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Encompass Health Corp. (EHC)

Q1 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone, and welcome to Encompass Health's First Quarter 2024 Earnings Conference Call. At this time, I'd like to inform all participants that their lines will be in a listen-only mode. After the speakers' remarks, there'll be a question-and-answer period. [Operator Instructions] You'll be limited to one question and one follow-up question. Today's conference call is being recorded. If you have any objections, you may disconnect at this time.

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

Mark Miller

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

Thank you, operator, and good morning, everyone. Thank you for joining Encompass Health's first quarter 2024 earnings call. Before we begin, if you do not already have a copy, the first quarter earnings release, supplemental information and related Form 8-K filed with the SEC are available on our website at encompasshealth.com.

On page 2 of the supplemental information, you will find the safe harbor statements, which are also set forth in greater detail on the last page of the earnings release. During the call, we will make forward-looking statements which are subject to risks and uncertainties, many of which are beyond our control. Certain risks and uncertainties, like those relating to regulatory developments as well as volume, bad debt and labor cost trends, that could cause actual results to differ materially from our projections, estimates, and expectations are discussed in the company's SEC filings, including the earnings release and related Form 8-K, the Form 10-K for the year ended December 31, 2023 and the Form 10-Q for the quarter ended March 31, 2024 when filed. We encourage you to read them.

You are cautioned not to place undue reliance on the estimates, projections, guidance and other forward-looking information presented, which are based on current estimates of future events and speak only as of today. We do not undertake a duty to update these forward-looking statements.

Our supplemental information and discussion on this call will include certain non-GAAP financial measures. For such measures, reconciliation to the most directly comparable GAAP measure is available at the end of the supplemental information, at the end of the earnings release and as part of the Form 8-K filed yesterday with the SEC, all of which are available on our website.

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

With that, I'll turn the call over to Mark Tarr, Encompass Health's President and Chief Executive Officer.

Mark J. Tarr

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

Thank you, Mark, and good morning, everyone. The broad-based momentum of our business continued in the first quarter, evidenced by 13.4% revenue growth and adjusted EBITDA increase of 19.2%. Owing largely to our Q1 results, we are increasing our 2024 guidance. Doug will cover the details of the quarter and increased

guidance in his comments. Demand for IRF services remains strong and we are continuing to invest in capacity additions to meet the needs of patients requiring inpatient rehabilitation services.

During Q1, we added 51 beds to existing hospitals. Over the balance of the year, we plan to open six de novo hospitals with a total of 280 beds, as well as a 40-bed freestanding hospital to be licensed as a satellite location of an existing hospital. Consistent with our historical practice, the satellite will be accounted for as a bed addition. We anticipate adding another 93 beds to existing hospitals in 2024, inclusive of the aforementioned satellite.

We continue to build and maintain an active pipeline of de novo projects, both wholly-owned and joint ventures with acute care hospitals. Since the beginning of this year, we've announced three additional de novo projects, bringing our pipeline to 14 hospitals under development with opening dates beyond 2024.

We remain keenly focused on further enhancing the quality of our patient care and resulting outcomes through the deployment of clinical technologies and protocols. We have previously highlighted the installation of in-house dialysis capabilities at many of our hospitals. We now offer this service in 88 of our hospitals and we'll continue the rollout to additional locations in 2024.

As another example of an ongoing clinical project, our quality of life improvement project incorporates an individualized approach to inpatient care in which our therapists focus on a specific patient's interest, lifestyle, home improvement and community mobility needs. The goal of this program is to improve the patient's inpatient experience and readiness for discharge to their community.

On March 27 of this year, CMS released the 2025 IRF proposed rule. This included a proposed net market basket update of 2.8%, which we estimate would result in an approximately 3% increase for our IRFs beginning October 1 of 2024 based on our current patient mix. The IRF final rule is expected to be released in late July or early August.

