Encompass Health

MFIF
Minutemen Fixed Income Fund

Encompass Health Corporation

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Investment Thesis

We recommend a market overweight position on Encompass Health Corporation's 4.500% 2028 senior unsecured notes. EHC is the largest inpatient rehabilitation facility operator in the United States with 155 hospitals and a footprint that covers 37 states and Puerto Rico. EHC provides high quality, lower cost rehabilitative care to individuals who have suffered from major complications including strokes, amputations, spinal cord, and brain injuries. EHC now operates in one segment after their spinoff of Enhabit Home Health & Hospice (NYSE: EHAB) on July 1, 2022. The spinoff will help EHC become fully committed to their inpatient rehabilitation facilities and no longer straddle different industries within managed care. Following the spinoff, EHC is in a comfortable position with a relatively low leverage ratio of 3.38x. We believe that EHC will successfully be able to maintain or decrease their leverage ratio over the next 5-10 years by using their current position within the rehabilitative industry to continue their aggressive organic expansion strategy of 6-10 new hospitals and 80-120 beds per year, targeting areas that are primed for rehabilitative services and rising macro trends in US health. Additionally, we believe that Encompass Health's commitment to data-driven AI technology will help lower excess spending and promote organic growth as cash increases. **We expect the spread on EHC's 4.500% 2028 senior unsecured notes to tighten 30-50 bps by YE25 with continued tightening as the maturity date approaches.**

Figure 1: Capitalization Table

Encompass Health Capitalization Table (EHC)						
LTM Adj. EBITDA	817.5				**Debt/EV**	35%
Outstanding Debt and Leverage Metrics						
Type of Debt	**Rate**	**Maturity**	**Debt Outstanding**	**xEbitda**	**Price**	**YTW**
Term Loan Facility due 2027			55			
1st Lien Debt			**55**	**0.1x**		
Senior Unsecured Notes						
2025 Notes	5.750%	09/15/25	348		99.35	6.04%
2028 Notes	4.500%	02/01/28	782		92.41	6.38%
2030 Notes	4.750%	02/01/30	779		89.41	6.74%
2031 Notes	4.625%	04/01/31	391		85.78	6.99%
Total Unsecured Notes			**2,299**	**2.8x**		
Other Notes Payable			**53**			
Finance Lease Obligations			**360**			
Total Debt			**2,767**	**3.38x**		
Market Captialization			5,266			
Less: Cash			22			
Enterprise Value			8,011	**9.80x**		

Source: Company Filings, MFIF Analysis, Bloomberg

Security Data

Bond Maturity: 02/01/2028
Rating: B+
Rank: Senior Unsecured
Price: 92.41
Yield-to-worst: 6.38%
Call Date: 04/21/2023
Coupon: 4.500%
OAS: 245.2 bps

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Industry Overview

Encompass Health operates within a $38.6B niche IRF industry that is extremely fragmented. Currently they have roughly a 10% market share, but with continued M&A activity and organic expansion there is substantial room for growth. The IRF industry is expected to grow at a CAGR of roughly 3.6% through 2026. Other competition within the industry struggles with the scale and services that EHC provides. As the Acute care market expects a 4.8% CAGR through 2028, EHC biggest competition could likely come from large acute care hospitals that decide to create their own rehabilitation sector. Currently, EHC can outperform its competitors by maintaining desirable relationships with insurance companies, acute care hospitals, and patients, allowing them to increase their patient pool through referrals. To maintain their industry leading position, EHC must continue to provide high-quality care at an affordable cost that translates into more referrals and increased revenue.

Investment Rationale and Catalysts

We expect EHC to use their current position within the rehabilitative industry to continue their aggressive organic expansion strategy of 6-10 new hospitals and 80-120 beds per year, targeting areas that are primed for rehabilitative services and rising macro trends in US health.

