Q2 2015 HealthSouth Earnings Call

PARTICIPANTS

Corporate Participants

Mary Ann Arico – Chief Investor Relations Officer, HealthSouth Corp.
Jay F. Grinney – President, Chief Executive Officer & Director, HealthSouth Corp.
Douglas E. Coltharp – Chief Financial Officer & Executive Vice President, HealthSouth Corp.
John P. Whittington – Secretary, Executive VP & General Counsel, HealthSouth Corp.

Other Participants

Whit Mayo – Analyst, Robert W. Baird & Co., Inc. (Broker)
Ann K. Hynes – Analyst, Mizuho Securities USA, Inc.
A.J. Rice – Managing Director, Equity Research, UBS Securities LLC
Frank G. Morgan – Analyst, RBC Capital Markets LLC
Chris D. Rigg – Analyst, Susquehanna Financial Group LLLP
Gary Lieberman – Analyst, Wells Fargo Securities LLC
Joshua R. Raskin – Analyst, Barclays Capital, Inc.
Joanna S. Gajuk – Research Analyst, Bank of America Merrill Lynch
Dana Nentin – Analyst, Deutsche Bank Securities, Inc.
Sarah James – Analyst, Wedbush Securities, Inc.
Chad C. Vanacore – Analyst, Stifel, Nicolaus & Co., Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning everyone and welcome to HealthSouth's Second Quarter 2015 Earnings Conference Call. At this time I would like to inform all participants that their lines will be in a listen-only mode. After the speakers' remarks there will be a question-and-answer period. [Operator Instructions] You will be limited to one question and one follow-up question. Today's conference is being recorded. If you have any objections you may disconnect at this time.

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

Mary Ann Arico, Chief Investor Relations Officer

Thank you, Hope, and good morning everyone. Thank you for joining us today for the HealthSouth second quarter 2015 earnings call.

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

Before we begin if you do not already have a copy, the second quarter earnings release, financial statements, the related 8-K filing with the SEC, and the supplemental slides are available on our 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 SEC filings, including the earnings release and the related 8-K, the Form 10-K for 2014, and the Form 10-Q for second quarter 2015 when filed. We encourage you to read them.

You are cautioned not to place undue reliance on 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 the call 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 submit 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 F. Grinney, President, Chief Executive Officer & Director

Great. Thank you, Mary Ann.

Before we begin I'd like to reintroduce Ross Comeaux (3:19), our new Director of Investor Relations. Something I am embarrassed to say I should have done at our Investor Day back in June.

Ross joined HealthSouth on May 26 and came to us from JPMorgan, where he was a sell side analyst for five years, covering medical technology and devices. Prior to JPMorgan, Ross was an analyst with RBC Capital Markets and before that Bank of America. He began his career at PWC as a Healthcare Consultant. And we are very pleased to have him on the team. He has done an excellent job of moving up the learning curve and acclimating to HealthSouth during his brief tenure with us and will be a tremendous asset, as Mary Ann transitions to retirement.

Now to our second quarter results. Although there were a lot of moving parts in the quarter that may require some time to digest, we believe there are five key takeaways.

First, both segments had a very strong second quarter in terms of volumes. Discharges grew in our Inpatient segment by 8.3%, while admissions at Encompass locations owned since January 1, 2014, grew 15.9%.

Second, Encompass had an exceptionally good quarter. They not only had double-digit volume growth, they also did an excellent job of managing their costs, generated $19 million of adjusted EBITDA, continued to successfully integrate legacy HealthSouth agencies, and added new locations in five markets, four of which were markets that overlap with our hospitals.

Third, our Inpatient segment's adjusted EBITDA was up against two headwinds, a 13.5% comp for the company and $9 million of unusual items. While we obviously can't forecast when these unusual items will occur, it was very disappointing that they happened on the heels of the $4 million litigation settlement charge we took in the first quarter.

Fourth, we continued to see more non-Medicare patients in our hospitals. And the payments for these patients was less than traditional Medicare.

And fifth, we continued to invest in future growth with the announcement of the Reliant transaction, eight Inpatient development projects, and the Home Health projects I mentioned a moment ago.

Since the increase in non-Medicare patients is affecting our payer mix and our pricing assumptions for the balance of the year, I want to take a few moments to discuss this trend. Beginning last year we saw an increase in the number of Medicaid patients we treated. And this trend continued in the first and second quarters of this year. As noted on previous calls we believe this change to our payer mix is tied to expanded Medicaid enrollment resulting from the Affordable Care Act.

On page 25 of the supplemental slides shows that Medicaid revenues as a percent of total Inpatient revenues grew 80 basis points in the quarter to 2.6%, the highest Medicaid has been for at least 10 years. In 2012 and 2013 Medicaid was 1.2% of net revenues. In 2014 it was 1.8%. In Q1 of this year it was 2%.

Some of the second quarter's increase, about 10 basis points, occurred as a result of our purchase of Cardinal Hill, a hospital that historically has treated a higher percentage of Medicaid patients compared to most of our other hospitals.

The balance primarily came from hospitals in states that have experienced increased Medicaid enrollment, most notably for us, California, Colorado, Ohio, New Mexico, Kentucky, and Indiana. It should be noted this growth didn't occur because of new marketing strategies on our part. Rather we believe it reflects the inevitable consequence of a larger number of patients who are now eligible to receive inpatient rehabilitative care by virtue of being enrolled in their state's Medicaid programs.

17 of the 29 states where we have hospitals, and Medicaid patients are eligible to receive inpatient rehabilitative care, expanded their Medicaid coverage and saw significant growth in enrollment. It's in these states where we have seen the majority of our Medicaid growth.

We also saw a disproportionate increase in our commercial managed care discharges. While we can't say for certain that this increase is attributable to expanded coverage from the Affordable Care Act, anecdotal feedback from our hospitals indicates a portion of these patients had coverage through an exchange.

As noted in End Note 22 on page 37 of the supplemental slides, the relative percent of net revenues from Medicare Advantage has remained fairly constant at approximately 8%. So the majority of the increase in total managed care payments came from commercial managed care patients.

I also want to highlight our development activities, because they will help augment future growth. The most significant of these was the announcement on June 11 that we signed a definitive agreement to buy the operations of Reliant Hospital Partners, a pure-play inpatient rehabilitation hospital company with 11 hospitals and 902 beds. Reliant generated approximately $249 million of net revenues and $82 million of adjusted EBITDA in 2014.

Although we had planned to discuss this transaction at our Investor Day, we were not able to conclude negotiations in time to do so.

