Operator: Good morning, everyone and welcome to the HealthSouth First Quarter 2012 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. Today's conference call is being recorded. If you have any objections, you may disconnect at this time.

I would now turn the call over to Mary Ann Arico, Chief Investor Relations Officer.
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Mary Ann Arico, Chief Investor Relations Officer

Thank you, Lynn, and good morning, everyone. Thank you for joining us today for the HealthSouth first quarter 2012 earnings call.

With me on the call in Birmingham today are Jay Grinney, President and Chief Executive Officer; Doug Coltharp, Executive Vice President and Chief Financial Officer; Mark Tarr, Executive Vice President and Chief Operating Officer; John Whittington, Executive Vice President, General Counsel and Corporate Secretary; Andy Price, Chief Accounting Officer; Ed Fay, Senior Vice President and Treasurer; Julie Duck, Vice President of Financial Operations.

Before we begin, if you do not already have a copy, the press release, financial statements, the related 8-K filing with the SEC and the supplemental slides are available on the website at www.healthsouth.com.

Moving to Slide 2, the Safe Harbor which is 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, uncertainties and other factors that could cause actual results to differ materially from management's projections, forecasts, estimates and expectations are discussed in the company's Form 10-Q for the first quarter of 2012, which will be filed next week, and its previously filed 10-K for year-end 2011 and other SEC filings. 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. Statements made throughout this presentation are based on current estimates of future events and speak only as of today. The company does not undertake a duty to update or correct these forward-looking statements.

Our slide presentation 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 slide presentation or at the end of the related press release, both of which are available on our website and as part of the Form 8-K filed last night with the SEC.

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

And with that I will turn the call over to Jay.

Jay Grinney – President & Chief Executive Officer

Great. Thank you Mary Ann, and good morning everyone. The first quarter was a strong start for the year for HealthSouth as key operating metrics, discharges, net revenues, adjusted EBITDA and pre-tax income, all grew significantly compared to the first quarter of last year. We also continued the development of four de novos, one that will open later this year, and three that will open in 2013, received favorable rulings on certificate of need proceedings involving two additional de novos that we expect to begin construction on later this year, and repurchased 25,000 shares of our preferred stock, which simultaneously reduced our cash

dividends, and our diluted share count. Most importantly, we maintained our focus on providing superior outcomes and continued to outpace the industry with our FIM gains and length of stay efficiency.

We believe our hospitals' commitment to providing this high quality, cost effective care resulted in quarter-over-quarter total discharge growth of 6% and same store discharge growth of 5%. The benefits of leap year notwithstanding, this growth occurred despite very difficult comps. As a reminder, discharges increased by 7.8% in the first quarter of 2011.

Net operating revenues were $538.6 million in the quarter, an increase of 6.4% over last year and was driven by the strong discharge growth I just mentioned and pricing per discharge that was in line with expectations.

Adjusted EBITDA came in at $127 million, representing an 8.1% increase over prior year and was achieved through a 40 basis point improvement in our operating leverage. Diluted earnings per share from continuing operations was $0.40 and reflected an effective tax rate of approximately 40%. Last year we had a $0.27 per share benefit primarily from an IRS settlement for tax years 2007 and 2008. Adjusting for this onetime benefit, diluted earnings per share from continuing operations would have increased 33.3% quarter-over-quarter.

We are obviously very pleased with these results and the quality of care our employees continue to provide to their patients. We also believe these results underscore the strength and consistency of our business model and positions the company for another good year.

Doug will now provide a more detailed review of our operational and financial results.

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

Thank you, Jay, and good morning everyone. As Jay mentioned, Q1 represented a very solid start to 2012. Revenue grew by 6.4%, driven by inpatient revenue growth of 8.3%, offset by a 13.4% decline in outpatient and other revenue.

Revenue growth in the quarter did benefit from the additional day attributable to leap year. The growth in inpatient revenue resulted from a 6% rise in discharge volume, 5% on a same-store basis, and a 2.2% increase in revenue per discharge. The discharge volume growth for the quarter was particularly encouraging in the context of a difficult 7.8% comp from Q1 of 2011.

The factors contributing to the increase in net revenue per discharge were similar to those cited last quarter, and included the 1.6% increase in our Medicare reimbursement rates, an increase in average acuity, stroke and neurological comprised 35.9% of our patient mix in Q1 2012, versus 33.8% in Q1 2011. And a shift in our payer mix, 73.5% Medicare in Q1 2012, as compared to 71.5% in Q1 2011.

The $5.9 million decline in outpatient and other revenue was primarily attributable to the $3.4 million in non-recurring state provider tax revenue in Q1 2011, with the residual resulting from the year-over-year decline in the number of satellite clinics. We ended Q1 2012 with 26 outpatient satellites in operation, six less than Q1 2011. There were no closures during the quarter. As a reminder, we continue to offer outpatient services at all of our hospitals, and the vast majority of our outpatient revenue is generated from these hospital-based outpatient departments.

I want to point out that in Q1 2012, we adopted new accounting guidelines, which require the presentation of revenues net of the provision of doubtful accounts. This is an income statement geography issue only, and simply moves the provision line up from a component of operating expenses.

The adoption of this accounting guideline had no net impact on our financial position, results of operations or cash flows, and it did not change our accounting policies or methodologies for determining our revenues or

provision for doubtful accounts. As anticipated, bad debt expense increased to 1.2% of net operating revenues in Q1 2012, as compared to 0.9% in Q1 2011.

The factors leading to the increase were those identified in last quarter's call, an increase in medical necessity claims reviews, and a lengthening of the Medicare denials adjudication process related to a mounting administrative backlog. We continue to anticipate a $6 million increase in bad debt expense for the full year 2012 over 2011.