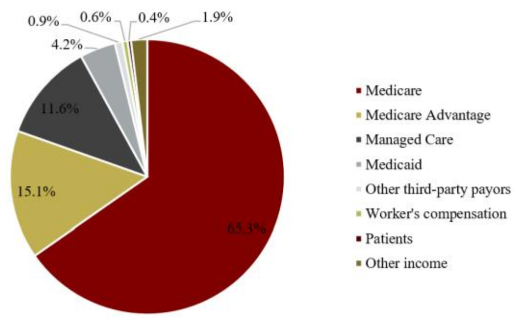
Overview

EHC currently operates an industry leading 155 facilities across 37 states and Puerto Rico. As the IRF industry leader in the US, EHC has great opportunity to capitalize on an aging demographic of the “baby boomer” population. EHC caters to all ages, but the average age of patients they attend to is 76. Through 2026, the population size from the ages of 75-79 is expected to grow at a 5% CAGR. Additionally, we expect the number of people eligible for Medicare to increase at a CAGR of 3.18% leading to roughly 63 million eligible recipients by YE24. Medicare patients made up 65.3% of EHC revenue in FY22. In the foreseeable future we expect an average increase of 1.5% in Medicare revenue leading to increased Q/Q growth. Although Medicare reimbursement is not always favorable towards for-profit managed care providers. In the past 5 years, the CMS (Center for Medicare & Medicaid Services) has increased the PPS (Prospective Payment System) reimbursement to IRF facilities by an average of 1.8% annually. With increased payments rates and an increased patient demographic, we believe EHC is set up for ~1.9% revenue growth within the foreseeable future which should provide increased cash to pay off debt and continue expansion.

Growing Macro Trends

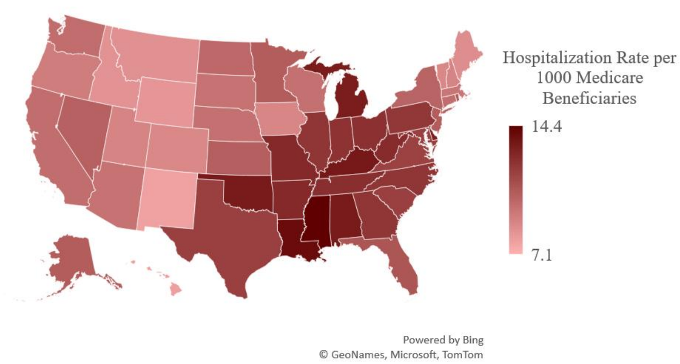
With an aging population and higher obesity rates across the US, the number of people who are diabetics has steadily grown through the turn of the century. In 2020 there were 29.27 million people living in the US with diabetes. By 2030, there will be an expected 39.71 million people in the US with diabetes. Roughly 90% of people who have diabetes, specifically type 2, are at risk of having a stroke. Based on these numbers we expect there will be an average of 939,600 people at risk for stroke annually from 2020-2030, just from diabetes. As of YE22, 130 of 153 EHC facilities had stroke-specific certifications. However, in FY22 only 6% of patients recovering from strokes in the U.S. were treated at EHC facilities. This accounted for roughly just 1/5 of EHC’s total patient mix. EHC can expand their presence in stroke rehabilitation by targeting the “stroke belt” which is a region in the southeast US where stroke prevalence is ~18% higher than other regions. From this, we believe