Review Choice Demonstration, or RCD, began in August 2023 in Alabama. Recall that under RCD Cycle 1, which lasted six months, every Medicare claim was reviewed for documentation and medical necessity. The affirmation rate target set by CMS under Cycle 1 was 80%. All seven of our Alabama hospitals ended Cycle 1 above the target affirmation rate.

For Cycle 2 in Alabama, which runs from May 1 through October 31, we had the choice of continuing with 100% pre-claim review or a random spot check pre-claim review of 5% of claims. Based on our Cycle 1 claim experience, we elected to continue with 100% pre-claim review for Cycle 2. The target affirmation rate for Cycle 2 is 85%.

On March 1, CMS announced it is expanding IRF RCD to Pennsylvania for hospitals billing to the Medicare administrative contractor Novitas. Our nine hospitals in Pennsylvania will not be subject to RCD at this time, as they bill to a different Medicare administrative contractor.

During Q1, many providers across the US healthcare spectrum experienced significant disruptions due to the cyberattack on Change Healthcare. We have historically used Change for the vast majority of our claims processing across our payer base. Our teams in our centralized business office and information technology quickly rallied to successfully implement workarounds using alternative third-party vendors and enhancing our own claims processing capabilities. As a result of these efforts, we experienced minimal impact to our Q1 cash flow from the Change outage. We resumed claims processing with Change in early April and continue to maintain the alternative channels we recently developed.

Across our 160 inpatient rehabilitation hospitals, we are daily providing high-quality, cost-effective care to medically complex patients. Our dedicated clinical teams work collaboratively with physicians to administer this care, producing leading scores in patient satisfaction and quality outcomes. This value proposition increasingly resonates with patients, caregivers, referral sources and payers. The demand for inpatient rehabilitation services remains considerably underserved and continues to grow as the US population ages. We intend to continue to expand our capacity and capabilities to meet this need.

Now, I'll turn it over to Doug.

Douglas E. Coltharp

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

Thank you, Mark, and good morning, everyone. As Mark stated, we are very pleased with our Q1 results. Revenue growth for the quarter of 13.4% was primarily driven by volume, as total discharges grew 10%, inclusive of 6.7% same-store growth. Q1 revenue growth did benefit from both leap year and the timing of the Easter holiday. Our Q1 revenue also included a $6.9 million increase in provider tax receipts, primarily attributable to prior periods.

Q1 adjusted EBITDA increased 19.2% to $273 million, driven by revenue growth, stable premium labor trends and prudent expense management. Other operating expenses as a percent of revenue decreased 80 basis points, benefiting from the favorable impact of on-site dialysis implementation and efficiencies in our recruiting efforts. Q1 adjusted EBITDA included approximately $5 million related to the aforementioned provider tax receipts.

Q1 net preopening and ramp-up costs were $1.8 million, as compared to $4.2 million in Q1 last year. Given the timing of our new hospital openings and the balance between joint venture and wholly-owned de novos, our net preopening and ramp-up costs will be concentrated in the final three quarters of the year. We anticipate $15 million to $18 million of de novo net preopening and ramp-up costs for 2024, as compared to $6.6 million in 2023.

We continue to generate significant levels of free cash flow. Adjusted free cash flow for the quarter increased 5.6% to $167.6 million due to higher adjusted EBITDA, partially offset by an increase in working capital, which was unrelated to the Change Healthcare outage and higher cash tax payments.

Primarily based on the strength of our adjusted EBITDA growth, our net leverage again declined, falling to 2.5 times from 2.7 times at year-end 2023. We ended the first quarter with no amounts drawn on our $1 billion revolving credit facility and more than $130 million of cash on hand.

As Mark alluded to, based primarily on our Q1 results, we are raising our 2024 guidance as follows: net operating revenue of $5.25 billion to $5.325 billion, adjusted EBITDA of $1.03 billion to $1.065 billion, and adjusted earnings per share of $3.86 to $4.11. The key considerations underlying our guidance can be found on page 12 of the supplemental slides.