During Q1, we again generated improved operating leverage and labor productivity in spite of the ramp-up cost associated with our two new hospitals, and the incurrence of $1.6 million in incremental expenses related to the installation of our new clinical information system.

SWB for the quarter was 48.5% of net operating revenue, an increase of 30 basis points from Q1 2011, excluding the benefit of $3.4 million in non-recurring state provider tax revenue in Q1 2011, SWB as a percentage of net operating revenue would have been flat year-over-year as increased labor productivity in Q1 2012, evidenced by a decline in EPOB to 3.34 from 3.39 a year ago, was offset by a ramp-up of operations at two new hospitals, a continued investment in higher skills mix, including additional Certified Rehabilitation Registered Nurses or CRRNs, and support personnel for our case managers resulting from our TeamWorks initiative. It also included the annual merit increase for our non-executive employees.

We generated improved operating leverage within hospital related expenses, which is comprised of other operating supplies and occupancy expenses as that declined to 20.8% of net operating revenues in Q1 2012 as compared to 21.4% in Q1 2011. We also achieved leverage in G&A, which excludes stock-based compensation, which declined by 10 basis points to 4.4% of net operating revenues in Q1 2012. The combination of strong revenue growth and improved operating leverage generated adjusted EBITDA of $127 million for Q1 2012, an 8.1% increase over Q1 2011. We were able to overcome the higher bad debt expense, the increase in installation cost for our clinical information system, and the $1.5 million net benefit from non-recurring state provider tax revenue in Q1 2011.

Interest expense for Q1 2012 was $23.3 million, down from $35.1 million in Q1 2011 with the decrease attributable to year-over-year decline in total debt and the other improvements we have made to our capital structure.

During the quarter, we repurchased 25,000 shares of our convertible preferred stock requiring a cash outlay of approximately $25 million. The repurchase of these shares will reduce our annual dividend obligation by $1.6 million and our diluted share count by approximately 800,000 shares. Our leverage ratio at the end of the quarter was 2.7 times, unchanged from yearend 2011.

With the expected acceleration of free cash flow generation over the remainder of the year, we will continue to evaluate opportunities to repurchase our debt and equity securities balanced against incremental growth opportunities.

Diluted earnings per share from continuing operations for Q1 2012 were $0.40 per share as compared to $0.57 per share in Q1 2011. Once again, the earnings per share comparison for the first quarter was impacted by fluctuations in the effective tax rate. The effective tax rate for Q1 2012 was approximately 40%, in line with our expectations. However, as Jay mentioned earlier, Q1 2011 included a tax benefit of $0.27 per share related to items such as a settlement with the IRS on prior year tax audits and reductions in unrecognized tax benefits. Cash income tax expense for the quarter was $2.1 million, and we continue to anticipate cash income tax expense in a range of $7 million to $10 million for 2012.

Let's move now to adjusted free cash flow. And you may find it useful to turn to the bridge that is included on Slide 11 of the supplemental slides. Please recall that in 2011, our adjusted free cash flow increased by 34.1% over 2010. As discussed in last quarter's call, we entered 2012 expecting to again generate a significant level of adjusted free cash flow. We noted however, that the growth in 2012 would reflect anticipated increases in net working capital and maintenance CapEx.

Our Q1 2012, adjusted free cash flow reflected these items, as it decreased modestly to $45.2 million from $48.2 million in Q1 2011. A significant component of the working capital increase was a $16.4 million decline in accrued interest. This is an interest coupon timing difference related to our refinancing activities, and it will reverse in Q2, thereby providing a benefit to second quarter adjusted free cash flow. And you may recall that we experienced something very similar in Q3 and Q4 of 2011.

As anticipated, and as we discussed in last quarter's call, our net working capital also increased due to a $16.1 million decline in payroll liabilities, primarily attributable to tax withholding payments related to the vesting of a 2009 restricted stock grant to our employees. The combination of these items resulted in a $31 million increase in net working capital for Q1. For 2012, we continue to estimate a year-over-year increase in net working capital in a $30 million to $40 million range.

As anticipated, maintenance CapEx for the quarter was $19.1 million, an increase of approximately $10 million from Q1, 2011. As stated previously, we expect maintenance CapEx for 2012 in a range $75 million to $85 million with the increase over 2011 primarily attributable to investments in our clinical information system – and be reminded that unlike the acute care hospitals, we are not eligible for the high-tech payment subsidies on this investment – as well as two substantial hospital renovation projects. The strong free cash flow generation of our company, is allowing us to invest in these enhancements to our core business, fund our compelling growth opportunities, and continue to improve our balance sheet.

With that, I'll turn it back to Jay.

Jay Grinney, President & Chief Executive Officer

Thank you, Doug. Before taking questions, I'm going to ask our General Counsel, John Whittington to provide an update on the status of the E&Y arbitration. And then I'll come back, and address guidance. John?

John Whittington, Executive VP & General Counsel

Thank you, Jay. As Jay and I have both mentioned in prior calls, the timing of the arbitration process, including the three member panel's consideration of the evidence and legal argument is not within our control. Starting in July of 2010 the arbitrators have held a series of hearings generally in four day blocks of time. We have now completed 88 days of arbitration during 25 weeks of hearings. We currently have additional weeks scheduled through December 2012. At this state in the proceedings we do not know whether we will need all those weeks that are currently scheduled to conclude this matter or whether additional weeks will be needed in 2013. What I do know is that we remain confident in our claims and we are absolutely committed to aggressively pursuing our claims to conclusion.