Figure 2: 2022 Revenue Distribution



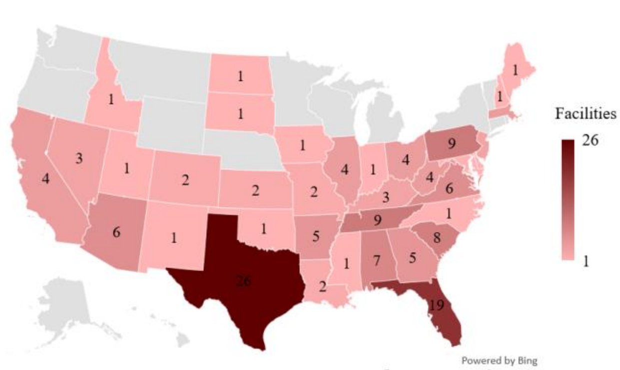
Source: Company Filings, MFIF Analysis

Figure 3: Stroke Hospitalization Rate



Source: CDC, Company Filings, MFIF Analysis

Figure 4: Facilities per State

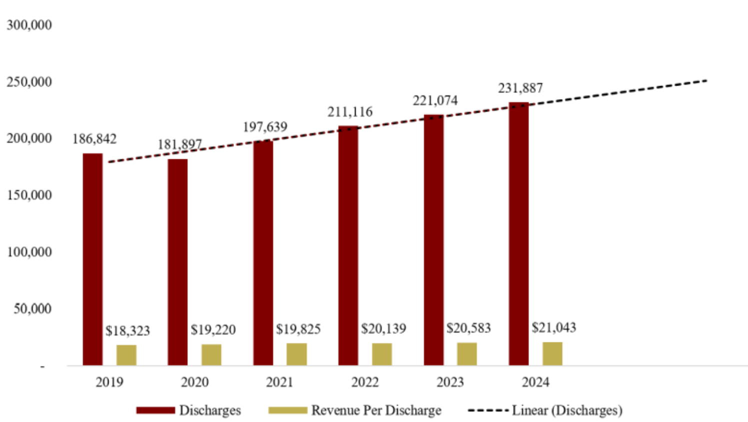


Source: Company Filings, MFIF Analysis that EHC could see a 3.0% increase in Medicaid revenue leading to about a revenue of $59 M in 4Q24 compared to $47 in 4Q22, as their percentage of patients backed by Medicaid increases due to lower income patients populating the "stroke belt". Based on guidance, we believe leadership within EHC seems committed to strengthening their stroke rehabilitation through strategic partnerships and sponsorships including one with the AHA (American Heart Association).

Organic Expansion

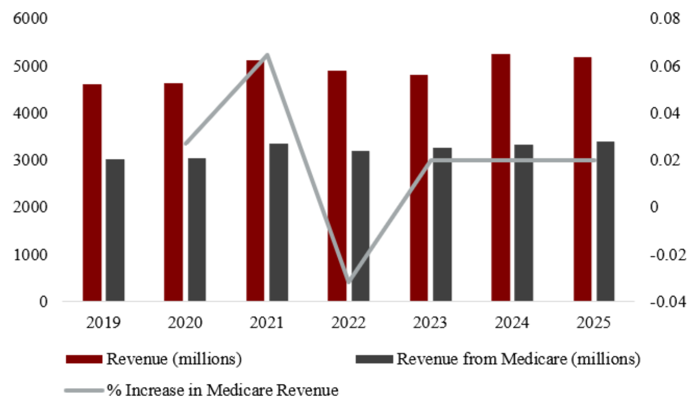
Historically, EHC has seen successful organic growth while expanding into current and new markets. It is important to note that in 2020 and 2021, EHC declined any support from the Federal CARES act as they felt they were in a strong enough position to handle the never seen before pressures of the COVID-19 pandemic. Instead, EHC was still able to expand and have added 18 facilities since YE20. In FY22, they were able to fund most of their new facilities and bed additions with free cash flow and there revolving credit of roughly $1B. At YE22 they had $912 M available to them through revolving credit. EHC's continued hopes of expansion will be boosted through their shift towards the use of pre-fabrication construction. Prefab construction is the process in which certain parts or complete structures of buildings are put together in a controlled factory environment. In FY23, EHC plans to have four prefabricated hospitals assembled in or by 3Q23. The use of pre-fab construction can save roughly 15% in costs per building and increase the time in which the facility is brought to market by about 25%. If EHC continues to target prefabrication for their new facilities and bed additions, we expect that they will be able to generate a higher operating margin in the 10-12% range up from a previous 9.22% in FY22 leading to a projected EBITDA upwards of about $1 B by YE24. An increase in EBITDA coupled with a steady long-term debt schedule, primes EHC to see consistent deleveraging from 3.38x to around 2.71x by YE24. The strong presence of organic expansion will most likely protect Encompass Health from any potential interest rate volatility in the current and future economy.