The fundamental reason for acquiring Reliant, as it was for Encompass, is our belief the industry is evolving toward coordinated care and coordinated payment models. We believe successful post-acute

providers within this new delivery system will be those who can offer comprehensive, high-quality, cost-effective, facility-based, and home-based care across an entire service area.

The acquisition of Reliant provides us with additional geographic coverage to compete effectively with other rehab providers, including SNFs in the Houston, Dallas/Fort Worth, and Austin markets, while allowing us to enter new markets in Abilene, Dayton, and the greater Boston metropolitan area. It also complements our existing Home Health presence in all but the Dayton market.

The recently announced mandatory Comprehensive Care for Joint Replacement Model suggests that Medicare is determined to accelerate the pace of this delivery system change. The CCJR Model validates our belief that providers increasingly will be held responsible for a patient's entire episode of care. And that post-acute providers that can manage a patient's episode on a high quality cost effective basis after they have been discharged from an acute care hospital will be better positioned to succeed than those who cannot.

To put the impact of this model on HealthSouth into perspective. HealthSouth has hospitals in 33 of the model's 75 metropolitan statistical areas and Home Health agencies in 25 of these MSAs. In 15 of these markets we have both hospitals and Home Health agencies.

Lower extremity joint replacements in the 33 hospital markets account for 2.3% of our total Medicare discharges and 1.6% of our overall discharges. While we are concerned about the precedent the model's compulsory requirement sets, we are encouraged that CMS recognizes the need for greater clinical coordination among providers and believe this model may prove to be a net positive for us.

Getting back to Reliant. In the overlap markets of Boston, Houston, and Dallas/Fort Worth we have the near-term opportunity to consolidate and enhance the collaboration of our sales and marketing teams across these markets, providing a consistent message to referral sources regarding the value proposition of Inpatient Rehabilitative Care. And because of our strong Home Health footprint in these markets, the value proposition of coordinated Home Health Care. We also can provide referral sources with coordinated admissions processes that will ensure patients receive care in the most conveniently located hospitals in each of these markets. Having a larger critical mass also gives us flexibility with physician coverage and labor management.

Finally, irrespective of the pace of industry change, we believe there will be near-term in-market revenue synergies through enhanced clinical collaboration between the Reliant hospitals and our Encompass Home Health agencies in all but the Dayton market, where Encompass currently does not have a presence.

As noted in the supplemental slides, we have agreed to purchase Reliant for $730 million in cash, plus the assumption of the real estate leases. And intend to fund this acquisition with cash on hand and senior debt. We also expect to realize an approximate $125 million to $150 million NPV tax benefit.

In determining the price we were willing to pay we took into consideration the near- and long-term strategic benefits I mentioned a moment ago, the scarcity factor of these assets – Reliant is the largest remaining pure-play inpatient rehabilitation company – and the tax benefit. We were also pleased to be able to finance this transaction at relatively low cost. This has been made possible by having maintained a disciplined balance sheet and remaining committed to our long-term leverage target. We expect to close on this transaction in the fourth quarter.

In addition to announcing the Reliant transaction we also announced or completed the following development projects that should contribute to future growth.

On April 1 we entered into a joint venture with Memorial Health to begin operating their 50-bed rehab hospital in Savannah, Georgia, and began site work for a new 50-bed replacement hospital.

On May 1 we acquired Cardinal Hill Rehabilitation Hospital in Lexington, Kentucky, which has 158 rehab beds and 74 SNF beds.

We executed four joint venture agreements for new hospitals in Jackson, Tennessee; Tulsa, Oklahoma; Westerville, Ohio, which is a suburb of Columbus; and Hot Springs, Arkansas.

We also continue the construction of the new 40-bed hospital in Franklin, Tennessee, and a new 50-bed hospital in Modesto, California. Franklin is expected to open in Q4 of this year. And Modesto is scheduled to open in Q2 of next year.

And finally, we added new Home Health locations in Houston; Lexington; Texarkana, Arkansas; Fayetteville, Arkansas; and Ardmore, Oklahoma.

Before I turn it over to Doug I want to touch on guidance. First, as we indicated in the press release and supplemental slides, our guidance does not include any contribution from Reliant. We will update guidance once we close on this transaction.

Second, as noted on page 16 of the supplemental slides, we are now guiding to the lower end of our adjusted EBITDA range. This is different from the guidance we provided at our Investor Day in two regards. First, the $4 million group medical reserve was not known at that time and brings to $13 million the amount of unexpected headwinds encountered this year. And second, we are now assuming that the relative proportion of Medicaid patients will remain at an elevated level, which will depress second half Inpatient pricing compared to earlier estimates.

Factors that could contribute to us coming in at the high end of the range include, pricing that is consistent with our initial expectations, stronger than anticipated discharge growth, better than expected EBITDA contribution from our new IRFs, or better than expected performance from Encompass, which is already off to a very solid start.

From an EPS perspective, we're adjusting full year guidance to reflect the Reliant transaction costs incurred to date. The new range after incorporating these costs is $2.11 to $2.17 per share.

Finally, before I turn it over to Doug I want to comment on last week's announcement that John Whittington, our Executive Vice President and General Counsel, will retire at the end of the year.

Over the last six years John has been an invaluable member of the company's executive management team and has played a key role with every major accomplishment this company has achieved. The successful resolution of all legal issues related to the fraud perpetrated by the company's previous management, the divestitures of our non-core businesses so we could pay down debt and strengthen our balance sheet, the relisting of HealthSouth in the New York Stock Exchange, and the repositioning of the company as a growth company through his leadership of the development, real estate, and design and construction departments. He also has provided consistent outstanding management of the legal, compliance, and aviation departments. And more recently had the foresight to establish our Medical Services department.

Throughout his tenure we have benefited from John's unmatched legal knowledge, his disciplined intellect, his ability to see the big picture, and his calm, yet decisive leadership style. Although John will retire as General Counsel, he will continue to assist the company with ongoing legal matters and will serve in an of-counsel role.

We thank John for his many contributions to HealthSouth and wish him and his wife, Debby, many years of happiness together as they begin the next chapter of their lives.

I'll now turn it over to Doug.

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

Thank you, Jay, and good morning everyone. As was evident from Jay's comments we've got a lot to cover this morning. So I'll jump right into the numbers.

On a consolidated basis Q2 net operating revenues increased by 26.5%, and adjusted EBITDA increased by 11% over Q2 2014, largely owing to the acquisition of Encompass. Diluted EPS for Q2 was $0.47, as compared to $0.81 in Q2 last year. The year-over-year EPS comparison for Q2 was rendered difficult by two items, the gain of $0.26 per share realized in Q2 last year on the Fairlawn transaction, and the $0.11 share – per share loss on debt extinguishment experienced in Q2 this year, related to the completion of the call of the 8.125% senior notes.