And with that, operator, we'll now open the lines for questions.

QUESTION AND ANSWER SECTION

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

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

Good morning.

Kevin Fischbeck
Analyst, BofA Securities
Q

Good morning. Thanks. I guess, I would love a little bit more color on the volume in the quarter. Do you have any details about the strength you mentioned, the leap year help. There's been a lot of kind of focus on how maybe March slowed down. Any comments about volume intra the quarter and how things are maybe trending so far in April? Thanks.

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

The volume remained pretty constant throughout the quarter. And so, in the month of February, you had the extra day because of leap year, which certainly helped volume in that month. And then March, discharge volumes certainly benefited from the fact that the Easter holiday fell on the last day of the quarter, which also happened to be a Sunday. But really, we saw good momentum on volume through the entire quarter.

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

Kevin, not only was it consistent throughout the quarter, but if you look at it geographically across our eight regions, it was very consistent across all of our regions and we're very pleased with the progress that we've continued to made on just overall volume growth.

Kevin Fischbeck
Analyst, BofA Securities
Q

Great. And then I guess maybe...

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

And it's across payers as well. When we look at the total discharge volume growth, we had a 12% increase in Medicare fee for service and north of an 11% increase in Medicare Advantage.

Kevin Fischbeck
Analyst, BofA Securities
Q

Okay. Great. And then I guess maybe just to talk about that then for a second. A lot of focus on Medicare Advantage rates and can you talk a little bit about how the contracting there for you is going? And then are you expecting any pressure or flow through from the negative rate adjustments they're getting for next year? Is there any concern about how that might flow down through to your contracting or their utilization management? Thanks.

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

So we're right at about 90% of our Medicare contracted revenues being on an episodic basis versus on a per diem basis. And the payment differential for the quarter was just over 3%, so good progress there. Most of those contracts that are on an episodic basis, the annual increases are tied directly to the Medicare fee-for-service rule. So at this point in time, we're really not expecting any adverse consequences from what's going on with regard to the Medicare Advantage rule.

Kevin Fischbeck
Analyst, BofA Securities
Q

All right. Great. Thanks.

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

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

Good morning.

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

Good morning, A.J.

A.J. Rice
Analyst, UBS Securities LLC
Q

Hi. How are you, guys? I know SWB per FTE was about 4% to 5% in the quarter, and I think that's your target for this year. I wonder when you look at it, underlying permanent wage trends, premium labor sign-on bonuses, ship bonuses, is there any place where you're running higher than the pre-pandemic, where there's still opportunities in your mind potentially to improve on that year-to-year rate?

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

Yeah. So total SWB for the quarter was actually up 3.8%, so slightly below the low end of the range that we have out there for the year. And the biggest reason for that is that we would expect a higher growth rate on benefits for the last three quarters of the year, just based on the positive accrual adjustments we had in the last three quarters of 2023.

Both categories of premium labor continue to be elevated above where they were pre-pandemic, although they settled down quite a bit. If we look at what transpired in the quarter in terms of sign-on and shift bonuses, the total there was $14.3 million. That's about a $2 million improvement over where we were in Q1 of last year and it's up just modestly about $1.2 million from the run rate we experienced in Q4. That's not unanticipated, just given our normal seasonal trends and also the volume increase that we had in the quarter.

Looking at kind of the same pattern for contract labor dollars, we were at $19.3 million in Q1. Again, that compares favorably to $20.7 million in Q1 of last year, up sequentially from Q4 which was $17.7 million. We again would attribute that predominantly to seasonal patterns and to the volume trend. The contract labor FTEs as a

percentage of total FTEs for the quarter was at 1.6%. That's in the range that we've been – we were running at in the second half of last year, right around 1.5%. Again, pre-pandemic, we would have been just below 1%.

