before you anniversary some of the acceleration. Can you give us a bit more detail on the trends you're seeing there? Are there any specific drugs or categories that you would call out as driving the increase in the group medical line? Thanks.

Douglas E. Coltharp

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

A

Yeah, there are three. So the two largest – there'll be no surprise to anybody on this call. One is certainly GLP-1 and it is just getting – even though we limit that to those that are at risk or have diabetes, physicians are prescribing it much more widely as even somewhat of a prophylactic. So we're seeing increased utilization there, and it remains expensive. We're hopeful that given the number of entrants into the GLP-1 category that, over time, the cost of that drug will decrease. But right now, what we're counting on is anniversarying the stepped-up usage in the second half of the year.

The second is, there are a – and this is a good thing, but there are a number of notable enhanced cancer-related drugs that we're seeing increased utilization of. Those are expensive as well. I'd make similar comments with regard to cost trend and utilization trend there. And then the third and I don't know that I could pronounce the

name if even if I wanted to, is there is one drug that is specifically related to eye sight and eye health that has popped up a little bit more frequently.

Andrew Mok

Analyst, Barclays Capital, Inc.

Q

Got it. That's helpful. And if I could just follow-up, I think the total net benefit from provider taxes this year totaled \$16 million, I think, for the year. How should we be thinking about this for 2025? Is there an explicit assumption around these items in guidance? And is that benefit in 2024 largely expected to recur? Any color there would be helpful.

Douglas E. Coltharp

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

A

Sure. So the EBITDA impact from net provider taxes, so the revenue less the associated expense for 2024, it was \$15.4 million. As we've noted previously, approximately \$5 million of that was related to prior periods. And so there really isn't any reason to expect that that portion would repeat itself. The balance then of about \$10 million, as we've talked about before, has a low level of predictability to it.

And to reinforce that point, we'd point to the net impact from provider taxes in the two prior years. In 2023, the net provider tax impact to EBITDA was a decrease of \$800,000. And in 2022, it was an increase of \$2 million. So, this feels a little bit like an outlier and we'll just have to wait to see.

In terms of the 2025 guides, we haven't included a point estimate for provider taxes within that guidance range. It is highly variable. And wherever provider taxes winds up falling in 2025, will obviously be a determinant as to where we land within that \$40 million EBITDA guidance range.

Andrew Mok

Analyst, Barclays Capital, Inc.

Q

Great. Thanks for all the color.

Operator: We'll hear next today from the line of Joanna Gajuk at Bank of America. Please go ahead. Your line is open.

Mark J. Tarr

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

A

Hi, Joanna.

Joanna Gajuk

Analyst, BofA Securities, Inc.

Q

Hi. Yes. Hi. How are you? Thanks so much for taking the question. So I guess, first, a follow-up on the maintenance CapEx. In the slides, you talk about major renovation projects and programmatic hospital asset replacement. So a little bit call there. Is there something that you do this year differently than prior's?

Douglas E. Coltharp

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

A

Yeah. So just we've got more hospitals now. The hospitals utilize a lot of the same equipment and we have programs that will, in order to leverage our scale, buy that equipment and replace it on a regular basis, sometimes in cycles across the hospitals and sometimes more uniformly.

The spend specifically in that programmatic category for 2025 relates to bed replacement. About every five to seven years, all of the beds need to be replaced in order to ensure safety and comfort for our patients. Other categories that will occasionally fall into that, wheelchairs are a pretty significant spend. Sometimes the machinery that we utilize to dispense narcotics – not narcotics, drugs, prescription drugs is a better term, will fall into that category as well.

So we just – we think it's really important that we maintain all facets of our hospitals.

Joanna Gajuk

Analyst, BofA Securities, Inc.

Q

Okay. That's helpful. And if I may, so the adjusted free cash flow came in, call it, \$100 million, is still better than expected in your prior guidance for the full year. So what drove that? Was there some sort of pull forward from 2025, because now, I guess, your guidance for 2025 kind of calls for decline from 2024 because 2024 came in so much better?

Douglas E. Coltharp

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

A

Yeah. So it's really two things. One is EBITDA came in better than we expected. The second is the favorable result in working capital was better than we expected. And some of that will definitely be a pull forward because some of that relates to the increase in claims activity under our group medical, where we're seeing a liability, a near-term liability increase, and it doesn't translate into cash until you get into subsequent periods.