Jay Grinney, President & Chief Executive Officer

Okay. Thank you, John. So although Q1 was a strong start to the year, we don't think it prudent to change full year guidance based solely on one quarter's results. This is consistent with our historic practice and we continue to believe it's a correct approach, primarily because we don't take anything for granted. We know physicians and patients have a choice when deciding where to receive inpatient rehabilitative services and although we are proud of the high quality care our hospitals provide and acknowledge our past success in driving market share, we also appreciate the fact that future success has to be earned one patient at a time.

Additionally, we face challenging discharge comps in the second and third quarters of 6.1% and 5.1% respectively and in May, we begin the onsite installation of our clinical information system at 12 hospitals.

While we believe the planning for these installations has been detailed and thorough, we appreciate the challenges inherent in moving from a paper to an electronic medical record system.

And although, we're not raising guidance at this time, our strong first quarter does allow us to guide shareholders to the high end of our adjusted EBITDA and EPS ranges. And if we continue to see better than expected volumes for the remainder of the year, we anticipate exceeding the high end of these ranges. As we have done in the past, we will revisit full year guidance when we report second quarter results.

With that operator, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Your first question comes from the line of Adam Feinstein with Barclays Capital.

<Q – Adam Feinstein – Barclays Capital, Inc.>: Good morning. Very strong numbers here, if I guess maybe – one quick housekeeping Jay, then I got a more in-depth question. Just on the IRF reg, what are you guys hearing? There has been some commentary that there may not even be a full rule coming out for various sectors, so just any update in terms of what you're anticipating?

<A – Jay Grinney – HealthSouth Corp.>: Yes. In fact, we are hearing from multiple sources that there will not be a proposed rule, that there will be a notice, that that notice will be published on or before August 1. And clearly, we see that as a very positive sign.

<Q – Adam Feinstein – Barclays Capital, Inc.>: Okay, great. And then just with the volume growth in the quarter, obviously a really robust number, were you guys surprised by the trend here? I think back in March, you were saying the quarter was kind of tracking in line, but just curious as you think about this, such a strong number. And, then just any other observations about things that may have benefited here, anything at all, just to better understand in terms of service lines or geographies or any thoughts? Thank you.

<A – Jay Grinney – HealthSouth Corp.>: Sure. First of all, we were very pleased with the quarter and the volumes that we were able to realize. I do think that we all have to keep in mind there was an additional day, and it's very hard to know exactly what that effect might be. We've looked at it a number of different ways, and it kind of vectored in on about a one percentage point impact for the extra day. We looked at that by the average for February, the average for the quarter. We dropped out the 29th day, we dropped off the 31st day, and it was really interesting. The numbers all kind of migrated around that 4.8% versus the 6%. So, about a one, maybe little bit more, one percentage point impact.

Having said that, we were still very pleased with the discharge growth, and we think it really comes from a couple of different sources. One is the quality of the services at our hospitals. You saw in the supplemental slides, we continue to outperform in FIM gain and length of stay efficiency. That really does drive market share. The TeamWorks initiative that we've had in place now for several years continues to drive market share.

We also had the continuing benefit of new hospitals that had opened up in the last say 15 to 18 months, they've anniversaried out of new store into same store, but we're continuing to see really nice growth in those hospitals. And then of course, we have the benefit of the bed additions that were added in our, in the hospitals where we were at or near capacity, and then of course we have some pickup from Drake and from Cypress. So those are examples of what helped to drive the volume, but I would also say just in conclusion, that all of those are part of the core strategy. So the simple answer is the strategies that we put in place that we've been able to get results from over the last several years, continue to yield positive results for the company.

<Q – Adam Feinstein – Barclays Capital, Inc.>: Okay, great. And then just one final question here. Just on the use of free cash, you guys did a great job of outlining your priorities in the slides, but was just interested with the repurchase of the preferred in on the quarter, maybe Doug, you can just comment on that and just how you're thinking about that opportunity?

<A – Douglas Coltharp – HealthSouth Corp.>: The repurchase of any of our securities is going to be done on an opportunistic basis. During the quarter, we liked the price that was made available to us on that purchase of the converts. And really like the fact that it accomplishes two things for us, it gives us an immediate cash return by reducing the required dividend payment, and then it also has the reduction to the diluted share count.

As I mentioned in my comments, we expect free cash flow to accelerate over the course of the year. Our top priority remains compelling all – or funding all of the compelling growth opportunities within the IRF space that we can identify, but we will also continue to look for opportunities to improve the balance sheet, and to invest our cash back into the repurchase of our own securities.

Operator: Your next question comes from the line of Darren Lehrich with Deutsche Bank.

<Q – Darren Lehrich – Deutsche Bank Securities, Inc.>: Thanks. Good morning, everybody.

<A – Jay Grinney – HealthSouth Corp.>: Good morning, Darren.

<Q – Darren Lehrich – Deutsche Bank Securities, Inc.>: Hi, So I just wanted to ask about the healthcare IT implementation, you guys are embarking on little bit more aggressively this year. And I guess just the question I had is more about the resources that your vendor is giving you, and I just, I wanted to get your sort of impressions about how you think you are being resourced, and whether or not you're getting everything you need to sort of go at it as quickly as you're planning?

<A – Jay Grinney – HealthSouth Corp.>: Yeah. I'm going to ask Mark to provide a little more color commentary on that, but the answer generally is, and broadly I should say, is yes. We do feel that the resources from Cerner have been excellent. The planning has been very through. We had a session earlier this year with me, Mark, Doug all of the CEOs of the hospitals that were involved or will be involved in this rollout. The leadership of the IT&G team. We have a specific team set up that helps with this installation, but the planning has been thorough. We feel that the resources absolutely are there, and Mark can provide a little more color on it.