So, we do think that there's some continued opportunity, but it really does feel like at least for the foreseeable future, A.J., we've kind of settled into this rate – this range. I will note, we continue to make good progress through our recruiting efforts on the quarter. Net new RN hires for the quarter were 148, and that's a pretty significant increase over the less than 50 that we had in Q1 of last year.

A.J. Rice
Analyst, UBS Securities LLC

Q

Okay.

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

A

And final comment on labor, A.J., is not only on the recruitment side, but retention continues to be a big focus. And our turnover, particularly around the nursing, continues to trend downward, as well as therapy. So, we're seeing a lot of positive aspects within the broader umbrella of labor itself.

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

A

Yeah. And just to put a finer point on Mark's comments there, annualized Q1 nursing turnover was at 20.2% and therapist turnover 6.6%. So those are very positive numbers.

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

A

And both of those would be lower than pre-pandemic.

A.J. Rice
Analyst, UBS Securities LLC

Q

Yeah. It's a very low number on the therapists. Interesting. Thanks a lot.

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

A

Thank you.

Operator: Our next question comes from Andrew Mok with Barclays.

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

A

Hello, Andrew.

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

A

Good morning.

Andrew Mok
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. I was hoping you could give us a little bit more detail on de novo openings this year, just overall cadence and timing. There were no openings in Q1. So, how should we think about the six de novos for the balance of the year? Thanks.

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

A

Yeah. Certainly, as we alluded to at the beginning of the year, you're going to have a different pattern this year than you did last year. Last year, we benefited in terms of the annual net preopening and ramp-up costs by the fact that we had earlier openings. We had those that were predominantly JVs. Five of the ones that we opened last year were JVs, and you had a couple of hospital and hospitals which tend to ramp up faster. We're skewed now with our openings into the final three quarters of this year, which is leading to kind of the year-over-year change and particularly over the balance of the three quarters.

If you look over the final three quarters of last year, net preopening and ramp-up costs were negative $2.4 million. If you subtract out from the $15 million to $18 million range we have for 2024, the $1.8 million we experienced in Q1, you're left with an anticipated $13.2 million to $16.2 million impact in Q2 through Q4. The midpoint of that range is $14.7 million, so that would represent a little over a $12 million delta on a year-over-year basis.

Andrew Mok
Analyst, Barclays Capital, Inc.

Q

Got it. That's helpful. But if we just take a step back and think about the six de novos, should we think two per quarter for the remaining three quarters or is there even more of a back-end skew to that?

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

A

I think we've got two opening in Q2 and then the balance are in Q3.

Andrew Mok
Analyst, Barclays Capital, Inc.

Q

Got it.

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

A

One will likely extend into Q4.

Andrew Mok
Analyst, Barclays Capital, Inc.

Q

Okay. That's helpful. And then occupancy in the quarter ticked up to about 76.7%, which I think was a notable sequential and year-over-year increase. I know you have elevated bed additions coming online this year, but can you give us a sense for what full capacity looks like or maybe where your top decile hospitals sit on an occupancy basis? Thanks.

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

Yeah. So occupancy during the quarter was definitely favorably impacted by normal seasonality, as well as the volume increase we saw and the fact that there were no counterweights in terms of de novos opening in the quarter. Again, as we move forward, we would hope to see the overall occupancy rate continue to move up modestly over time. And really the primary reason there, in addition to the fact the demand environment remains very positive, is that we are increasingly seeing a higher percentage of our overall beds in private rooms, which eliminates the capacity constraints that can be caused by gender compatibility and other issues requiring patient isolation.

And again, the increase in private beds is coming from really two initiatives, the first being that virtually all of our capacity additions, be they bed additions to existing hospitals or de novos, are comprised of all private rooms. And then the second is when we are doing major remodels and renovations, where we are able, we are taking the opportunity to convert semi-private rooms to private rooms.

In terms of targeting a specific theoretical occupancy peak, it's hard to do that because we still have such a mixed bag within our overall physical plan. But generally speaking, in a facility that is all semi-private, you start to hit capacity constraints north of 80%. When you're in a facility that is all private room, you can run into the mid- to high-90s.