Joanna Gajuk

Analyst, BofA Securities, Inc.

Q

Great. Thank you so much.

Operator: Ann Hynes at Mizuho, please go ahead. You have our next question.

Mark J. Tarr

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

A

Hello there, Ann.

Douglas E. Coltharp

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

A

Morning, Ann.

Ann Hynes

Analyst, Mizuho Securities USA LLC

Q

Great. Hi. How are you? Thanks.

Mark J. Tarr

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

A

Good.

Ann Hynes

Analyst, Mizuho Securities USA LLC

Q

So I know, post the pandemic, Encompass really benefited from gaining market share from nursing home. What is that like now? Is that still a tailwind for the company?

Mark J. Tarr

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

A

Yes, Ann, it is. I mean, we – I think we, along with the industry as itself, distinguish ourselves from the nursing homes. And the differences that – in terms of patients that could be treated, we continue to see increasing numbers of stroke and other neurological types of patients that are typically higher acuity in our hospitals. And we think the outcomes that we are able to get versus what previous referral sources saw from nursing homes, that has had some stickiness to it in terms of changing referral patterns in some of our marketplaces.

Douglas E. Coltharp

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

A

I think there's no perfect way to measure market share gains from the SNF industry, but I'd point to a couple things. One is we've now had 10 straight quarters where our same-store discharge growth was north of 4%. And that is growing faster than the underlying demographic, which means that we are taking market share from some place. The patients that we're treating are not patients that were eligible for discharge directly home, so the most likely source is either from SNFs or other IRFs. But I think that's a pretty good indication of the fact that we are gaining market share.

Ann Hynes

Analyst, Mizuho Securities USA LLC

Q

Great. Thank you. And then just on the – like Florida is an interesting state just because they were able to lift the CON laws. Is there any other state that is on the company's radar that would be similar to Florida? And if not, do you have that type of expansion potential in other states that you currently operate like Florida?

Mark J. Tarr

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

A

Yeah. So, Ann, there are other states that we have on our radar screen. Clearly, we have a strong presence in the state of South Carolina and only have one in the state of North Carolina. But if you look at the growth in the state of North Carolina, it would be a very attractive state for us to have a greater presence than what we currently have.

Douglas E. Coltharp

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

A

And particularly, when you consider the fact that South Carolina and North Carolina are really – those are destination states for retiring seniors right now and they are considerably under-bedded.

Ann Hynes

Analyst, Mizuho Securities USA LLC

Q

Thank you.

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

Douglas E. Coltharp

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

Hey, good morning, Scott.

A

Mark J. Tarr

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

Hello, Scott.

A

Scott J. Fidel

Analyst, Stephens, Inc.

...touch on the implied EBITDA margins in the guide. At the midpoint, it would imply a modest around 30 basis point contraction year-over-year, obviously, a very strong year in 2024. Just to, I guess, sort of put a fine pen on that. Sort of what would you say sort of be the drivers of that? And then more importantly, maybe some of the upside opportunities that you see tangible to potentially ultimately get margins landing at stable or even improving year-over-year in 2025?

Q

Douglas E. Coltharp

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

Yeah. So a number of things. One is we continue to believe that EBITDA dollars are better than EBITDA margin. It's tough to pay the bills with a margin. Some considerations in terms of the comparison from 2024 to 2025, as I mentioned in my comments, 2024 included \$13 million in favorable self-insurance accrual adjustments, as we just mentioned when we were responding to Andrew's question. 2024 benefited from \$15.4 million in provider tax impact, including \$5 million of out-of-period.

A

If you look at the startup and ramp-up costs associated with new hospitals, the midpoint of the range is about \$5 million higher in 2025 than it was in 2024, owing both to the fact that five of our hospitals in 2025 will open between September and the end of the year. And right now, we are targeting three new hospitals opening up in the first quarter of 2026. And then the delta on a year-over-year basis in terms of the G&A expense and NCI impact of Piedmont joint venture, specifically our contribution of the Augusta Hospital to that and Fusion implementation cost, is \$7 million.

So I think if I do the math right on all of those items, including just, say, the \$5 million of out-of-period on provider tax impact, right, there you've got about \$30 million of EBITDA that needs to be overcome moving from 2024 into 2025.

