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Encompass Health Corp. (EHC)

Q3 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone, and welcome to Encompass Health's Third Quarter 2024 Earnings Conference Call. At this time, I would like to inform all participants that their lines will be in a listen-only mode. After the speakers' remarks, there will be a question-and-answer period. [Operator Instructions] 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. Please go ahead.

Mark Miller

Chief Investor Relations Officer, Encompass Health Corp.

Thank you, operator, and good morning, everyone. Thank you for joining Encompass Health's third quarter 2024 earnings call.

Before we begin, if you do not already have a copy, the third 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 quarters ended March 31, 2024, June 30, 2024, and September 30, 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 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. We're very pleased with our third quarter performance, highlighted by an increase of 11.9% in revenue and 13.4% in adjusted EBITDA. Q3 total discharges increased 8.8%, including 6.8% in same-store. Once again, discharge growth was broad-based across geographies, payors, and patient type. Neurological and stroke, our two most common primary conditions treated, grew 9% and 9.7%, respectively. Within our payor mix, Medicare discharges increased 8.8% for the quarter, while Medicare Advantage discharges grew 12.6%. Owing largely to our Q3 results, we are again increasing our 2024 guidance. Doug will cover the details of the quarter and guidance in his comments.

The demand for inpatient rehabilitation care is underserved and growing. For more than a decade, the age cohort most in need of these services has grown at a 4% to 5% CAGR, while the total supply of licensed IRF beds has been essentially static. It is estimated that by 2030, one in five Americans, more than 70 million people, will be aged 65 or older. Older adults disproportionately experience chronic health conditions, which is likely to continue to drive strong demand for inpatient rehabilitation services.

We are continuing to invest in capacity additions to meet the needs of patients requiring such services. During Q3, we added 99 beds to our capacity, comprised of two de novo hospitals, with a total of 89 beds and the addition of 10 beds to existing hospitals. We expect to open one additional de novo in 2024, a 61-bed hospital in Houston that will be our first fully-prefabricated hospital and add approximately 22 more beds to existing hospitals. The Houston project marks an important milestone in our de novo construction strategy. Full prefabrication will facilitate lower cost and shorter design and construction times, but the process is not without complexities.

Together with our primary prefab partner, BLOX, we have learned a great deal on the Houston project, paving the way for efficiencies on future de novos. These efficiencies are starting to materialize on our Athens, Georgia de novo scheduled to open in the first quarter of 2025. We currently anticipate that at least two de novos per annum will be built with full prefabrication. With 15 development projects beyond 2024 already announced and underway, our pipeline remains robust and balanced between wholly-owned and joint ventures.

Many areas in the Southeast and Mid-Atlantic regions of the US were significantly impacted by Hurricanes Helene and Milton. We operate numerous hospitals within these geographies. We're very proud of our leadership, and how they prepare for and performed during and in the aftermath of these hurricanes, and we're humbled by the resiliency of our dedicated employees, some of whom experienced damage to their homes and personal property, as well as electricity and water outages. Given our presence in hurricane-prone markets, we have well-defined protocols for dealing with large storms. These protocols prioritize the safety and well-being of our patients and employees.

Our physical plants withstood hurricanes very well, 25 of our hospitals, including 10 that incorporated at least one element of prefabrication as part of either the initial build or bed addition, were in some way impacted by the hurricanes, yet in total, experienced only relatively minor damage. This is a testament to the quality and strength of our hospitals. We are still gathering estimates on required repairs, which we currently believe will amount to less than $1 million of expenses to be incurred in Q4.

For the safety of our patients and staff, we chose to evacuate our Largo and Cape Coral, Florida hospitals ahead of Hurricane Milton, with our Largo hospital closing for five days and Cape Coral for six days. Many patients from these two hospitals were evacuated safely to other Encompass Health hospitals and were accompanied by members of our clinical staff as needed, again, a testament to our hospital staff.