Operator: Our next question will come from Ann Hynes with Mizuho Securities.

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

Good morning.

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

Good morning.

Ann Hynes
Analyst, Mizuho Securities USA LLC
Q

Good morning. So I just want to talk about guidance. You beat consensus estimates on the adjusted EBITDA side by close to 10%. So even by Encompass's conservative history, just the 1% guidance rate seems conservative to me. So maybe can you tell us what the quarter actually was versus your internal expectations? And is there anything we should consider as we go out throughout the rest of 2024, why you wouldn't be able to see this type of strong growth going forward?

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

Yeah. Ann, I think you really hit on the key point, which is, as a reminder, we issue annual guidance. We don't provide quarterly guidance. And I know that creates a challenge for you and your peers because you need to provide quarterly estimates that are out there.

When we were thinking about our own expectations for Q1 performance, we were specifically looking at the momentum that we had coming in from Q4, the normal seasonality. But then we acknowledged the fact that you

had an extra day in the quarter due to leap year and that there would be some timing benefit that would be attributable to the Easter holiday falling on a Sunday, which is the last day of the quarter. That's kind of a rare phenomenon. In the quarter, we also got the unanticipated benefit from the provider tax income.

So, yeah, the quarter was still ahead of our expectation, which is the primary reason that we are revising our guidance upward. But there should not be an assumption made that our expectation internally was consistent with the consensus estimate.

As we look at the back end of the year, I think the primary considerations are one that I've already reviewed, which is the year-over-year change in the impact from de novo preopening and ramp-up costs. And then really it's a pretty straightforward story where you fall in the range that we provided or whether we're able to ultimately revise that range upward through the course of the year is going to be predominantly a function of two things.

One is, does volume continue? We're up against challenging comps, but feel very good about the underlying demand out there. And then what is ultimately the dynamic that exists over the final three quarters of the year between the pricing which is relatively locked in and the rate of labor inflation that we experienced.

Ann Hynes
Analyst, Mizuho Securities USA LLC

Q

Great. And I guess my follow-up question really has to do with that rate. I mean, I know you're getting a 3% increase from CMS, but it kind of seems lopsided given the labor environment over the past couple of years. Is there a delay and the way the calculation works that maybe over the next couple of years you should see an acceleration of rates given what's happening just in the labor environment?

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

A

So when you look at – if you look at the rulemaking for all of the post-acute sectors, the only sector that has a forecast error adjustment, which means it's looking backwards to say, did we miss a rate of underlying inflation in the providers' cost structure that needs to be factored in the go-forward rate is SNFs. And that dates back to some legislation from the early 2000s. They must have had a good lobbying effort, I can't really tell you anything more about that.

For IRFs, there's no catch-up. And so every year, the market basket update is based on forward-looking. It's the anticipated rate of inflation in the next year, not what you experienced in the previous year. So you would hope at some point those become relatively consistent, but there isn't a catch-up mechanism built into the IRF making – into the IRF rulemaking cycle.

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

A

And, Ann, one of the other areas on that, so you never really know when there's going to be some other adjustment around productivity or something that's unforeseen that CMS would apply, that would pull the net rate increase downward. So that's what makes it a bit of challenge.

Ann Hynes
Analyst, Mizuho Securities USA LLC

Q

All right. Thanks.

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

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

Good morning.

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

Good morning, Scott.

Scott J. Fidel
Analyst, Stephens, Inc.
Q

Hi. Thanks. Good morning. First question, just curious on your thinking right now around potential capital return, particularly as it relates to buyback, when thinking about the strength in the performance of the business, leverage now being at the low end of the target, the cash on hand, etcetera, just curious on your sort of thinking about potentially ramping up buyback activity.