It's worth noting that Q2 is our toughest comp for consolidated adjusted EBITDA, as Q2 2014 increased 13.5% over Q2 2013. And as Jay mentioned in his comments Q2 was a challenging quarter, as strong volume growth for the IRF segment did not flow through to adjusted EBITDA, primarily due to lower than expected pricing and an unexpected increase in our group medical insurance reserves.

IRF segment revenue rose 8.1% in Q2 2015 over Q2 2014, driven by an 8.3% increase in discharges. Same store discharges grew 2.8% and new store discharges grew 5.5%, approximately 110 basis points of that attributable to the Fairlawn consolidation, with solid contributions from the four new hospitals added in Q4 of last year and the two additional hospitals that came on board in the first half of 2015.

Pricing growth for the IRF segment as measured by revenue per discharge was lower than expected at 0.3%. As previously disclosed Q2 2015 was negatively impacted by approximately $5 million by the updated SSI ratios for 2013 published in the quarter. Conversely Q2 2014 benefited by approximately $2 million due to the updated SSI ratios for 2012.

The year-over-year swing in the SSI ratio adjustment resulted in a negative impact of approximately 110 basis points. Unfortunately the timing, magnitude, and direction of the periodic SSI updates are difficult if not impossible to predict.

Average acuity as measured by CMI was relatively constant in Q2 2015 as compared to Q2 2014.

As Jay discussed in his comments IRF pricing in Q2 was also negatively impacted by a change in our payer mix. We experienced disproportionally higher discharge growth in the managed care and Medicaid payer categories, in which our revenue per discharge is lower than traditional Medicare or Medicare Advantage.

In Q2 we saw solid discharge growth across all of our major payers with approximately 50% of the increase coming from traditional Medicare. But the growth was proportionately higher in managed care and Medicaid.

Our payer mix has historically vacillated from quarter-to-quarter. And we believe it is too early to declare the managed care increase exhibited in Q2 as either a trend or the new normal. However given the increase in the number of commercially covered lives, it is not unreasonable to expect we will treat more commercial managed care patients in the future.

Further, as you heard Jay describe there are reasons to believe that the increase in Medicaid will continue. Specifically Medicaid enrollment is expanding in certain states in which we operate as a result of the ACA implementation. And we have significantly increased our presence in one such state with the acquisition of Cardinal Hill. Accordingly our adjusted EBITDA guidance assumes the IRF segment payer mix for the second half of 2015 will be similar to that experienced in Q2.

Continuing with the IRF segment, Q2 SWB was 49.2%, as compared to 46.9% in Q2 last year. The Q2 2015 SSI adjustment and the $4 million increase in group medical insurance reserves impacted this metric by approximately 100 basis points.

The $4 million increase to the group medical reserves relates predominantly to two items, a single high-risk delivery claim in Texas and higher than assumed utilization of specialty drugs. At least a portion of the increase in specialty drug utilization relates to the treatment of chronic conditions, and is therefore expected to continue through the second half of the year.

The Q2 2015 SWB percentage was also impacted by the continuing ramp-up of the four hospitals added in Q4 last year and the two added in the first half of this year. We are very pleased with the progress at each of these hospitals and anticipate increasing adjusted EBITDA contributions in the second half of the year.

Finally, SWB in Q2 was also impacted by a portion of the cost related to the investments we are making in our IRF operating platform, and I'll remind you of these initiatives in just a moment.

Bad debt was 1.6% of revenue in Q2 2015, up from 1.5% in the prior year. ADR activity continued with the amount of claims denied in Q2 increasing by approximately $2 million from that experienced in Q1. And the adjudication of previously denied claims continuing to experience extensive administrative backlogs.

To place this in context through the first six months of 2015, 86 of our appeals had been heard at the ALJ level, the majority of which relate to 2011 denials, compared to 2,039 total new denials during this period. We remain frustrated by both the claims denial and adjudication processes. Our new medical services department continues its education efforts with the physicians attending our patents in order to further improve our documentation. And we have engaged with our largest MAC in an attempt to understand how future denials can be reduced or eliminated.

During Q2 we continued the incremental investments in our IRF operating platform related to CIS implementation, compliance with new CMS quality reporting measures, our new medical services department, and participation in the bundling pilot initiative. These incremental investments totaled approximately $1.6 million for Q2.

The rollout of our CIS continues to be very positively received in our hospitals. And we are currently installed in 73 of our IRFs.

As a result of these factors IRF segment adjusted EBITDA for the quarter was $170.5 million, as compared to $174.7 million in Q2 of last year.

For the first six months of 2015 IRF segment adjusted EBITDA was $289.7 million, as compared to $295 million for 2014. As is evidenced in our guidance we do not expect this trend to continue and expect second half IRF segment adjusted EBITDA growth over the comparable period in 2014.

As Jay noted we were very pleased with the pace of our IRF development activity in Q2. Most significant is our announced agreement to acquire Reliant.

As Jay described this transaction will add 11 IRFs and 902 beds in Texas, Massachusetts, and Ohio to our portfolio. And also provides additional opportunity for clinical collaboration with our Home Health business. The cash purchase price for Reliant is $730 million, and we will assume the real estate leases for each of the 11 hospitals.

We have expressed many times previously our preference to own our real estate. And over time we will evaluate the feasibility of converting some of the Reliant assets to owned. For the time being we are comfortable with the lease terms on the Reliant hospitals and do not believe this transaction detracts from our ability to proactively manage our real estate portfolio.

Based on the terms and conditions contained therein, we believe that seven of the assumed leases will be treated as capitalized lease obligations for financial reporting purposes. As a result we anticipate a

liability of approximately $210 million to be included on our balance sheet along with the corresponding assets. The rental stream associated with the capitalized leases will be included as interest expense. We also expect to realize a tax benefit with an NPV of $125 million to $150 million as a result of this acquisition.

The Reliant transaction is pending regulatory approval. And we expect to close in Q4 of this year.

We expect to fund the Reliant transaction with cash on hand and senior debt. This week we completed the initial phase of our financing plan, amending our bank credit facilities to extend the maturity, revise certain covenants, and add $500 million in term loan commitments. The incremental term loan commitments are bifurcated into two $250 million tranches.

Our present intent is to utilize $250 million in new term loan capacity as a component of the ultimate transaction financing with the balance to be funded from cash on hand, a revolver draw, and the issuance of new senior notes.

The second $250 million incremental term loan commitment essentially serves as a backup in the event we do not find the terms available to us on new senior notes palatable. Our balance sheet remains strong and we are well positioned to finance the Reliant transaction.

Our Home Health and Hospice segment generated net operating revenues of $119.1 million in Q2, as compared to $7.3 million in Q2 last year.