Four additional Florida locations did not admit patients prior to and immediately after Hurricane Milton passed through Florida on October 9th and 10th. By Saturday, October 12th, all of our hospitals had resumed normal operations and were admitting patients. Although, our operations are back to normal, some of the communities we serve are still in recovery mode. Disruptions to the healthcare systems in those communities may impact our volumes and length of stay in Q4, and we have attempted to account for that as well as the aforementioned facility repairs in our updated guidance.

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, Q3 was another strong quarter with revenue increasing 11.9% to $1.35 billion and adjusted EBITDA increasing 13.4% to $269.3 million. Total discharges increased 8.8% and net revenue per discharge increased 2.5%. As we saw in Q2, discharge growth in Q3 was skewed somewhat more towards same-store, based primarily on the timing of de novo openings.

Revenue growth in Q3 included a $7.9 million increase in provider tax revenues, partially offset by $4.5 million increase in associated expense, netting to a $3.4 million adjusted EBITDA benefit. Bad debt expense as a percent of revenue was 1.9%, down 30 basis points from Q3 2023 and 100 basis points from Q2 2024. Recall that in Q2, we had a substantial increase in claims requested for review by our primary MAC. Consistent with our historical practice, we established a reserve against those claims in Q2 as the review was still pending. During Q3, substantial majority of those claims was resolved favorably, contributing to strong collections. We had a relatively small number of new claims selected for review under TPE in Q3.

Moving on to Review Choice Demonstration or RCD. As a reminder, Alabama was the first state to implement RCD, inclusive of seven Encompass Health hospitals. RCD began with Cycle 1, which ran from August 2023 until February 2024, and had a minimum required affirmation rate of 80%. Cycle 1 participants were given an option of 100% prepayment claims review or 100% post-payment claims review for all Medicare claims. We elected 100% prepayment claims review and all seven of our hospitals completed Cycle 1 with an affirmation rate of approximately 89%, exceeding the 80% required threshold.

Accordingly, we were given the option for Cycle 2 of remaining on 100% prepayment claims review, changing to 100% post-payment claims review or being subject to a 5% spot audit. Given the processes we have established and the success we had achieved in Cycle 1, we elected to remain on 100% prepayment claim review. Cycle 2 began in May 2024 and then concludes on October 31st. The required affirmation rate in Cycle 2 increased from 80% to 85%. We do not expect any of our seven hospitals to achieve that target by October 31st.

Many of our RCD non-affirmations are based on the application of improper standards for requirements that directly conflict with the Medicare coverage criteria for inpatient rehabilitation facilities. We are appealing incorrect determinations and we are working directly with CMS to address our concerns related to these improper standards. We are still early in this process, but we believe our approval rates of approximately 90% in Cycle 1 better reflect our long-term affirmation rates than the lower initial approval rates we have thus far experienced in Cycle 2. There is no financial penalty for not meeting the affirmation rate in Cycle 2. Rather, as we enter Cycle 3, we will remain at 100% prepayment claim review. The required affirmation rate in Cycle 3 increases to 90%.

SWB per FTE increased 4.1% in Q3, inclusive of a 3.5% increase in salaries and wages per FTE and a 14% increase in benefits per FTE. The large increase in benefits per FTE in Q3 was driven by group medical costs, which included several large dollar claims and an increase in prescription costs. The incurrence of large claims is sporadic, and the frequency of such claims tends to be mean-reverting. Total premium labor expense for Q3 was $32.6 million, down 2% from Q3 2023 and flat sequentially. Q3 contract labor FTEs were 1.5% of total FTEs. These metrics were consistent with our expectations of a stable labor market.