<A – Mark Tarr – HealthSouth Corp.>: Yeah, Darren. Good morning. We feel like we're in good shape and ready to go. We have not only the resources working with Cerner, but we also have considerable resources that we have hired, subject matter experts, that will divide up into implementation teams to go out and install this. And our 12 new hospitals that we'll be installing at, 13 if you count the Ocala de novo. So not only do we have the Cerner, but we have a number of individuals that we hired ourselves, some of which came out of our hospitals, as subject matter experts. So we feel like we'll have the resources out there to do a good job and not only implementation, but adoption at the hospital level.

<A – Jay Grinney – HealthSouth Corp.>: And one thing that we've committed internally is to make sure that we get this right. I know that there have been other instances where companies looking at a large portfolio move very quickly to get the system installed in as many hospitals as quickly as possible, not focusing on perfect execution and implementation with the idea that they can circle back and mop things up, clean things up at a later date. And we're simply not going to do that. But we feel very confident that we have the planning in place. We are looking forward to getting these 12 hospitals on, and then more importantly looking forward to rolling that out to the other hospitals in the next several years.

<A – Mark Tarr – HealthSouth Corp.>: Darren, one final note, the leader of our implementation team is a former hospital CEO for a company. So that lends itself well to working within the operations group.

<Q – Darren Lehrich – Deutsche Bank Securities, Inc.>: That's great. My follow-up here is, just a little bit more on the discharge growth, clearly a very strong number. We've been hearing sporadically about a little bit of strength on the surgical side from some of the hospital companies. It's sort of mixed I guess in terms of what we're hearing, but I'd be curious to see if you saw any benefit at all from surgical growth and whether any of that was orthopedic related that may have filtered your way?

<A – Mark Tarr – HealthSouth Corp.>: Darren, as you – it's Mark. As you know, less than 8% of our total discharges came from joint replacements this last quarter. So we don't always see a direct impact from the surgery schedules picking up, although from a secondary standpoint, the busier the acute care hospitals are, the quicker they are looking for the ability to discharge patients to the appropriate setting. And in that case, we absolutely benefit. When their surgical schedules pickup, they get busy, they look for help on the post acute side and we're there to help them.

Operator: Your next question comes from the line of Colleen Lang with Lazard Capital Management.

<Q – Colleen Lang – Lazard Capital Markets LLC>: Hi, good morning. Thanks for taking the question. I was just curious about your discharge growth guidance for the remainder of the year of 2.5% to 3.5%. Q1 was your most difficult comp of the year and you came in far ahead of this range, and while recognizing Q2 has a tough comp as well. What will cause the volume growth to decelerate, so to speak in the remaining quarters of the year, is there anything embedded explicitly for the IT disruption potentially that you talked about earlier?

<A – Jay Grinney – HealthSouth Corp.>: There is nothing specific. Quite frankly we are being conservative and cautious, as we typically are. And it really does go back to what we talked about a minute ago, and that is, we don't take our successes for granted. And we want to get at least one more quarter under our belt. We feel good about the volumes thus far this year, and we feel certainly that the hospitals are all operating on all cylinders.

Having said that, we've got 12 hospitals, so roughly 12% of our portfolio will be going through a pretty big change. Now do we, have we built-in any sort of disruption? No. Is it prudent for us to think about the fact that there may be some? Yes. And, clearly that's part of our thinking, but overall we still feel good about the discharge growth. We don't want to take anything for granted. We're being little bit conservative as we typically are this early in the year. And we think that we're going to have a good year.

<Q – Colleen Lang – Lazard Capital Markets LLC>: Okay, great. And as my follow up, can you just talk little bit about the M&A landscape and the opportunities you're seeing to acquire freestanding IRFs as well as hospital-based units?

<A – Jay Grinney – HealthSouth Corp.>: Yeah, first of all, as you know, the number of freestanding of IRFs is pretty limited. So, there isn't a huge market to go after. And some of those that may be potential acquisitions, I think frankly there's still a little bit of a mismatch between pricing expectations. As you all know, our multiple has gone down dramatically over the last 12 months, not because of anything that we are doing at the company, but because of the perceived risks that are out there in the healthcare reimbursement environment. So, as you approach potential sellers, they are looking in the rearview mirror and saying, "Well that's the trailing 12 I want to use, and by the way, I'd like to use sort of historic multiples." So, there is a little bit of a disconnect there.

In terms of acquisitions on unit front there – that pipeline is picking up, but a lot of that is going to be joint venture activity. What we are seeing is the emergence of a trend, where more of the systems out there are acknowledging that as they look out over the next couple years, 2013 with sequestration, and the third year of paying for the Affordable Care Act, who knows what's going to be out there in 2014. I think there are a lot of systems that are saying we may not be able to do all – or be all things to all people the way we have in the past. We may have to be a little more disciplined in how we spend our capital, and that may require us to joint venture some of our non-core secondary services. And we are seeing some increased activity on that front.

And then finally, we have the de novo pipeline, we're very excited about that. We talked about the hospitals that are under construction, we talked about the two that have certificates of need that are still being litigated. We're making good process on those. So, all in all, we're feeling pretty good about the M&A pipeline.

Operator: Your next question comes from the line of Sheryl Skolnick with CRT Capital Group.

<Q – Sheryl Skolnick – CRT Capital Group LLC>: Thank you so much and -

<A – Jay Grinney – HealthSouth Corp.>: Good morning, Sheryl.