The current year includes the results from both Encompass and the 25 legacy HealthSouth Home Health locations. The prior year includes only the results of the legacy HealthSouth locations.

Within Encompass volume and revenue growth were driven both by locations owned prior to 2014 and those acquired during 2014. In Q2 2015 for those locations owned by Encompass prior to 2014, admissions increased 15.9%, recertification increased 9.3%, and episodes increased 12.2%, all as compared to Q2 last year.

The Home Health development pipeline remains strong and is now prioritized on markets in which we operate an IRF and do not currently have a Home Health presence. During the first half of 2015 we acquired seven new Home Health locations, all in markets in which we have an IRF presence.

The integration of our two businesses continues as planned. One key area of focus, the transition of the 25 legacy locations to the Encompass platform. 16 of those transitions have been completed and another three are scheduled for August.

The residual six locations each involve one of our IRF JV partnerships and may result in our purchase of the minority interest in the Home Health location from our partner. We expect these locations to be resolved by the end of 2015.

We also continue to focus on increasing clinical collaboration between our two business segments. Our legal and compliance teams have worked closely with our IRF and Home Health operating teams to develop appropriate guidelines and protocols for this collaboration. These guidelines were only recently completed.

We are already seeing tangible evidence of the value of bringing together our high-quality cost-effective facility and home-based platforms to deliver improved patient experiences and outcomes. To place this in context, in January Encompass received 79 admissions from 21 HealthSouth IRFs. In June Encompass received 381 admissions from 35 HealthSouth IRFs. We are at the very beginning on clinical collaboration. Much work still needs to be done here, but the opportunity remains exciting.

Finally, we continue to generate significant levels of free cash flow. For the first six months of 2015 adjusted free cash flow was $173.9 million, as compared to $163 million in the first six months of 2014.

The free cash flow we are generating is supporting our development activity in both segments, as well as our common dividend, which has been raised by 9.5% to $0.23 per share per quarter, effective with the dividend declared in Q3.

Post-closing of the Reliant transaction we do expect higher levels of consolidated adjusted EBITDA. And we intend to devote a portion of our free cash flow to debt reduction, both of which will serve to reduce our financial leverage.

At this time we'll open the line for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Please limit yourself to one question and one follow-up question. Your first question comes from the line of Whit Mayo with Robert Baird.

<A – Jay Grinney – HealthSouth Corp.>: Morning, Whit

<Q – Whit Mayo – Robert W. Baird & Co., Inc. (Broker)>: Hey thanks for all the color this morning, very appreciated. Just wanted to go back to the mix changes in the rehab business for a second. Just to be clear these new Medicaid patients and exchange patients, really we shouldn't think of this as being dilutive to EBITDA, nor are they really displacing the traditional Medicare patients. Is the right way to think of this that this is a tailwind for earnings and a tailwind for volumes, but to the detriment of margins and pricing? Again you don't look at this as a headwind to total growth, do you?

<A – Doug Coltharp – HealthSouth Corp.>: Hey, Whit, it's Doug. I think that the – when we look on average – and of course the Medicaid reimbursement varies pretty widely from state-to-state. But on average at least looking for the first half of this year, the reimbursement that we were receiving on Medicare patients was about sufficient to cover our variable cost per day. So they were essentially breakeven.

So what that suggests is that you could see higher volume, but a little bit of pressure on the EBITDA margin. These patients are not displacing traditional Medicare or Medicare Advantage patients. So we're not sacrificing EBITDA because of a reallocation of existing space to a lower margin patient.

<A – Jay Grinney – HealthSouth Corp.>: And, Whit, I would just say that that average clearly has a lot of variability associated with it. In many of the states where we are able to treat Medicaid patients, the payments create actual EBITDA and contribute to EBITDA growth.

Where we have the challenge is addressing the Medicaid volumes in those states where, as Doug just suggested, the payments are inadequate. And that's a delicate balancing act as I'm sure you can appreciate, particularly when we have a partnership, and we're getting referrals from those – from that partner, we really need to be in a position to treat all comers.

<Q – Whit Mayo – Robert W. Baird & Co., Inc. (Broker)>: No. That's helpful. And maybe my second question just on Reliant. Can you just maybe update us on where the EBITDA run rate is today? And are you planning on rebranding that as a HealthSouth Hospital? Are you going to keep the name Reliant? And I guess I'm just kind of curious, what's different about those assets versus your assets? And just maybe help us think about the earnings stream and synergies as we fold that into our model?

<A – Jay Grinney – HealthSouth Corp.>: Yeah. We'll provide the information on earnings and so on once we close. We're really not in a position to do that, since we don't own the assets quite yet.

In terms of the rebranding, yes, they will definitely be rebranded as HealthSouth Hospitals in those markets. And there are differences. But they're really differences that reflect what we have seen with other acquisitions. Specifically in the case of Reliant and other acquisitions, the patient mix tends to be more oriented towards orthopedic and less oriented to the neuro and the stroke populations. Converting that over time will be a function of introducing the clinical competencies, introducing necessary new technology. But we believe we will be able to do that.

We know these hospitals. We compete against them today. In two instances, Braintree/Woburn up in the Massachusetts area, if you recall we used to own those two hospitals. We lost them in a lease dispute. And frankly the PE firm was able to clean up a lot of those lease issues as a result of a series of events that really forced a fire sale by the previous owner to the PE firm. The PE firm did a very nice job – Nautic Partners did a very nice job of getting in and cleaning that up.

So we're very excited to get back into the greater Boston metro area. And particularly Braintree has quite a fine reputation up there.

So there are some similarities, some differences. But as I said we'll provide information on what to expect in terms of incremental EBITDA and so on once we close.

Operator: Your next question comes from the line of Ann Hynes with Mizuho Securities.

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

<Q – Ann Hynes – Mizuho Securities USA, Inc.>: Hi, thank you. So I have a couple of questions, one on the medical reserve. So I guess it's a little surprising, given you reiterated guidance on June 11. So can you just kind of go over your policies? And why this was, a few weeks later, a big uptick?

And then my second question is SG&A. Even when we take out that $4 million, SG&A as a percentage of revenue was flat. And when I look at my model over the past 6 years that typically goes down in Q2. So is there anything else going on with the labor that needs to be pointed out? I'm not sure if it's the Medicaid mix or anything like that? Thanks.

<A – Doug Coltharp – HealthSouth Corp.>: So, Ann, it's Doug. To begin with on the group medical there were two things that led to us recognizing that need to add to the accrual in the quarter that we found out after the June 10 Investor Day.