Net preopening and ramp-up costs were $5.4 million in Q3 2024 as compared to an adjusted EBITDA contribution of $900,000 from the 2023 openings in Q3 2023. We continue to generate significant free cash flow. Adjusted free cash flow increased 27.1% to $189.7 million, bringing our year-to-date total to approximately $0.5 billion. We now expect full year adjusted free cash flow of $560 million to $620 million. Our leverage and liquidity remain very favorable. Net leverage at quarter end was 2.3 times compared to 2.7 times at yearend 2023. We ended the third quarter with approximately $148 million in unrestricted cash and no amounts drawn on our $1 billion revolving credit facility.

On October 22nd, we issued a notice of redemption for an incremental $100 million of our 5.75% Senior Notes due in September 2025. This redemption will settle next month, following which we will have a remaining balance of $100 million on these notes. We are again raising our 2024 guidance. We now assume net operating revenue of $5.325 billion to $5.375 billion, adjusted EBITDA of $1.07 billion to $1.09 billion, and adjusted earnings per share of $4.19 to $4.33.

The key considerations underlying our guidance can be found on page 12 of the supplemental slides. There are number of factors to keep in mind as you contemplate year-over-year comparisons for Q4. Q4 of 2023 included a $22 million revenue reserve related to bad debt stemming from the write-off of older claims, predominantly pre-2018. After giving effect to minority interest, the impact of this revenue reserve on Q4 2023 adjusted EBITDA was $16 million.

Q4 2023 also included $6.8 million in favorable reserve adjustments for workers' comp and general professional liability insurance. We are anticipating net preopening and ramp-up costs of $3 million to $3.5 million in Q4 2024 as compared to $1 million in adjusted EBITDA contribution from 2023 openings in Q4 2023. And we anticipate a Q4 adjusted EBITDA impact of $3 million to $3.5 million related to the addition of our Augusta hospital to the Piedmont joint venture together with Oracle Fusion implementation costs.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. At this time, the floor is now open for your questions. [Operator Instructions] We'll go first to the line of Joanna Gajuk with Bank of America Securities. Please go ahead.

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

A

Good morning, Joanna.

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

A

Good morning, Joanna.

Christian Malachy Porter
Analyst, BofA Securities, Inc.

Q

Hi. This is Christian Porter on the line for Joanna. Thank you, guys, so much for taking our question.

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

A

Sure.

Christian Malachy Porter
Analyst, BofA Securities, Inc.

Q

I was wondering, because same-store volumes were very strong and accelerated quarter-over-quarter, just wondering what drove that strength and how much of this was from the addition of new beds? Thank you.

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

A

Christian, this is Mark Tarr. As I noted in my comments, it was very broad across geographies. All of our eight geographic operating regions had nice growth. We saw nice growth in our stroke and other neurological categories. We saw the continued ramp-up of the facilities we brought on for the past couple of years. So, we believe that we continue to take market share. We believe that our value proposition continues to be out there relative to the quality outcomes that we're able to achieve and it's recognized, it's our ability to get patients back home and not readmitted back to the acute care hospitals.

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

A

I do think the bed additions had a favorable impact. Prior to Q3, on a year-to- date basis, we had added 115 beds, including 40 beds in the satellite location. And so, those are accounted in same-store. It's also the case that in the first half of the year, the 23 de novo openings were rolling into same-store and those are still in ramp-up mode. So, that provides a little bit of a tailwind to the same-store number as well.

Operator: And we'll hear next from Andrew Mok with Barclays. Please go ahead.

Andrew Mok
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning.

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

A

Good morning, Andrew.

Andrew Mok
Analyst, Barclays Capital, Inc.

Q

Hi. How are you? Total FTEs have been up about 7% to 8% for the last year or so. Should we expect that to continue to increase in that ballpark to keep up with the discharge growth or should we expect that to moderate as we distance ourselves from some of the severe labor issues of 2021 and 2022? And then, relatedly, it sounds like there are some additional group medical expenses hitting the SWB line in the quarter. What was the underlying wage inflation and what's the outlook for that going forward? Thanks.