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

Yeah. Certainly, on the table, it's going to be a topic of continuing board discussion for all of the reasons that you cited. Even with the cyberattack on Change Healthcare, our cash flow remained very strong in the quarter because we were able to implement those workarounds and because of the strength of the business and the flow-through from the adjusted EBITDA. And all of the points that you noted are very important ones, which the net leverage is all the way down to 2.5 times. There's $130 million of cash on balance sheet. We're generating enough internal cash flow to fund all of our discretionary CapEx plus the dividend. So it certainly opens up other options for capital deployment and that's very much on the agenda for our board now.

Scott J. Fidel
Analyst, Stephens, Inc.
Q

Okay. Thank you. And then a follow-up question. Just would be interested in your thinking on the final SNF staffing rule. I know it's somewhat second degree removed, but just really in sort of two areas in particular. One, as you've talked about the opportunity over the long-term for capturing more volumes from SNFs in terms of SNF conversion, whether that final staffing rule would have any influence over that?

And then just also whether any thoughts on this type of sort of staffing mandate at the federal level, if you've heard anything about that moving into other post-acute sectors? Obviously, IRFs would be top of mind for you in terms of any slippery slope type dynamic relating to the final SNF staffing rule. Thanks.

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

Yeah. So this is Mark. And certainly, I don't know all the details of the SNF rule. But just in general, we feel like we have done a really nice job with our quality outcomes and making that value proposition that helps separate us from other providers in the marketplace, whether it's other IRFs or skilled nursing facilities. Clearly, the SNFs have been challenged the past several years through COVID and otherwise. So they have a lot of ground to make up, so to speak. But we're very focused on what we're doing right now and around our programming and our quality, and I don't see the SNF rule having any impact on the market share that we've been able to take.

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

And it really shouldn't be applicable to IRFs in the future because our staffing is really already dictated by the mandated requirements of care. The complement of therapists that we have in our facilities is driven by the therapy rules. Again, that's the three hours of therapy per day, five days a week. It's got to be multi-disciplined therapy. And the preponderance has to be administered in individual versus a group or a concurrent setting. And then we also have very stringent nursing requirements that are mandated.

So, this was something that was lacking in the SNF industry, which is why I think you're seeing this come down. It is not something that is applicable because there needs to be adjustment in the IRF segment.

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

And keep in mind, we're already taking a pretty acute level rehab patient that's medically complex. And as part of that, we adjust our nursing staffing to make sure that we can do a great job in taking care of those patients and not have those patients go back to the acute care hospitals. So, there are a lot of either rules of thumb or formal rules that are currently in place around what it takes the staff or hospitals to meet the type of patients that we're taking in.

Scott J. Fidel
Analyst, Stephens, Inc.
Q

Okay. Thank you.

Operator: Our next question will come from John Ransom with Raymond James.

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

Morning, John.

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

Good morning.

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

Hey, good morning. I'm just kind of curious the role of – there was a lot of talk a few years ago about the conveners and the navigators. I'm just wondering, in the fight for these patient referrals, if you really notice any sort of change or have things kind of settled down and the three legs of post-acute kind of have their share? It looks fairly stable when you look at the numbers across the three modalities. But how do you think about when you talk to discharge planners, these navigators, how are they thinking about things the same or differently than maybe five years ago?

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

Yeah, John, I think it has settled down a bit. When we've seen these navigators come into various marketplaces, there might be a short-term impact on referrals or their approval for a patient to be discharged to an IRF, but that is usually somewhat short-lived. They see the issues, quality and otherwise, that come in place in the market when they try to dictate where the patient goes according to just the cost of care. And so, that pops up in the marketplace and seems to go away within 30 to 45 days. So, I think it's settled down overall compared to where it was three, four years ago.

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

Q

Thanks very much.

Operator: Our next question will come from Pito Chickering with Deutsche Bank.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Hey. Good morning, guys.

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

A

Hey, Pito.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

How are you guys doing?

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

A

Good morning, Pito. Good.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.