First is we received the claims information on that particular severe claim that I mentioned, the high-risk delivery in Texas, from our TPA after June 10. And then the second is we were in the process of conducting our semi-annual actuarial update, and that occurred after June 10 as well.

With regard to the SG&A I don't think there's anything else specially to point out. I think the impact on the revenue from the SSI adjustment was certainly a factor. But it's not really a material difference.

<Q – Ann Hynes – Mizuho Securities USA, Inc.>: Okay. Thanks.

Operator: Your next question comes from the line of A.J. Rice with UBS.

<Q – A.J. Rice – UBS Securities LLC>: Thanks. Hello everybody. First off on these continuing issues around the MACs and the audits. Can you maybe, Jay or someone, give us any update on any discussions beyond just your back and forth with the MACs, trying to get any resolution here? And is there an updated number as to the aggregate amount of funds you have tied up in this at this point?

<A – Jay Grinney – HealthSouth Corp.>: Yeah. Let me address the first one. And I'll ask Doug to address the second part of that question.

We have engaged with the largest MAC that we deal with. And we've talked about this in the past. There is one MAC that handles the claims for 70 plus of our hospitals. And that's where we have seen the vast majority of the denials.

We have had a couple of meetings with them, trying to better understand their rationale and their logic for denying these claims. And we're very pleased that they have agreed to sponsor a forum, an educational forum in August for all of the rehabilitation providers in their jurisdiction to explain their process for denying these claims. We're looking forward to that. We think that will be informative.

Frankly in the private meetings we received general information, not specific information. We hope to get more specific information in August. And that information will help us in two areas.

First, it will help us better understand their process so that we can then – to the extent that it is necessary – modify any of our internal processes to help eliminate or as Doug said reduce or eliminate the denials going forward.

Secondly, we will get I think meaningful information about how they are approaching these. Because frankly we, based on our meetings, believe that rather than following the letter of the law with respect to medical necessity and so on, they are utilizing what basically amounts to rules of thumb, where medical necessity is not the consideration, it's a rule of thumb.

I'll give you an example. They, as a rule of thumb, will deny a simple knee or a simple hip replacement that has no comorbidities, irrespective of what the underlying physician's assessment is with respect to that patient's medical necessity. Rule of thumb, we're just not going to – that we're not going to permit that IRF payment.

Well that – there's nothing in the Medicare guidelines that state that rules of thumb should be used in determining the appropriateness of care. It's all a function of medical necessity.

Now maybe we misunderstood. I don't know. But we certainly are looking forward to that August educational form, because it will help us assess as I said whether or not there are any grounds for challenging the approach that is being taken by this MAC. And as I said I think on at least one other call, we are gearing up to challenge anything that is being done that is outside of what the strict requirements that they are operating under or should be operating under.

So we – this is something that is a very vexing problem for us. I think it's slowly kind of grinding to forward. Whether or not it's going to be resolved anytime soon, I don't know. We're certainly taking this very, very seriously.

We are looking forward to getting this information in August, because I think once that information is out and everybody understands how they're operating, that will give us a much better idea of what we then need to do, both from an operations standpoint and also potentially from just a legal standpoint and an administrative process standpoint within the Medicare program.

<Q – A.J. Rice – UBS Securities LLC>: Okay. And the order of magnitude?

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

<A – Doug Coltharp – HealthSouth Corp.>: A.J., it's Doug. On that as of the end of June we had a total of 5,408 denied claims were outstanding. And that represented approximately $86.6 million of billings. That amount of billings is prior to the reserves we've established against those.

<Q – A.J. Rice – UBS Securities LLC>: Okay. All right. Thanks a lot.

Operator: Your next question comes from the line of Frank Morgan with RBC Capital Markets.

<A – Jay Grinney – HealthSouth Corp.>: Hello, Frank.

<Q – Frank Morgan – RBC Capital Markets LLC>: Good morning. I was hoping you could – obviously with this increase in development activity that you have underway, there's clearly a drag that comes with that. But I was just hoping maybe you could give us – I'm not necessarily asking for guidance for next year. But just conceptually when we think about the magnitude of the drag from development, could you comment about – in general terms about that? And then how that would compare to say just the underlying organic growth rate, say EBITDA growth rate for both the IRF and the Home Health segment?

<A – Jay Grinney – HealthSouth Corp.>: No, I don't – at this juncture the drag for the hospitals that came on in Q4 is certainly decreasing. As you know in our investor reference book we highlight what that first year ramp up is. And on average you get to an EBITDA positive somewhere in that 6-month range.

So we're kind of getting to that point for the fourth quarter – hospitals that were opened in the fourth quarter.

Memorial, Cardinal Hill, little different story. Those are two hospitals that kind of reflect that mix that I was talking about before that you typically see in other IRFs.

The good news is Cardinal Hill did a little bit better than what we expected in the second quarter. We hope to be able to continue that going forward. So that kind of characterizes what that drag might be in the second quarter and maybe even the first half of the year.

Not a lot of drag on the Home Health side, Encompass is very accomplished at getting into these agencies especially – I mean they're very small, so it's not like they're tackling a huge operation. But they are significant. And making the transition is not easy, but they do it very, very well. And so there's not a lot of drag there. There may be some with the transition from the legacy HealthSouth, but I think that's pretty de minimis.

<A – Doug Coltharp – HealthSouth Corp.>: And, Frank, just to add to that. We only have one new IRF scheduled to come on board this year. And that's the one that we're opening in your backyard in Franklin, Tennessee, in the fourth quarter.

And then 2016 is really – 2016 we'll start to see some additional hospitals come on board. And we've outlined those on slide 6 of the supplemental slide.

I think the really big focus in terms of what we'll be dealing with from an on-boarding perspective is going to be the Reliant transaction. And obviously we'll have a whole lot more to say about that and its potential impact on 2016 once we get to the closing table.

<A – Jay Grinney – HealthSouth Corp.>: And as you think about the startup costs and that drag, if you want to try to quantify it, I don't have our IRB immediately in front of me but in – I believe in the growth section of the IRB, we characterized what the typical startup costs are and what the CapEx is and what the startup costs are. So if you look at that, that'll give you at least some order of magnitude.

<Q – Frank Morgan – RBC Capital Markets LLC>: And the organic growth, like putting startups aside, just what do you feel like based on what you know today the – we should be modeling on organic EBITDA growth, just on the base organic same store business? Thanks.

<A – Jay Grinney – HealthSouth Corp.>: Yeah. I guess it's way too early to be talking about 2016. We're focused on completing this year. And we'll provide guidance on 2016 once we get to that point. Obviously we'll update the balance of 2015 once we close on Reliant. But it's really kind of too early to talk about 2016.