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

A

Yeah. I'll take the second part of the question first. And SWB per FTE – or SW per FTE was up 3.5%. So, pretty consistent with what we saw in Q1 and Q2. With regard to the total FTEs, we pretty much has stabilized EPOB of about 3.4% now. You'll have some noise from quarter-to-quarter based on the timing of new openings. But generally speaking, we would expect that the growth in total FTEs will be pretty highly correlated to discharge growth.

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

A

And as we've noted in the past, with this EPOB level, we feel like it's at a level that is conducive with us being able to continue to retain staff and also produce the outstanding outcomes. So, we have put a lot of focus on that in the past couple of years as well.

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

A

And we do believe that we are seeing tangible evidence of the impact of EPOB as well as a number of the other initiatives we've been pursuing on our turnover rates. The Q3 annualized turnover rate for RNs was 20.7% and for therapists 7.6%, and those are very strong numbers.

Andrew Mok
Analyst, Barclays Capital, Inc.

Q

Great. Thanks for all the color.

Operator: Next, we'll hear from the line of Ben Hendrix with RBC Capital Markets. Please go ahead.

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

A

Hello, Ben.

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

Good morning.

Michael Murray
Analyst, RBC Capital Markets LLC
Q

Hi. This is Mike Murray on for Ben. Congrats on the quarter and I appreciate all the commentary you gave on the hurricanes. Just given your expectations for lower volumes, could you provide a ballpark estimate for revenue impact in the fourth quarter?

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

Yeah. We really can't, because as we said, our hospital resumed normal operations very quickly. So, the impact to discharge growth and to revenue from those disruptions would have been relatively minor. What we're still evaluating is whether or not the systems in the communities in which we operate hospitals have been impacted in any way that might cause us, for instance, to see a longer length of stay, because there aren't available places for patients who have been treated in our facilities to be discharged. We are confident that the updated guidance ranges for revenue and adjusted EBITDA incorporate any impact that we're going to see from the hurricanes, whether it's the volume, whether it's the length of stay or making the repairs to the facilities that will be expensed in Q4.

Michael Murray
Analyst, RBC Capital Markets LLC
Q

Okay. And just to follow on, so you had some de novos in development in the areas that were impacted by the hurricanes, and sorry if I missed this, but are you expecting any delays in construction as a result? Thanks.

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

We are not, and you're right, we're scheduled to open five hospitals in the state of Florida next year, and those sites were all secured in advance of the storm and came through very well. So, any of the relatively minor disruptions that we may have experienced there, we believe we will be able to make up and stick with the timeframe that is depicted on the schedule in those supplemental slides.

Michael Murray
Analyst, RBC Capital Markets LLC
Q

Awesome. Thank you.

Operator: And now, we'll turn to the line of Brian Tanquilut with Jefferies. Please go ahead.

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, Brian.

Meghan Holtz
Analyst, Jefferies LLC
Q

Good morning, guys. This is Meghan Holtz on for Brian. Congrats on the quarter. Just going back to...

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

Thank you.

Meghan Holtz
Analyst, Jefferies LLC
Q

...bad debt really quick, we noticed that you're guiding 4Q bad debt reserves to the midpoint of 2.2%, 2.5%. Is that a step up from Q3? Is that just conservatism or is that attributed to the small new audit claims that you guys mentioned in 3Q?

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

Before Q3 that was – for Q2 and Q3, we had some noise in each one of those. That was kind of the run rate that we were at. And so, we don't think it's reflecting anything other than what we suggest as a normalized level of activity. In Q3, we benefited from the decrease in our aging-based reserve and some of that was attributable to processing some previously denied claims.

Meghan Holtz
Analyst, Jefferies LLC
Q

Got it. Thank you so much.

Operator: And next, we'll hear from the line of Pito Chickering with Deutsche Bank. Please go ahead.

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

Hey, Pito.