<Q – Sheryl Skolnick – CRT Capital Group LLC>: Good morning. And great job to all of the many people involved in meeting the challenge of the quarter. You have an interesting slide, which is slide number 10, which you see the slides over and over again, and sometimes you actually have your attention called to it or you pay attention to it. And I'd like to have – we focus so much EBITDA, and less so on bottom line earnings, and its relationship to cash flow that I think maybe we overlook some things. So I'd ask you to interpret what I'm looking at there, which is pre-tax income, but even the line above that, which I guess would be income from continuing operations before certain items. And you had $77.3 million versus $58.6 million. So, very significant growth, looking – in part from the $6 million, from the $10 million increase roughly, $9.5 million of EBITDA. But that's where we're seeing the real impact of the balance sheet I think. So first of all, is that interpretation correct?

Second, how much should we read into that kind of bottom line earnings power, especially since you don't pay cash taxes in any substantial amount? And then, I'm going to relate that to my follow-up question, which is that clearly drives cash flow. So, I'm curious as to why the working capital buildup this year will be as much as it will be, and therefore have a somewhat slower rate of growth on the cash flow?

<A – Jay Grinney – HealthSouth Corp.>: Let me ask Doug to address that last question, but let me try to approach the first question. And the simple answer is yes, that difference between the $58.6 and the $77.3, we think is a very important line. I wish we could label it, but as you know the accountants don't let us do that and frown on our ability to do so, but that's really an important item that should be focused on. And it goes back to the free cash flow generating capacity of this company, which is significant.

Now as far as the working capital buildup this year, and why that is, I'll ask Doug to elaborate a little bit more on that.

<A – Douglas Coltharp – HealthSouth Corp.>: Certainly. There are – and there was some noise in the working capital buildup that occurred in the first quarter predominantly, because we had that very significant decrease in the interest accrual, which is just a timing issue.

<Q – Sheryl Skolnick – CRT Capital Group LLC>: Right.

<A – Douglas Coltharp – HealthSouth Corp.>: It's going to bounce around a little bit from Q1 to Q2, and you'll see a little bit of the same kind of activity in Q3 and Q4, but on a year-over-year basis, it's not going to have a big impact. And the fluctuations in the quarter I think are well illustrated by the bridge that we provided on Slide 11.

The impact that is going to occur within net working capital for the year is really attributable to two things. One is we are anticipating that we will see our receivables balance build. And there are two components to that. One of them is the – is just related to the slowdown in the adjudication and the increase in the number of medical necessity claims reviews. And I know that we had cried wolf a little bit of that, on that a little bit over the last two years, but we have actually seen an increase in that activity, and it showed up in the bad debt number in the first quarter. So it is starting to materialize.

And the second component of the increase in receivables is just the year-over-year growth that we're seeing. The other component of working capital and you saw it manifest itself in the first quarter was that reduction in accrued payroll liabilities, and that was related. So that was kind of a onetime thing, but it impacts not only the quarter, it also impacts the year and that again was associated with the withholding taxes on the 2009 restricted stock grants.

<Q – Sheryl Skolnick – CRT Capital Group LLC>: Right, okay. So it's not as if it's a timing difference, that's a permanent difference?

<A – Douglas Coltharp – HealthSouth Corp.>: That's right.

<Q – Sheryl Skolnick – CRT Capital Group LLC>: Okay, I understand. That's very helpful, because it did look to me like your ability to generate cash flow is quite a bit stronger than the EBITDA growth would indicate because of all the deleveraging which of course is the beauty of it. So your point about the slowdown in the AR makes sense.

On the growth side, when you start a new facility, just to close this loop, when you open a new facility, sometimes when you acquire a facility, you may have to wait for timing notice, but when you open a new facility, you are fully licensed and able to bill from the day it's open?

<A – Douglas Coltharp – HealthSouth Corp.>: That is correct, except that we have a 30 day period – or we have treat 30 patients before we become eligible for reimbursement.

<A – Jay Grinney – HealthSouth Corp.>: So there is that startup of 30 patients, where we're open, we're licensed, we have to see those 30 patients. Once we cross that threshold, then we are eligible to receive Medicare reimbursement.

<Q – Sheryl Skolnick – CRT Capital Group LLC>: Perfect. Thank you so much. And again, congratulations on an excellent job.

<A – Jay Grinney – HealthSouth Corp.>: Thank you.

Operator: Your next question comes from the line John Ransom with Raymond James.

<Q – John Ransom – Raymond James & Associates>: Hi, I apologize, I had to jump off for a minute, but could you, would you mind just resetting the comments you made on the E&Y litigation?

<A – Jay Grinney – HealthSouth Corp.>: Sure, I'm going to ask John Wittington to just summarize what he said.

<A – John Whittington – HealthSouth Corp.>: Yeah. John, just as we've said in the past, the arbitration process is continuing, we have a three member panel, the scheduling is totally within their control, not within our control. Since July of 2010, we have completed 88 days of arbitration during 25 weeks of hearings.

<Q – John Ransom – Raymond James & Associates>: Okay.

<A – John Whittington – HealthSouth Corp.>: We currently have weeks scheduled through December. At this stage in the proceedings however, we cannot say whether we will need all those weeks that are scheduled to conclude the hearings or whether additional weeks will be needed in 2013. And in conclusion, we continue to feel confident in our claims and we are committed to aggressively pursuing them to a conclusion.

<Q – John Ransom – Raymond James & Associates>: I mean, is there a structural reason why E&Y couldn't say well, we'll give you some dates in 2084, we're just so busy, I mean, can they – how long – I mean, from a practical standpoint, how long can they keep claiming schedule conflicts and pushing this out? Because I know this has dragged on longer than you thought it would.