Q

Awesome. Nice quarter. So digging into the OpEx leverage you guys got this quarter, you talked about sort of dialysis and recruiting as large drivers there. What have been the returns on doing dialysis yourselves? And with dialysis at 88 hospitals, is it safe to model additional OpEx leverage going forward from that lever?

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

A

Yeah. So, the straight math on the dialysis conversion is when we use an outside contractor, on average, it costs us about $600. When we do it internally, it costs us about $300. The reimbursement is the same because that's basically coded into the requirements of the patient when they're admitted to our facility. So that incremental $300 per treatment is a flow-through. And then you get the other benefits that are very difficult to quantify, such as the fact that a patient's therapy isn't being disrupted and you're not having to incur transportation costs to go outside the facility if that's an alternative.

In terms of continuing leverage from that in OOE, we would expect to see that. Now bear in mind, some of that is the straight reduction in cost, some of it is also a geography issue. When we contract with a third-party, that $600,

100% of it runs through OOE as a contract services expense. When we do it internally, that cost gets spread out into other line items, the largest of which is SWB. And then we would expect that based on some of the efficiencies we're seeing both in terms of advertising costs that are out there and some of the different modalities and approaches that we have developed within our recruiting efforts that even as we continue robust recruiting efforts to make sure that we keep pace with our clinical requirements, with new hires, that we'll continue to see some efficiencies in recruiting as well.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.
Q

Okay. And then just – so a quick question on that one. I guess, how many dialysis patients do you guys have? And then sort of second part here is on provider tax revenues, haven't really been a big driver for you guys historically. You obviously saw $6.9 million in the fourth – or in the first quarter. I guess, how should we think about that going forward? Thanks.

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

Yeah. So, Pito, somewhere between around 3% to 5% of our total patients are on dialysis care, either internally or where we have a vendor come into our hospital. So we do think that's going to be a continued focus and, look, a larger percentage of the population has issues that will put them on some sort of dialysis care. So we think it's a growing need for our hospitals.

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

Provider taxes, Pito, are notoriously hard to predict in terms of timing and magnitude. And in most quarters where we get that kind of provider tax revenue, we've got the largely offsetting expense. So from an EBITDA perspective, it doesn't cause much fluctuation. We haven't baked any net benefit from provider taxes into our guidance for the balance of the year.

Pito Chickering
Analyst, Deutsche Bank Securities, Inc.
Q

Great. Thanks so much.

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

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

Good morning.

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

Good morning.

Ben Hendrix
Analyst, RBC Capital Markets LLC
Q

Good morning. Thank you very much. I think most of my questions have been answered, but I did want to follow-up on your comments about the Review Choice Demonstration and specifically your decision to continue with

100% pre-claim review in Alabama. I know you've had periods of elevated denial activity with fiscal intermediaries in the past. It seems like the sampling election would help you sidestep some of that risk. I just wanted to get your thought process there and kind of how relations with intermediaries are going? Thank you.

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

Yeah. So the relations have gone well thus far around that, particularly majority of our hospitals under Palmetto. We decided – actually the team decided to continue on with the 100% review. We felt like we put in a good discipline within our hospitals around documentation and capturing everything we needed to in the chart and to stray from that just seemed like it wasn't the right thing to do given the process that we already had put in place. So the hospitals actually helped make that decision to stay at 100%.

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

The benefit of the 100% pre-claim review, there's really kind of twofold. One is it allows for a much more iterative process with the MACs, so that we can find out if they're viewing anything regarding a patient's appropriateness in our hospitals as either – if they're either viewing it erroneously or if they're perceiving they require a change in our documentation, we can make that adjustment.

The other thing is you get a larger sample size. So one of the risks that's associated with that 5% pre-claim review is they look at one particular patient and they disqualify that patient set based on a circumstance and then apply that through extrapolation to a broader base. Whereas if we've got the 100% pre-claim review that are out there, we can line that patient that they may be contesting up with many others that have been approved elsewhere in their organization and say you tell us what's different. So we just think because the infrastructure is already in place and the procedures are already in place, that this is the right way for us to proceed through Cycle 2.