Kieran Ryan
Analyst, Deutsche Bank Securities, Inc.
Q

Hey. Good morning, everyone. This is Kieran Ryan on for Pito. Thanks for taking the question. It looks like 4Q EBITDA margin guidance maybe down somewhere about 50 bps from 3Q, excluding the provider taxes. I don't think there's any negative seasonality from 3Q to 4Q on margins or EBITDA dollars. So, just wanted to confirm is that kind of just the opening costs and any potential impact from hurricane headwinds or is there anything else we should be thinking about sequentially?

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

Yeah. I think it's really that series of year-over-year considerations that I reviewed at the end of my prepared comments, and those are laid out in the guidance considerations.

Kieran Ryan
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. And then, on free cash flow, it looks like the working capital tailwind came down pretty significantly, but you still raised your guidance quite a bit in free cash flow dynamics in the quarter, and if there's anything we should pay attention to there for 2025? Thanks.

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

A

I think probably the most significant item in Q3 was just the strong collections [indiscernible] (00:27:28), and a lot of that was moving through that bulbous of claims that had been selected for review under TPE at the end of Q2.

Kieran Ryan
Analyst, Deutsche Bank Securities, Inc.

Q

Thanks.

Operator: And next, we'll go to the line of Scott Field with Stephens. Please go ahead.

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

A

Good morning.

Scott J. Fidel
Analyst, Stephens, Inc.

Q

Good morning. Well, Fidel, but close enough. Good morning. Wanted to, first question, just ask about just in understanding that you're not providing guidance at this point, but you wanted to maybe frame the key headwinds and tailwinds for 2025. And just from, I guess, the bigger picture, any modeling considerations at this vantage point that you think it is important to call out for analysts and investors?

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

A

So, as we head into 2025, our starting assumption and we've got the better part of another quarter to continue to flesh this out is that we'll see SWB per FTE inflation of somewhere in the 3% to 3.5% range. We think it's kind of settling down there. We have not yet put a fine pencil to what preopening and ramp-up costs will be on a year-over-year basis, but it's probably not going to be too distinct from the impact that we're seeing this year.

The last thing I'd call to attention is, already on a year-to-date basis through Q3, we've had a favorable EBITDA impact from net provider taxes of $13 million. As we've mentioned previously, it's difficult to have a lot of confidence in the visibility of those provider taxes on a go-forward basis, because those programs vary from state to state and they're typically implemented on an annual basis. We know of the $13 million that's been included in EBITDA on a year-to-date basis that approximately $4 million to $5 million relates to out-of-period. So, I think it's a fair assumption that that portion is not likely to repeat going into 2025. Some portion of the balance, maybe even a substantial portion of the balance, probably will. So, those are the things that come immediately to mind, Scott.

Scott J. Fidel
Analyst, Stephens, Inc.

Q

Okay. Thanks, Doug. That's helpful. And then, just my follow-up question, wanted to circle back just on some of the comments that Mark had made around the sort of lessons learned on the prefabs and then starting to see efficiencies realized more on the Athens facility. I was hoping maybe you can sort of frame if there's any type of quantitative figures you can share with us in terms of like maybe the initial process, how much maybe additional costs you had just as you were sort of working your way through this new format. And then, as you sort of move towards the efficiencies, how much you think you could bring down those costs, for example, on the Athens facility, and then as you continue to launch more of the prefabs?

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

A

Yeah. So, you've got two primary advantages that we're trying to achieve. One is shortening the actual construction process, because that, obviously, connotes speed to market, and the faster we get these things open, the faster we can start to generate cash flow from those. If we look specifically at Houston, and again, this was a learning exercise for us, because it was the first fully prefabricated facility we did, we laid the first module in Houston in June, in the early part of June, and we got all of the final permitting and licensing, final inspection will happen in the first week in November. So, that's really fast, right. You're talking about a little over five months there or just about five months, and that compares to conventional construction, which would be 11 to 12 months. And we think we're going to be even a little bit faster than that for Athens.