I will say we're very excited about the development pipeline. We're very excited about the new hospitals that are going to be coming online. Very excited about Reliant. And we're very confident that 2016 is going to be a very good year for us.

<A – Doug Coltharp – HealthSouth Corp.>: And we continue to believe that the CAGRs that are represented on our business model slide are appropriate.

<Q – Frank Morgan – RBC Capital Markets LLC>: Okay. Thanks.

Operator: Your next question comes from the line of Chris Rigg with Susquehanna Financial.

<Q – Chris Rigg – Susquehanna Financial Group LLLP>: Good morning. Given the mix shift can you help us right size the payment differential between the payers? So if Medicare fee-for-service is 100%, how do we think about Medicare Advantage, Medicaid, commercial on a per discharge basis?

<A – Doug Coltharp – HealthSouth Corp.>: Yeah.

<A – Jay Grinney – HealthSouth Corp.>: So if you look at the Medicare Advantage it was about 10%; Managed Care, it's about 26%; Medicaid is on average about 33%.

<Q – Chris Rigg – Susquehanna Financial Group LLLP>: Yeah. So you're saying 33%? So you're getting $1 for...

<A – Jay Grinney – HealthSouth Corp.>: It's a 33% discount, 26% discount...

<Q – Chris Rigg – Susquehanna Financial Group LLLP>: Got you. Perfect.

<A – Jay Grinney – HealthSouth Corp.>: ...10% discount off of traditional Medicare.

<Q – Chris Rigg – Susquehanna Financial Group LLLP>: Perfect. And then can you give us your thoughts on the initial Home Health proposal for 2016?

<A – Jay Grinney – HealthSouth Corp.>: Yeah. It's kind of hard to do that, because as you know CMS stated that there was an error in the original case mix weightings. And they said that there was a misalignment between the case mix weights and the payment groups. And I guess it was table 9. And that they're going to be issuing a correction. So until we have that it's a little bit hard to really assess what that rule is going to look like.

Overall our view is that any proposed rule that continues to advance differentiation among providers based on quality is very good for HealthSouth. Be it on the IRF side or on the Home Health side. And certainly that – this proposed rule does that.

And so my – our initial take is we'll wait to see what the pricing effect is going to be. But certainly on the quality metrics – whether or not they're the right quality metrics, I mean you can argue all day long on that. But again anything that can – that will advance differentiating providers based on quality and outcome, we believe is very good for our company.

<Q – Chris Rigg – Susquehanna Financial Group LLLP>: Perfect. Thanks a lot.

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

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

<Q – Gary Lieberman – Wells Fargo Securities LLC>: Hey good morning. Thanks for taking the question. Could you give us your thoughts in terms of strategy for dealing with the mandatory Joint Replacement Program? And any risks to volumes from that?

<A – Jay Grinney – HealthSouth Corp.>: Yeah. As I mentioned in my comments the total number of joints that are affected, or could possibly be affected is pretty de minimis for our company.

Stepping back, the compulsory nature I believe caught everyone by surprise. It certainly caught us by surprise. But it does signal that CMS is committed to moving the industry into some kind of coordinated care and coordinated payment system.

The Affordable Care Act got a lot of attention with respect to increasing coverage for those who did not have any insurance. And most of the focus appropriately was on what that meant for the uninsured. But certainly as we looked at the Affordable Care Act, our attention was on those provisions that addressed changes to the Medicare program. And the creation of the Center for Medicare & Medicaid Innovation was one that definitely got our attention. And the authority that the secretary has to make these changes was I think an overlooked component of the Affordable Care Act. But that's the reality we're in.

Frankly we think that there is an opportunity for us, particularly in those markets where we have both a hospital and a Home Health presence. If we can get certain regulatory relief, and that's certainly what we're going to be proposing, we think that this could create a market share gain opportunity for us with respect to knees and hips.

As you know it's a pretty small amount of our business today. We're really limited by the 60% rule in terms of the kinds of patients, knee and hip patients that we can treat. But we do believe that we can compete very effectively with any rehab provider, be it other IRF or other SNF, in getting these patients home and getting them back into some semblance of an independent life.

So the devil's in the detail. We will be approaching CMS with some thoughts on pricing flexibility, so that we have the ability to work with our Encompass Home Health partner and approach the acute care hospitals with some innovative ideas. It's really too early to talk about what those details look like.

But if it's going to be driven by who can provide the best care on the most cost effective basis, we think we've got the pieces to do that – the pieces in place to be able to do that.

<Q – Gary Lieberman – Wells Fargo Securities LLC>: Okay. Thanks. And then, maybe my follow-up would be, it sounds like you're making decent progress of entering Home Health in the markets where you have IRFs and no Home Health presence. Can you maybe just give us an update of how quickly you think you'll be able to do that? And what you're seeing in the marketplace in terms of opportunity for Home Health acquisitions?

<A – Jay Grinney – HealthSouth Corp.>: Yeah. The development pipeline in Home Health is very impressive. The folks at Encompass are well known in the industry. They're well respected in the industry.

Trends that we have talked about for some time – regulatory, barriers to entry, quality, reporting measures that may force some out, pricing pressures – all of those are still in play. And we think that that's contributing to a pretty favorable development landscape for Encompass in particular and Home Health in general.

So clearly as we said before as we look at growth opportunities, we will be looking to enter states and markets where we have a hospital presence but no Home Health presence. And we believe we're going to be able to execute on that strategy going forward.

Operator: Your next question comes from the line of Josh Raskin with Barclays.

<A – Jay Grinney – HealthSouth Corp.>: Hello, Josh.

<Q – Josh Raskin – Barclays Capital, Inc.>: Hi, good morning, Jay. Just quick one on the insurance, the medical insurance reserve boost. I'm assuming the big case was probably the minority of the increase there. So just from a run rate perspective was any of this relating to 2014? Or should we think about the $4 million, maybe less, whatever that big one-timer was, as sort of the new run rate? I know you mentioned especially pharmacy will sort of continue.

<A – Doug Coltharp – HealthSouth Corp.>: Hey, Josh. It's Doug. So actually it was split almost evenly between the two. They were both essentially $2 million items.

We don't expect that the severe claim will be repeated in the second half of the year. As I mentioned my comments we do anticipate that at least a portion of the increase in specialty drug utilization will continue.

We're anticipating about a 7% year-over-year increase in group medical expenses for the second half of the year. And that's embedded in our guidance. That's the combination of the higher run rate, and it's also taking into effect the fact that we had some favorable adjustments to the reserve in the second half of last year.

<Q – Josh Raskin – Barclays Capital, Inc.>: Okay. That makes sense. Got you. That's a big claim. Okay. And then on the Medicaid payer mix I just want to better understand the impact on EBITDA. And I think you said covering variable cost.