<A – John Whittington – HealthSouth Corp.>: Yeah, for sure. In actuality what we do is get together with the panel and all the lawyers and we set our calendars out on the table and we go through and we look at it and say we are going to need hearing dates through this time period and then we all work together comparing schedules. And you know the schedules are of say 10 people or 11 people.

<Q – John Ransom – Raymond James & Associates>: Okay.

<A – John Whittington – HealthSouth Corp.>: Then we agree on dates that we think are sufficient, but the flow of the case is really not within our control and sometimes a witness that we think will take a week, maybe takes six weeks. And then the end result is we have to come back and go through that process again and then get additional weeks scheduled and that's what we've done now. We have these dates through the end of the year.

<Q – John Ransom – Raymond James & Associates>: Right.

<A – John Whittington – HealthSouth Corp.>: Hopefully that pans out but I can't guarantee it.

<Q – John Ransom – Raymond James & Associates>: Sounds like a bunch of guys billing by the hour doesn't it?

<A – Jay Grinney – HealthSouth Corp.>: But, John I will say in that equation and that process, our side has always said we will meet any time, any place for as long as it takes.

<Q – John Ransom – Raymond James & Associates>: Right.

<A – Jay Grinney – HealthSouth Corp.>: So the scheduling conflicts are not on our side, but it is a complex process.

<Q – John Ransom – Raymond James & Associates>: Sure.

<A – Jay Grinney – HealthSouth Corp.>: And, I do want to make it clear that, when everybody is looking at their calendars to determine when they can participate, our attorneys are saying, and our team is always saying we will be available at any time.

<Q – John Ransom – Raymond James & Associates>: As I would expect. My follow-up would be – ran into an interesting business model this week from our friend Scully, who is trying to bring some coordination to the post acute discharge process. And I know he was running around meeting with a bunch of not for profits, and it tells you that I'm not really concerned about your business as it stands, I'm asking such a theoretical question, but what's your thought, even on the government side, bundling, especially out four or five years, do you see any efforts on the managed care side, using tools like this to bring more close coordination, and is that even on the forefront of your strategic planning for maybe a bundled world in the future?

<A – Jay Grinney – HealthSouth Corp.>: You know, it's certainly something that we're paying attention to. And I think you're talking about naviHealth, it's a joint venture. From what I understand, isn't United part of that? So, I was under the impression – I don't know all the partners, but if United is, I can't see Humana buying that. I mean they may buy – develop it for their own enrollees. But I guess the question is first of all, is it intriguing? Absolutely it's intriguing. Are we thinking about that? Yes we are. But who is going to buy that product and at what price? I mean what's the value that's created in that? I know Select is, it's my understanding that they are a joint venture partner in that as well. So, I don't know the whole details. I think it's intriguing. Whether or not, it's anything that is imminent, I would suggest it probably isn't, but we're certainly thinking along those same lines as well.

Operator: Your next question comes from the line of Matthew Gillmor with Robert Baird.

<Q – Matthew Gillmor – Robert W. Baird & Co. Equity Capital Markets>: Good morning, everyone.

<A – Jay Grinney – HealthSouth Corp.>: Good morning.

<Q – Matthew Gillmor – Robert W. Baird & Co. Equity Capital Markets>: On the margin side, I think where you all have consistently beat our model is on the SWB line and it seems like most of this is being driven by improvements on EPOB. So, can you provide some commentary on what's driving that lower. I know a lot of

those are probably obvious. And then also, do you have a view on where EPOB can go over the next few years?

<A – Jay Grinney – HealthSouth Corp.>: So in terms of the EPOB improvements, obviously a lot of that is driven by the volume increase in those hospitals where maybe the staffing was a little bit rich and we are able to leverage the growth across that existing platform. In terms of the SWB as a percent of net, we do focus on that, but frankly the number that really is important is the productivity number because we've made some conscious decisions over the last year to invest in more nurses, to invest in training and providing educational opportunities for CRRNs or Certified Rehabilitation Registered Nurses. We then pay those nurses a higher rate. We've also beefed up our case management resource base, again, part of the TeamWorks. So, that we expect is going to probably hover in the range that you've seen this last quarter. The productivity though is really driven by the continued volume gains.

<A – Mark Tarr – HealthSouth Corp.>: Yeah. Hey, Matt. This is Mark. You've heard us talk in the past too about some of the IT reports that were – have created for our managers, we call it Beacon. It gives us real-time feedback relative to our staffing and allows us to make staffing adjustments to better fit the fluctuations we have in volume and that's been one of the key areas for the past couple of years that has helped us to maintain or drive up our productivity. As Jay said, volume certainly helped. If you look at the hospitals where we've had bed additions, so we've been able to add that volume, but not add as many staff that you might have to if you are looking at it compared to a de novo hospital where you've got a lot of the overhead that comes on at the same time. But either way, rest assured, we stay focused on the productivity and labor management every day in our hospitals.

<Q – Matthew Gillmor – Robert W. Baird & Co. Equity Capital Markets>: Okay, thanks. That's really helpful. And then just as a follow-up. This is kind of related to a question John asked. But I know in 2013 at least, there seems to be some sort of consensus that there will be a larger federal budget discussion. So just wanted to see if you all had any expectations around that event and does this change at all how you think about your planning process for next year?

<A – Jay Grinney – HealthSouth Corp.>: Well, it certainly affects our planning for 2014 because whatever may be legislated next year, and I think we all should hope for something to occur, because it's inevitable that the debt ceiling is going to breached, sometime either at the end of this year or potentially early next year. And with that will come another round of discussions about how to rein in that debt and how to reduce the budget deficit. I think a lot of it depends on who's in control in Congress.