From an expense perspective – and so, ultimately, what we're looking at, because the elements of the timeframe that you're not really able to impact much with the prefabricated construction, you get some savings with regard to the design process, because we're using a lot of replication from project to project. But permitting and site work are going to continue to vary pretty significantly from location to location. And so, there's not really an opportunity there. But again, from laying the first module to when the door opens, it's a pretty substantial [ph] time to (00:32:14) improvement. The – on the cost side, Houston, because we were still [ph] standing (00:32:20) the learning curve was essentially a breakeven with conventional cost. We do expect that as we hone the process further and we'll see a little bit of the impact on Athens, it's really going to be for future projects we will get there, that will move towards an estimated 15% cost savings versus conventional construction.

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

A

Scott, this is Mark. So, I'll just pitch in there. We've been at this now for a number of years on an incremental basis, first starting with bathrooms and headwalls, and then working our way up to the Uber Modules and it has really turned out to be a nice, what we consider to be a competitive advantage in terms of building our hospitals. I also commented on the fact that these have been tested in a number of severe storms in terms of their quality and soundness of construction. So, we just couldn't be happier in terms of the success and the way this is working its way through our implementation phase.

Scott J. Fidel
Analyst, Stephens, Inc.

Q

Okay. Great. Thanks for the color.

Operator: And now, we'll hear from the line of Jared Haase with William Blair. Please go ahead.

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

A

Hey, Jared.

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

Good morning.

Jared Haase
Analyst, William Blair & Co. LLC
Q

Hey. Good morning and congrats on a solid quarter. Maybe just taking a step back and kind of really thinking about sort of the durability of growth, again as we look out to 2025, I'm curious do you feel like the same-store growth trends, is that largely reflecting sort of the underlying demand environment for IRF services or do you feel like you are taking, I guess, more than your fair share as you capture market share from other care settings like SNFs, which I know has been kind of a focus area from recent years. So, just any thoughts around that.

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

Yeah. Jared, I think it's both. It's hard to put an exact number on what is taking additional market share versus just organic growth from a demographic tailwind. But it's some of both, in some marketplaces, it's more evident than others in terms of where we're taking it from, in terms of whether they're nursing homes or other providers in the marketplace. As I noted in my general comments that the aging demographics and the increased demand, just by the aging population for inpatient rehab services is certainly playing its way out and can be seen in our same-store growth.

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

As we've stated on a number of occasions, we believe that the traditional measure of looking at market share in the IRF space, which is to look at the number of discharges we have over the total industry discharges grossly underrepresents the total addressable market for IRF services. And one of the primary reasons we think that is that we can look upstream at the number of annual discharges coming out of all of the acute care hospitals in the US that are prima facie CMS-13 compliant, and obviously, only 60% of the patients treated in any particular IRF during the course of the year have to be CMS-13 compliant, but only 14% of that total population of acute care hospital discharges that are CMS-13 compliant are winding up in an IRF bed.

Now, we recognize that the number shouldn't be 100% for various reasons, including the fact that a portion of that population would not meet medical necessity criteria, but that – the potential for that number to be a lot higher than 14% is out there. It's important to note, too, that that 14% that winds up in an IRF bed includes existing Encompass Health facilities. And in virtually all of the markets in which we operate, we convert higher than 14% of the CMS-13 eligible discharges in that market into the IRF bed. If you strip us out, that number on a national basis is probably at a high-single-digit. And we know in more mature markets where we've been operating for a period of time, it's not unusual for us to see that conversion rate at 30% or higher.

Jared Haase
Analyst, William Blair & Co. LLC
Q

Okay. Great. I think that's super helpful. And then, maybe I'll just ask a quick follow-up on the quarter. It sounded like the Medicare Advantage discharge growth was solid. I think that was running a couple points higher than the Medicare – traditional Medicare discharge growth. It does look like in the revenue mix for the quarter MA declined a little bit sequentially just as a percentage of total revenue. So, I'm curious, I assume that's related to sort of a mix dynamic in terms of the conditions that were treated in the quarter or is there something else we should be thinking about from a revenue mix perspective?