Scott J. Fidel

Analyst, Stephens, Inc.

Okay. That's helpful. And then for my follow-up question, especially given just all of the development activity playing out. It would be great if you could give us an update just on sort of construction sort of inflation dynamics? Obviously, that's been swinging around.

Q

And then related to that, just curious whether – as you sort of think about the prefab models that you spent a lot of time putting into place, have you've been able to do any type of analysis around Trump's tariffs? And are there any sort of, I guess, elements of those prefabs that may come from international sources that could be affected by

the tariffs and have alternative options in the US? Just curious sort of what work you've been doing or if there is even any effect on the tariff side. Thanks.

Douglas E. Coltharp

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

A

Yeah, absolutely. I'll try to take those in order. One is construction – new construction costs, well, have continued to stabilize right around \$1.2 million per bed. For new hospitals, somewhat lower, closer to \$800,000 a bed for bed additions, but it depends on the specific project. And we're not seeing any overt inflationary pressures on that cost right now. If anything, we think that we may be seeing some green shoots in terms of maybe some relief on that, but it's too early to call the ball.

The second is, we remain very pleased with our prefabrication effort. Mark mentioned earlier that in the fourth quarter, we brought on our first fully prefabricated hospital. That's 61-bed facility in Houston, Texas. Our second fully prefabricated hospital is getting ready to open any day right now in Athens, Georgia. So that'll continue to be part of our construction strategy, along with hospitals that are utilizing components of prefab, everywhere from headwalls to bathrooms to the uber modules, which are groups of rooms that are attached by a corridor.

The cost for the prefabrication right now from a per bed perspective is essentially right on top of conventional construction as well. The primary benefit that we're seeing today is, on the full prefab, we're getting about a 25% enhancement in terms of the speed to market, which is not insignificant.

With regard to the threat of tariffs, in the near-term, it's very low for us in terms of design and construction. There could be some impact if you impose those upon Mexico in terms of our concrete cost, but that's a very small component of our overall construction costs.

With regard to steel, we use predominantly US-sourced steel and much of it is recycled specialty steel that comes out of the US. We did a broader analysis of our potential exposure to tariffs coming out of Mexico, Canada and China around overall supplies. It's difficult to say what that might look like right now because we don't know how comprehensive it would be.

You should also bear in mind that in prior periods when tariffs have been invoked, typically, medical supplies have been exempted from those tariffs. Having said that, we do not believe that there's a lot of near-term risk to the imposition of any tariffs. It's certainly something we'll continue to monitor.

Scott J. Fidel

Analyst, Stephens, Inc.

Q

Great details. Thank you.

Operator: Our next question comes from Pito Chickering at Deutsche Bank.

Douglas E. Coltharp

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

A

Morning, Pito.

Mark J. Tarr

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

A

Hello, Pito.

Pito Chickering*Analyst, Deutsche Bank Securities, Inc.*

Q

Thanks for taking my questions. I guess, looking at for 2024 with provider taxes, the medical fees and then looking at 2025 with the headwinds and startup losses and then the Oracle and Fusion implementation, I just want to make sure that we're modeling the year right. Looking at quarterly EBITDA seasonality, is 2025 different than a normal year? And if so, how should we think about EBITDA in the first half of the year versus the back half of the year? And any thoughts on leap year and the Oracle and Fusion on the first quarter?

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

A

Yeah, so a couple things. One is in terms of our assumptions regarding specifically group medical expense and Oracle and Oracle Fusion implementation and the NCI impact from the contribution of Augusta to the Piedmont joint venture, you had those second half expenses in 2024. So it's really going to be a more pronounced impact on EBITDA from a comparison perspective in 2025.

The second thing to keep in mind is one that I just alluded to with regard to the pace of the preopening and ramp-up costs. And that is that it's going to be skewed more heavily towards the back half of the year because of the timing of the openings in 2025 and 2026.

And then the other thing I'd ask you to remember is that we had that spike in bad debt expense in Q2 because of the timing of the [ph] GPE (00:53:29) review by Palmetto, which subsequently then reversed itself in the second half of the year. And if there's a chance, just based on what we've seen in terms of the historical review pattern from Palmetto over the last couple of years, that you see a similar spike in Q2 of this year, but there's no really – no real way for us to determine that. I think those are the primary pacing considerations I can think of, Pito.