So does this change the way you think about markets that have expanded Medicaid? I sort of look at your occupancy, it certainly seems like you've got room for some of these patients. So to your point I can't imagine it eating into any other opportunity. So I understand the impact on margin. But shouldn't we think of these – shouldn't we think of this as a good trend that you're seeing more people come in?

<A – Jay Grinney – HealthSouth Corp.>: We do frankly. And even though this may be a bit of a transition to the total population that we're treating. At some point that anniversaries. And we do get some pricing lift from Medicaid. So at some point we'll start to see some tailwind in terms of unit pricing. But, yes, we do believe that this is a positive development.

But it's a change. And the biggest impact is that is having – that it's having is on the year-over-year pricing growth. As Doug pointed out in his comments however, 110 basis point delta in the pricing was attributable to the SSI. So you got to put that into the equation as well. But, yes, we see that incremental growth and the incremental volume as being positive.

<A – Doug Coltharp – HealthSouth Corp.>: It is as I mentioned in my comments as well, Josh. Though because of the extreme variability in the Medicaid reimbursement rates on a per state basis, it's a question that literally needs to be addressed hospital by hospital. Looking at what the current occupancy levels are in an existing hospital, and what the state Medicaid reimbursement rates are.

<Q – Josh Raskin – Barclays Capital, Inc.>: Got you. But I mean – so is there a way to delineate these rates? As you mentioned the Medicaid expansion states, right, which I think is the majority of your states that you have IRFs in. Is there a way to say, okay the rates there are not adequate? Or more – or they are adequate to cover their rates? Or is it just again it just doesn't – it doesn't sort of fall out that way?

<A – Doug Coltharp – HealthSouth Corp.>: Yeah, it's – unfortunately it's a mixed bag in those states too. There are some states where Medicaid is expanding, and the reimbursement is more than sufficient to cover our variable costs per day. And there are others where it's a real challenge.

So it's something we're going to be spending a lot more time digging in on and working in concert with our referral partners to understand how we can better manage that. But I think as Jay mentioned overall we do think the fact that the patient population which we can address is expanding is a positive thing.

<Q – Josh Raskin – Barclays Capital, Inc.>: Right. Okay perfect. Thanks.

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

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

<Q – Joanna Gajuk – Bank of America Merrill Lynch>: Good morning. This is actually Joanna Gajuk filling in for Kevin. Thanks for taking the question here. So just to clarify...

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

<Q – Joanna Gajuk – Bank of America Merrill Lynch>: Good morning, Jay. So just to clarify the comments you made on your traditional Medicare, which you said that half of the, I guess year-over-year volume, same-store volume growth came from traditional Medicare. So I just want to confirm that you meant like same-store volume.

And also would you characterize the traditional Medicare sort of growth rate that you experienced so far this year versus last year, whether this is kind of the way it should be? With expectation accelerating, any color you might give there? Thank you.

<A – Jay Grinney – HealthSouth Corp.>: Yeah. I'll just – I'll answer the second part. Yeah. We were very pleased with that year-over-year Medicare growth. And that is reflective of our presence in markets where there's a large concentration of Medicare enrollees now and the strategic entering of those markets over time. But, yeah, we're pleased with what we've seen in terms of traditional Medicare.

<A – Doug Coltharp – HealthSouth Corp.>: And with regard to the clarification on my statement, 50% of the total, approximately 50% of the total discharge growth was from traditional Medicare.

<Q – Joanna Gajuk – Bank of America Merrill Lynch>: Great. Thanks. And just a quick follow-up. The comment you made on the proposed mandatory Joint Replacement bundle, you said it might be a positive, net positive for the company. Because I guess you feel like, first of all, what portion of your volumes would be impacted on your IRF side. But then you can pick up some patients on the Home Health side. So that's why you feel like it could be positive, because you just don't feel like you're going to lose much. But then you can potentially benefit from just operating the Home Health agencies in this market. Right?

<A – Jay Grinney – HealthSouth Corp.>: Well actually depending on how the final rule is laid out, what kind of pricing flexibility we may be able to secure, frankly we think it could be a positive for our hospitals as well. Clearly it's going to be a positive for our Home Health business.

Encompass does an outstanding job of taking care of joint replacement patients. They've done that for quite a period of time. They have special programs that are devoted to that.

But we think frankly that combining in those 15 markets our hospital and our facility based rehab capabilities with what Encompass does, and give us some pricing flexibility, I think we could be a very attractive partner for the acute care hospitals who are required to participate.

And I did say that we're concerned about the precedent, the mandatory aspect of this rule.

I also want to say that – this is just our opinion, and we're not in the acute care world anymore. But I spent a lot of time in that acute care world. I would think that there are going to be a fair number of acute care hospitals that are looking at that January 1, 2016, deadline and saying, how am I going to get there?

I certainly would advocate that it be pushed back a year to give the industry the opportunity to put the systems and processes in place to be able to manage this. We'll see how that plays out. But that's certainly going to be one of the comments that we will be presenting as we give our comments to CMS.

<Q – Joanna Gajuk – Bank of America Merrill Lynch>: Thanks. That's very helpful color as always. Thank you, Jay.

<A – Jay Grinney – HealthSouth Corp.>: You're welcome.

Operator: Your next question comes from the line of Dana Nentin with Deutsche Bank.

<Q – Dana Nentin – Deutsche Bank Securities, Inc.>: Thanks. Good morning.

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

<Q – Dana Nentin – Deutsche Bank Securities, Inc.>: Thanks for taking the call. So just going back to the pipeline. I appreciate the color that you've given. But specifically as it relates to the IRF pipeline, given the number of joint ventures you've announced so far this year, can you provide any color on sort of what the mix is between joint ventures and acquisitions at this point in the pipeline?

<A – Jay Grinney – HealthSouth Corp.>: Yeah. If you take Reliant out, because that is such a large transaction, and you just look at the development pipeline, most of what we're seeing is joint venture opportunities.

And what we predicted we would see several years ago continues to play out. And that is that not all acute care hospitals have the wherewithal to be all things to all people. And yet the industry pressures are demanding that. And so a lot of the hospitals recognize that partnering with players like HealthSouth makes more sense than trying to go it on their own. And so most of what we see on the IRF side are joint venture opportunities.

<Q – Dana Nentin – Deutsche Bank Securities, Inc.>: Got it.

<A – Doug Coltharp – HealthSouth Corp.>: But you look at specifically – if you look specifically at the IRF development projects that are listed on page 6 and 7, beyond what is already onboard, there are seven IRF projects listed and four of those are JVs.