Ben Hendrix
Analyst, RBC Capital Markets LLC
Q

And just is the added cost of the 100% material?

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

No, it's already in place.

Ben Hendrix
Analyst, RBC Capital Markets LLC
Q

Yes. Thank you very much.

Operator: [Operator Instructions] We'll now hear from Brian Tanquilut with Jefferies.

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

Hello, Brian.

Brian Tanquilut
Analyst, Jefferies LLC
Q

Hey, good morning. Congrats on the quarter.

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

Thank you.

Brian Tanquilut
Analyst, Jefferies LLC
Q

I actually just have one question. Maybe, Doug, can you share with us what it looked like in terms of the growth rates in the different diagnoses of patients coming in? I guess, where I'm coming from is as we think about broader utilizations trend, just curious if it's specific to stroke or are we seeing more from like elective procedures such as drug replacements?

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

No, the story is really pretty consistent with what we saw the back half of last year. So, good growth in neurological and stroke in the quarter. Neurological was up just north of 10%. Stroke was up almost 12%. We did see a pretty significant increase in brain injury, that was up 11.1%. Other ortho was up almost 16%. But again, remember, that's off of a smaller base. So we are seeing a broadening in terms of some more rapid growth in some of the smaller categories that had gotten deferred for a period of time during COVID, but the strength in our higher acuity categories continues to be there as well.

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

Brian, there's elective procedures, we just don't see a lot of them. Matter of fact, I mean, for just joint replacement, it's a little bit less than 3% of our total patient mix. So it's not really had a large impact on us.

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

One of our smallest categories, but knee and hip replacement was up 20% during the quarter.

Brian Tanquilut
Analyst, Jefferies LLC
Q

All right. Got it. Thank you.

Operator: Our final question will come from Jared Haase with William Blair.

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

Good morning.

Jared Haase
Analyst, William Blair & Co. LLC
Q

Yeah. Hi, guys. Good morning. Thanks for sneaking me in here. Maybe I'll just ask one around the Change Healthcare disruption. And specifically, I know you mentioned kind of some of the work you did to implement

workarounds and maybe enhance or build out some of your internal capabilities. I'd just been curious, any particular areas of interest that you called out where you made investments or sort of built out those workflows? And then I guess, the other question is just should we think about any leverage benefit from that, just in terms of you internalizing a little bit more of the sort of RCM capabilities?

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

A

Yeah. So the – if you think about how we and how most providers utilize Change, it was for two things. One is what's called claims scrubbing, which is just to make sure that as you are sending a claim to any particular payer, whether it's CMS through one of the intermediaries or to one of the Medicare Advantage or managed care players, that you're getting the documentation in the form that is most readily acceptable and desired by that particular payer.

The second thing is that for us and for others, Change really served as the electronic intermediary in terms of submitting the claims and getting those processed. The primary thing that we did internally was establish our own electronic interface with CMS and now extending that to other payers as well.

Whether or not there's going to be any kind of leverage that ultimately comes from that, I think is going to depend on a go-forward basis between the balance that we have in restoring claims processing through Change, these other third-party vendors that we identified and put in place during the process, and how much we choose to do internally. It's still somewhat of a dynamic situation. We will refrain from going back to a situation where we have an overdependence on any one single vendor.

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

A

Jared, I do want to call out our teams and our centralized billing office down in Tampa, as well as our IT staff, because they worked extremely hard to minimize impact on this and figure out workarounds, came in at night on the weekends to make sure that we were being taken care of from a company standpoint. So I did want to point that out.

Jared Haase
Analyst, William Blair & Co. LLC

Q

Yeah, that's great to hear. Thanks, guys, for all the color. And I'll go ahead and leave it there.

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

A

All right. Thank you.

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

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

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

Operator: This does conclude today's conference. Thank you for your participation. You may now disconnect.