Pito Chickering*Analyst, Deutsche Bank Securities, Inc.*

Q

Yeah. Great. And then a follow-up to Whit's question on leverage. Is there a minimum leverage ratio where you deploy all excess free cash flow into repo? Just looking at the share guidance of 103 million and looking at your EBITDA growth and the cash flow generation, it just seems like a minimum leverage ratio would be helpful for investors to just calculate how much cash could be returned via share repo. Thank you.

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

A

Yeah, it's a fair question. I wouldn't draw a hard line there, but I would say that certainly, if we see the leverage drop below 2 times, it's feeling like there's a lot of inefficiency in our cost of capital.

Pito Chickering*Analyst, Deutsche Bank Securities, Inc.*

Q

All right. So 2 times is your minimum where we'll model all that going into share repo going forward?

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

A

No, minimal is your term, not my term. As I said, I'm not putting a hard line there, but I would make the observation. If we fall below 2 times, then we're going to be looking hard at what I would view as an unnecessary inefficiency in our weighted average cost of capital.

Pito Chickering*Analyst, Deutsche Bank Securities, Inc.*

Q

Right, fair enough, Doug. Thanks so much, guys.

Operator: Our next question comes from Ben Hendrix at RBC Capital Markets.

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

A

Morning, Ben.

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

A

Morning, Ben.

Ben Hendrix*Analyst, RBC Capital Markets LLC*

Q

Good morning, guys. Thank you very much. So just wondering if we could get a quick update on the managed care contracting environment rate assumptions and guidance seem consistent with last year. And I know you guys have historically maintained favorable spread between MA and Medicare rates. But with the ongoing margin pressure among some payers, just anything changing in your negotiations? And separately, any changes in how payers are assessing patient eligibility for IRF care?

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

A

Yeah. I would say the answer there is nothing new. So we continue to do, I think, well with regard to our managed care, including Medicare Advantage contract negotiations. The rates that we're seeing in terms of the update are pretty consistent with what we've seen in recent history, which is somewhere kind of, call it, the mid to high 2%.

We're not seeing any pressure against those based on some of the conditions that are facing Medicare Advantage plans. And some of that just relates to the fact that when they were seeing 6% and 8% increases, they weren't passing those on to us. So it seems only appropriate they appear to recognize this as well that they're not trying to reverse that trend when they're seeing more pressures. I think they also understand that we provide great value.

And finally, we continue to make progress, albeit it's more marginal, just given the substantial improvement in our overall base, on converting more of our per diem MA contracts to an episodic basis. We've got a really good team that oversees our Medicare Advantage and our managed care contracting, and they continue to make good progress.

Ben Hendrix*Analyst, RBC Capital Markets LLC*

Q

Appreciate that. And just as a quick follow-up to something you mentioned in your prepared remarks. I think you noted some misconceptions among discharge planners around IRF versus SNF care. And I was wondering, as you're entering new markets, ramping up de novos, what is involved in that education process and how long does it take to break that muscle memory among the discharge planners and still the value proposition of IRF versus SNF care?

Mark J. Tarr

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

A

Yeah. Ben, it's a great question. So, yeah, that is a – that's a priority. Whenever we enter a new market, we'll have our nurse liaisons, we'll have our administrative staff, we'll have our medical director, whoever we can get out and whoever will listen to what we describe goes on at our hospitals and the differences between an IRF and a SNF, especially in a marketplace that has no other IRF facilities in there. But just talking about the differences in the intensity of care, the types of patients, the length of stay, what typically happens at the time of discharge, that can vary from market to market, but I think we've gotten really refined on that. I think that has proven in the ramp up of the de novos you've seen us bring on the last several years. But what you identified is a – that's a key priority as we go into new marketplace with both the newly hired staff that are there as well as existing staff that may come from that region or the home office going in to educate the marketplace.

Douglas E. Coltharp

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

A

And that education process starts as early as six months prior to projected opening. What we frequently encounter is some of the confusion is related to as simple a concept as the naming convention. And unfortunately, there's no prohibition within the Medicare regulations from a skilled nursing facility calling itself a rehabilitation center. They can't call themselves a rehabilitation hospital because you have to be licensed as an acute care hospital, which all of our IRFs are in order to be able to use that naming convention. But it's just things like that and we've demonstrated great success of being able to overcome those challenges.