<Q – Dana Nentin – Deutsche Bank Securities, Inc.>: Got it. And then just quickly on the Home Health and Hospice segment. Can you give any sense for how much of the year-over-year revenue growth in the quarter was driven by organic factors versus M&A?

<A – Doug Coltharp – HealthSouth Corp.>: I think the best measure of the organic factors are the kind of same store equivalents on the Encompass business that I cited during my comments. And to remind you of those, in Q2 for those locations that were owned by Encompass prior to 2014, admissions increased 15.9%, re-certifications increased 9.3%, and episodes increased 12.2%.

So the fact is we're seeing very strong organic growth. And we're also seeing very good growth from those acquisitions that were completed by Encompass during the course of 2014. Recall that they made a very significant acquisition that closed I believe late in the third quarter or early in the fourth quarter of last year. And that was the acquisition of the Phoenix business in Florida.

<Q – Dana Nentin – Deutsche Bank Securities, Inc.>: Great. Thank you.

Operator: Your next question is from the line of Sarah James with Wedbush Securities.

<A – Jay Grinney – HealthSouth Corp.>: Morning, Sarah.

<Q – Sarah James – Wedbush Securities, Inc.>: Good morning. Thank you. I wanted to go back to the topic of the advantage of the vertically integrated model. So specifically thinking about the opportunity for IRF discharge capture. Pre-Encompass I think it was 8% to 9%. But now you've had 6 months of strengthening relations with the referring physician. So are you starting to see some traction there? And now that you have an even greater geographic overlap with the addition of Reliant, how do you think about where the capture potential could be long term?

<A – Jay Grinney – HealthSouth Corp.>: Well the overlap clinically in those markets where we have both Encompass and HealthSouth is – we think it's sort of in the early stages. But the progress that we're making is quite good.

The document that Doug referred to, which helps to delineate how we will be able to work together on that clinical collaboration, that took a little while to get finalized. But that's now being promulgated across the entire company. So we think that those opportunities are there, and we're starting to see them. But there's more to come.

<A – Doug Coltharp – HealthSouth Corp.>: Yeah. And I would also again comment on a couple things here. First is as Jay mentioned those guidelines were just completed in June. But even with that I cited specifically, and I'll restate right now that in January – for a little bit of context in January Encompass

received 79 admissions from 21 HealthSouth IRFs. In June Encompass received 381 admissions from 35 HealthSouth IRFs. And this was before we really had those protocols completely lined out.

So we're at the very beginning of the process. In fact we're just really getting started.

I'll also note that with regard to an alignment of the development pipelines, for the first half of 2015 we acquired seven new Home Health locations. And all of those were in markets in which we have an IRF presence. And given the geographic footprint of the Reliant business, there's a lot of additional overlap that's going to come into play there.

So we think that the opportunity is increasing. There was a slide that we included in our Investor Day presentation that showed a prioritization of the clinical collaboration opportunities. And I think that really helps to scope out what the potential is in that regard.

<Q – Sarah James – Wedbush Securities, Inc.>: Thanks. I appreciate the color. And just to follow up, how do you think about what kind of spend may be needed over time to achieve this goal?

<A – Jay Grinney – HealthSouth Corp.>: What kind of what?

<A – Doug Coltharp – HealthSouth Corp.>: Spend.

<Q – Sarah James – Wedbush Securities, Inc.>: Administrative spend to really get the different practices working together, potentially staffing up. What kind of spend should we think about being related with this?

<A – Jay Grinney – HealthSouth Corp.>: I think – I don't think it's going to be significant. The spend will be more directed towards the establishment of clinical protocols. Those clinical protocols will be established in turn by clinical experts from Encompass, clinical experts from the Inpatient Rehabilitation side that are already out there on the ground and are providing care today.

There may be some modest supplemental costs associated with outside consultants and so on. But I don't envision that there would be a huge incremental cost to enhance that clinical collaboration. I think it would be much more a function of using our practitioners who are already on the ground doing this today, getting together, coming up with best practices, establishing those, and then throughout our organization promulgating those best practices.

<A – Doug Coltharp – HealthSouth Corp.>: And I think just to elaborate that. I would envision that any incremental operating expense with regard to this strategic initiative will very quickly translate into a revenue stream. I think the spend is really the capital spend. And that's the $30 million to $40 million in agency acquisitions that we cited previously, which I think continues to be a good number to use as a run rate. And that's to fill in those markets where we have an IRF but don't currently operate a Home Health business.

Operator: Your final question comes from the line of Chad Vanacore with Stifel.

<A – Jay Grinney – HealthSouth Corp.>: Morning, Chad.

<Q – Chad Vanacore – Stifel, Nicolaus & Co., Inc.>: Hey there. Thanks for fitting me in this morning. So first, could you give us a little more color on the Medicare prepayment claims experience? So what were the denials in the quarter? And then what's your progress on the new department that deal with claims denials? And can you say that there's any improvement at this date?

<A – Jay Grinney – HealthSouth Corp.>: Yeah, let me take the second part. The second – that department, that new department is really aimed at enhancing the documentation by physicians in our hospitals. And so – and we're starting to see some early traction there.

As we said previously we do think that the rollout of our clinical information system will enhance those efforts, not only for the physician, but it also will give us an opportunity to better manage and monitor the compliance with our new guidelines that Lisa [Charbonneau] and her team are putting out there.

<A – John Whittington – HealthSouth Corp.>: Yeah. In addition – this is John Whittington. In addition to providing continuous training and education to physicians on documentation, we're also training the physicians on how to prepare for these ALJ hearings and these claim denials. So that when they come into a hearing, they're really, really prepared to present evidence and justify the admission to begin with. And we are seeing results from that training already

<A – Doug Coltharp – HealthSouth Corp.>: And, Chad, it's Doug. The claims denials in the second quarter were a little over $18 million. That's up about $2 million from what we experienced in Q1.

<Q – Chad Vanacore – Stifel, Nicolaus & Co., Inc.>: All right. That's great. Thanks. And just one quick one on the Social Security ratio impact to Medicare rate. How much of that $5 million is related to the current period and year-to-date?

<A – Doug Coltharp – HealthSouth Corp.>: A very modest portion, because it dates back to 2013. I assume – I don't have it in front of me, but that it would be fairly ratable over what amounts to a 30-month period.

<Q – Chad Vanacore – Stifel, Nicolaus & Co., Inc.>: All right. Thanks a lot.

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

Operator: There are no further questions at this time. I would now like to turn the floor back over to management for any further or closing remarks.

Mary Ann Arico, Chief Investor Relations Officer

Yeah. Thank you. If you have additional questions, Ross and I will be available later today. Please call me at 205-969-6175. Thank you.

Operator: This concludes HealthSouth's second quarter 2015 earnings call. You may now disconnect.