I think that the other factor that's out there is what happens to the Affordable Care Act. So if the Affordable Care Act is deemed by the Supreme Court in its entirety to be unconstitutional or they throw the whole thing out, the mandate, they throw – is deemed to be unconstitutional, and it's not severable, so everything goes. There will be short term euphoria in the healthcare arena I would suspect, because all of those cuts, those 10 years of cuts will go away at the same time. Problem with that is that once the confetti drops to the floor, and they start looking at the – we start looking at the baseline for Medicare spending, the reductions that were put in the baseline, and I'm not saying if they are real or not, I'm just saying they are in the baseline, coming from Obama care goes away.

So then, you've got kind of a perfect storm of the spending curve is back up, because all those cuts aren't there. And you've got a deficit reduction initiative that is that much more complicated. So there is, I think that there is a lot of risk out there for providers in general.

Now there are some who take that and extrapolate that and say anybody who is in healthcare should be really worried, and the sky is falling, and this is going to be the end of the healthcare industry, which I don't buy. The demand is not going away – the demand is not going away. Not all providers are created equal. You look at our space, we have top margins, top cost profile. There are 1,200 other rehabilitation providers, and a bunch of them are down there with negative margins. So in that new world order, whatever that might be, will it be one that's characterized by less reimbursement? I suspect so. But I think that all that's going to do is make it easier, if you will, for those who are profitable, those who do have a focus on quality and cost to be successful.

It definitely is affecting our thinking. We were looking at our growth from a pretty focused core business perspective. It's one of the reasons why we're keeping our balance sheet as strong as it is. We've got a lot dry powder, because we do believe, and we've seen this time, and time, and time, and time again, when there's upheaval, with that upheaval, comes a lot of opportunities. So others may have decided to go down a different path, we're really kind of positioning ourselves to take advantage of whatever comes down the road in 2014.

That may be more than you wanted to know, but I really do believe that the next couple of years is going to be pretty choppy. And that those providers who are strong from a financial standpoint, have a good product to sell, are going to do very well. And those who are marginal or at the low end of the quality and cost efficiency scale, are simply not going to be around. But the demand is not going away.

Operator: Your next question comes from the line of Gary Lieberman with Wells Fargo.

<A – Jay Grinney – HealthSouth Corp.>: Good morning, Gary.

<Q – Ryan Halsted – Wells Fargo Advisors LLC>: Hi, this is Ryan Halsted on for Gary. Good morning.

<A – Jay Grinney – HealthSouth Corp.>: Good morning, Ryan.

<Q – Ryan Halsted – Wells Fargo Advisors LLC>: Just going back to the discharge growth. I'm trying to, I guess, continue to better understand the strong discharge growth you guys have had so far. I was looking at the occupied beds and your occupancy rate, and I was wondering if you could comment on how you're growing the occupied beds so quickly? And how you think you can continue to grow those, as you add bed capacity, is there any seasonality, or a ramp time with that or any comments on the occupancy side of it?

<A – Jay Grinney – HealthSouth Corp.>: If you go back, first of all if you look at page 31 of the supplemental slides, you can see that over the last period of time, the occupancy level has hovered in that 67% to 70% range. And that's pretty much what you would expect. What we do is we monitor very carefully hospitals that approach a full occupancy, and every hospital is different. But on average, in our company, the typical HealthSouth hospital, you get up to 85%, you're approaching – and that's the average occupancy – you're approaching really full capacity, because you've got gender issues, you've got infection control issues that you have to deal with. You've got peak times that you also have to deal with. And so what we try to do is stay ahead of the constraints by adding beds. And as Mark talked – said a minute ago, when we add those beds, we've been very successful in doing so, and continuing to be able to grow.

So, the occupancy level is one that is pretty much in line with what we'd expect, and as we bring new hospitals on, clearly that may drop a little bit, as you saw earlier on this line, on this chart. You go back into Q3 2011, and you go back into the fourth quarter, we had some new hospitals coming on. So, you had the new beds. They weren't necessarily filled, now you're starting to see them fill up. We've got new hospitals coming online next year. It will add to the bed count. It will change the overall occupancy level for the company, but we feel very good about the fact that if we build the beds, we're able to fill them.

<Q – Ryan Halsted – Wells Fargo Advisors LLC>: Okay. Thanks.

Operator: Your next question comes from the line of Kevin Fischbeck with Bank of America.

<A – Jay Grinney – HealthSouth Corp.>: Hey, Kevin.

<Q – Joanna Gajuk – Merrill Lynch, Pierce, Fenner & Smith, Inc.>: Good morning. Actually this is Joanna Gajuk for Kevin today. I have one follow-up, and one question. So the first follow-up is actually related to the recent – to the most recent question, basically given that you had mentioned that the discharge growth was helped by the recently added beds and also de novos, do you have a sense or you can provide us with the same store occupancy growth year-over-year?

<A – Jay Grinney – HealthSouth Corp.>: The same store occupancy. We don't have that right now. We can get that to you.

<Q – Joanna Gajuk – Merrill Lynch, Pierce, Fenner & Smith, Inc.>: Or a sense of growth in discharges if you would sort of-

<A – Jay Grinney – HealthSouth Corp.>: Oh sure.

<Q – Joanna Gajuk – Merrill Lynch, Pierce, Fenner & Smith, Inc.>:– exclude those new beds?