Mark J. Tarr

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

A

Part of that education, if we can get people over to tour the hospital, they'll see a big difference between a rehab hospital and a nursing home.

Ben Hendrix

Analyst, RBC Capital Markets LLC

Q

Thank you very much.

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

Mark J. Tarr

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

A

Hey, Brian.

Douglas E. Coltharp

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

A

Morning, Brian.

Brian Tanquilut

Analyst, Jefferies LLC

Q

Hey, good morning, guys. And thanks for squeezing me in. Hey, Doug, maybe just one question for me. As I think about the VitalCaring ruling that came out, how should we be thinking about the benefits to you guys or how you'd be recognizing that ruling on the P&L going forward? Thanks.

Douglas E. Coltharp

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

A

Yeah. So, first of all, great outcome for us. We're just really pleased with the judge's ruling on that. This is ongoing litigation, so we're not really able to comment further. And it's still playing out. So we can't give you with any specificity what it's ultimately going to look like. But as it does and as it proceeds, and we are able to share more with you, we will do so in a timely manner.

Brian Tanquilut

Analyst, Jefferies LLC

Q

All right. Got it. Thank you.

Operator: And our next question will come from Jared Haase at William Blair.

Douglas E. Coltharp

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

A

Hey, good morning, Jared.

Mark J. Tarr

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

A

Hi, Jared.

Jared Haase

Analyst, William Blair & Co. LLC

Q

Good morning and thanks for squeezing me in as well. I'll stick to one also. Just wanted to follow up on some of the comments you made about career ladders or career progression for the workforce. I thought that sounded interesting. And I was just curious, like what percent of the workforce today would you say is taking advantage of the progression opportunities that you offer?

And then, you mentioned that's supporting better turnover. I was wondering if there's any way to, I guess, quantify or unpack what you see in terms of turnover among those clinicians that pursue additional certifications versus those that don't?

Mark J. Tarr

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

A

Jared, I don't know that we have an exact number for you in terms of the participation level and the subsequent impact on our turnover. If you can – if you just take our turnover for RNs for 2024, we've taken that down to 20.4% for RNs and then therapists turnover was 7.7%. So both of those are on the downtrend for us, certainly at or below pre-pandemic levels, specifically the RN turnover rate.

This improvement in retention is playing in a number of different ways. There's not one particular approach, I think, to addressing retention, but clinicians appreciate having the opportunity to continue to learn and improve their skills. And providing those opportunities to them through clinical ladders and exposure to different experiences, that has proven itself over the years to be a really effective way to retain them. And if they're interested in working in a rehabilitation hospital, there's a strong chance they're going to be in Encompass. And whether that's therapists or nurses, we put a lot of effort and thought in terms of the educational opportunities that we provide for these staff members.

Douglas E. Coltharp

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

A

Jared, you've given us something that we now need to add to our preparatory materials, because as I'm sitting here, I know that our HR team tracks both the percentage of our clinicians, nurses and therapists who participate in these programs. And I also know that they're tracking the change in turnover within those groups. I simply don't have those at our disposal, but we won't be caught off guard on that question in future periods. So, thank you for asking it.

I do want to note that when you consider our hospital staffing, just a reminder, that about 36% of our overall FTEs in a hospital are going to be comprised of nursing FTEs and about 20% are therapy FTEs. So, again, great question and we will be better prepared to answer that with specificity in future periods.

Mark J. Tarr

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

A

Thanks for giving us another metric, Jared.

Douglas E. Coltharp

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

A

Yeah.

Jared Haase

Analyst, William Blair & Co. LLC

Q

Of course. Yeah. Happy to give you more work here on our side. Appreciate all the context. Thank you.

Mark J. Tarr

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

A

You're welcome.

Operator: And this does conclude today's Q&A session. Mr. Mark Miller, I'm pleased to turn it back to you, sir, for any additional or closing remarks you have.

Mark Miller

Chief Investor Relations Officer, 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: Ladies and gentlemen, this does conclude today's teleconference, and we do thank you all for your participation. You may now disconnect your lines.

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