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

No. As Mark cited, the growth has been broad-based across the payors. So, if you look at Q3, specifically, Medicare up 8.8%, Medicare Advantage 12.6%, and managed care saw a solid growth 9.1%. On a year-to-date basis through Q3, Medicare up 9.3%, Medicare Advantage 11.1%, and managed care up 8.5%. Looking at a three-year CAGR from 2020 through 2023, again, it reflects very balanced growth, Medicare over that period of time up 7.4%, Medicare Advantage 8.9%, and managed care 11.3%. I think what this really demonstrates is that our value proposition really extends well across all payor classes.

Jared Haase
Analyst, William Blair & Co. LLC
Q

Great.

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

We are solving the case that we create more value for our referral sources when we're not trying to cherry-pick patients between payors.

Jared Haase
Analyst, William Blair & Co. LLC
Q

Absolutely. Makes sense and thanks for all the color.

Operator: [Operator Instructions] We'll turn to the line of Matthew Gillmor with KeyBanc. Please go ahead.

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

Hey, Matt.

Cole Haggerty
Analyst, KeyBanc Capital Markets, Inc.
Q

Hey. Good morning, guys. This is Cole Haggerty on for Matt. Appreciate you taking our question. So, we've been getting questions on election implications for hospitals, especially on the [ph] exchange (00:38:49) subsidies in Medicaid supplemental payments. I guess, could you remind us what your exposure is to these programs or if you see any other election-related items that we should be aware of?

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

I think that from our perspective, the program that seems to be getting the most airplay, because of its size is Tennessee and it's really not a factor for us in the state of Tennessee. So, we've talked quite a bit about our net provider tax numbers. For us, the numbers are substantially smaller than they are for acute care hospitals or some other settings. They've been challenging to predict. If you look at the last two years preceding this year, the

EBITDA impact from our net provider taxes was nominal. It was give or take a couple million bucks on a year-to-date basis. This year, it's been $13 million, but $4 million to $5 million of that relates to out-of-period. So, as I said in my earlier comments, is it reasonable to believe that some amount of that continues into 2025? Yeah. I think it probably is, we just don't have a good estimate, because of lack of visibility.

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

A

And relative to your question just around the whole presidential election and if there's one preference over another, no, we really don't see a threat from either one. And if you look back historically, whether it's been Republican or Democrat, it doesn't seem to have had a significant impact one way or the other.

Cole Haggerty
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. That's helpful. And then, just as my follow-up, as you guys continue to reduce leverage in the business, is there a leverage ratio that you guys are targeting?

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

A

There's not. We're obviously very comfortable kind of in the current range. We used to say that we felt like a run rate leverage of about 3 times was appropriate. Obviously, we're substantially below that right now. It feels like just based on some of the macro factors that are out there that the market is appreciating 2.5 is the new 3.0. We recognize that if we get much below the current level of leverage, there's an inefficiency that kind of creeps in from a cost of capital perspective. But we continue to think that we have good opportunities to deploy cash towards capacity expansions and that will be our top priority. And I think the – our board of directors signaled some of the other potential utilizations of cash with the increase in the dividend that occurred in Q2 as well as the increase in the share repurchase authorization.

Cole Haggerty
Analyst, KeyBanc Capital Markets, Inc.

Q

Great. Appreciate the time, guys.

Operator: As there are no further questions in queue at this time, I'd like to turn the floor back over to Mr. Mark Miller for any additional or closing comments.

Mark Miller
Chief Investor Relations Officer, 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: Ladies and gentlemen, that will conclude the Encompass Health's third quarter 2024 earnings conference call. Thank you for your participation. You may disconnect at this time and have a wonderful day.