<A – Jay Grinney – HealthSouth Corp.>: Yeah. We always give you the same store discharge growth. We've been doing that for quite a few, I mean, as long as we've been reporting. So, if you go to page 4 of the supplemental slides, you can see that the discharge growth was 6% overall, and same store discharge growth was 5%.

<Q – Joanna Gajuk – Merrill Lynch, Pierce, Fenner & Smith, Inc.>: Right, but I would assume that the same store growth assumed the – includes the benefit of the recently added beds, right. Like you were saying that those beds that were added 18 months ago, they are already in the same store number?

<A – Jay Grinney – HealthSouth Corp.>: Yes. I mean we've – that's definitely true. I mean the same store, what we define new store, is any hospital that has been open for 12 months or less. So, once you get into that 12 months and one day, you anniversary into same store.

<Q – Joanna Gajuk – Merrill Lynch, Pierce, Fenner & Smith, Inc.>: Right. So, I guess that's why it would be interesting to know the same store occupancy, but you don't have it handy here, so maybe I could follow up on that later.

<A – Jay Grinney – HealthSouth Corp.>: Sure. Yeah.

<Q – Joanna Gajuk – Merrill Lynch, Pierce, Fenner & Smith, Inc.>: But then the other question I have is around your assumptions behind the merit increases in 2013 and 2014? So I guess the basic question is, are you assuming the status quo so to speak in labor markets, because to the extent that there is market improvement in terms of labor market, those assumptions could change, so can you comment on how you view those merit increases assumptions that you talk about on – in your slides on Slide 22?

<A – Jay Grinney – HealthSouth Corp.>: Sure. Our – the pricing for our labor is going to be sensitive to market conditions. And at this point, we do believe that that 2.25% to 2.5% is a pretty good number to use. Frankly, as we look at the previous slide, and if you look at some of the assumptions there in terms of what the pricing might be, that may be, especially you go out into 2014, we're not sure that the productivity adjustment is going to exactly be that 110 bps, it seems like it's coming down.

So we try to base our merit increases on the kind of rate increases we get from Medicare. We are able to do a little bit more than that because we are able to pick up the slack, if you will, through the volume increases. But for the most part, we feel pretty good that those are assumptions that can be used in your model, you may want to bump that number up, if you feel that that's a little bit light, but at this point we feel pretty good with those.

<Q – Joanna Gajuk – Merrill Lynch, Pierce, Fenner & Smith, Inc.>: Yeah. I mean, it just comes to mind, this question because definitely it feels like, at least in the midterm, there is some downward pressure on rates, like you mentioned the productivity adjustment of the reform, but if the markets, if the labor markets really improve, there could be some output pressure there. So I guess that's why what you're doing on your volumes is very important here. But then this question came from this idea that trying to offset the margin compression with volume growth could be difficult, because there is the incremental margin on the new volume. So would you agree that you need volumes to grow two to three times the pricing or the cost growth for that matter?

<A – Jay Grinney – HealthSouth Corp.>: No, I don't think that that's right. And if you go to page 23, you can see that, gosh, since 2008 we have had very significant growth in our volumes. Don't forget the demand, the underlying demand for inpatient rehabilitative services is approximately 2% overall in the country and our markets, it's a little bit north of that. So you have this underlying demand curve that's very compelling, it's not sensitive to fluctuations in the economy and then on top of that, we feel pretty good about the fact that we're able to provide a higher quality level of care which allows us to take that market share on a pretty consistent basis. So we feel pretty good about where we're positioned and think that that volume growth is going to able to continue and we feel that the business model that we put together is going to allow us to withstand just about any kind of hit that may be coming at us from Washington.

<Q – Joanna Gajuk – Merrill Lynch, Pierce, Fenner & Smith, Inc.>: Great.

<A – Douglas Coltharp – HealthSouth Corp.>: It seems like you may be drawing too tight a correlation as well, between conditions in the general labor market and the conditions in the healthcare labor market, because you haven't had nearly the degree of unemployment with regard to healthcare labor that you have in the general market and as a result, when and if the economy eventually improves to the point where that unemployment rate comes down and puts pressure on wages, it's unlikely that you'll see the same degree of that in healthcare. Recognize as well that within the healthcare services and provider community, the bulk of our employees are already pretty well compensated, when you look at the combination of their salaries and the benefit package. And again, I think where you're likely to see the acceleration in the future is areas where the competition for those jobs has been greatly increased by the pool of unemployed applicants and they are at a much lower overall wage scale.

<A – Jay Grinney – HealthSouth Corp.>: And the only other last comment would be, we are picking up in the marketplace that other providers are in fact either freezing their merits. They're reducing their benefits, they're taking steps to reduce their labor costs and that certainly is going to accrue to our benefit, because we've never taken a benefit away. We've provided consistent merit increases. So we feel pretty good about where we are from a labor standpoint, feel very good about the quality of our employees, and don't see this as a negative at all.

<Q – Joanna Gajuk – Merrill Lynch, Pierce, Fenner & Smith, Inc.>: Great. Thank you so much for the color. I appreciate it.

<A – Jay Grinney – HealthSouth Corp.>: Thank you.

Operator: And there are no further questions at this time.

Mary Ann Arico, Chief Investor Relations Officer

Thank you. As a reminder, we will be attending the Goldman Sachs Leveraged Finance Healthcare Conference on May 1 in New York City, the Deutsche Bank Annual Healthcare Conference on May 8 in Boston, and finally the BoA ML Healthcare Conference in mid-May in Las Vegas. If you have additional questions, we will be available later today. Please call me at 205-969-6175. Thank you. Lynn?

Operator: Thank you. This concludes today's conference. You may now disconnect.