Figure 6: Discharge Growth



Source: Company Filings, Bloomberg MFIF Analysis

Figure 5: Medicare Revenue Breakdown



Source: Company Filings, MFIF Analysis

<u>Encompass Health's commitment to data-driven AI technology will help lower excess spending and promote organic growth as cash increases.</u>

Encompass Health has been able to optimize their provided care by developing and investing in essential data-driven technology. ReACT, one of the many technologies that EHC has developed to improve patient care and experience, helps limit transfer rates of patients and better organizes caregiver's schedules. ReACT identifies 30 risk factors that identify likelihood of patients being transferred. We expect ReACT's ability to stimulate same-store discharges shown through the 4.2% y/y growth in 4Q22/4Q21, to translate into lower total costs shown in the drop from $4.24B in FY22 to $4.19B in FY23. As a result, this should free up excess cash leading to an expectation of $130M by YE23. EHC also uses an AI Readmission Prevention Program that aims to limit the risk of hospital readmission after patients are discharged. The program identifies 40 risk factors that have correlation to readmission. We believe this program is extremely important as EHC looks to reduce the number of readmissions they face to avoid instituted financial penalties by the CMS for facilities that have significant readmission rates within 30 days of discharge. EHC has also developed their own platform, Beacon. Beacon now has more than 45 apps that help management access data about patient experience, problems with expenses, and effectiveness of physician teams. Beacon helps leadership swiftly find and resolve problems within their company which boost patient experience and increase discharge rates. Beacon has helped increase the number of discharges by 8.7% from FY20-FY21 and 6.8% from FY21-FY22. In 2023 we project EHC will have 221,074 discharges which would reflect a 4.72% increase from 211,116 discharges in 2022. The rising trend in the number of discharges results in a lower average length of stay. During FY22 stays on average lasted 12.7 days compared to 12.8 in FY21. We expect this to contribute to projected increase in cash to roughly $130M by YE23. As trends increase for the number of discharges attributable to EHC, the net patient revenue per discharge is also increasing. In FY23, we expect to see a 2.23% increase in net patient revenue per discharge based off historical numbers.

Risks to Thesis

EHC is unable to grow it's revenue through Medicare and Medicaid for a multitude of reasons including industry regulation, lack of ability to expand stroke rehabilitation, and a lack of patient referrals.

EHC struggles to implement prefabrication construction to their expansion strategy and costs increase as construction headwinds effect the economy.

Large acute care hospitals create their own IRF's with rivalling technology that steals both patients and allows them to function at similar operating margins.

Relative Valuation

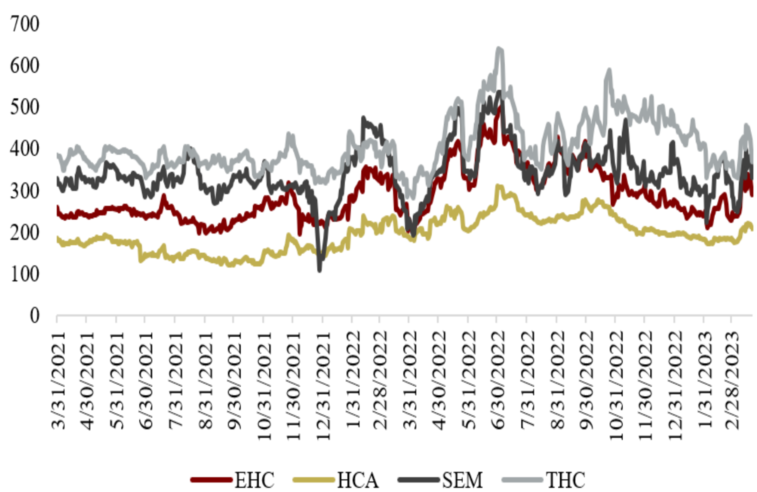
EHC has historically traded at a similar OAS to its competition within the managed care industry. We feel that EHC provides the most attractive investment because they hold a lower Debt/EBITDA of 3.38x compared to similar HY companies like SEM (5.69x) and THC (4.75x). We believe that EHC is primed to tighten by 30-50 bps as their leverage ratio continues to fall to a projected 2.71x by YE24. Additionally, Encompass Health's appealing leverage ratio provides insight into how stable the company should be in the future even with aggressive expansion plans. In comparison, HCA, SEM and THC have all issued great amounts of debt and with current economic pressures, they are at higher risk for interest rate fluctuation. We also feel that EHC is an enticing investment opportunity because they have historically traded just 50-100bps above investment grade HCA Healthcare. As of late, Encompass Health has seen spikes in their OAS which we believe is the market reacting to labor market headwinds and an undervaluing of EHC's competitive advantage within their niche industry. Although EHC is trading tighter than SEM and THC, their spread/turn of leverage is higher and relatively the same among HY companies at 72bps (EHC) compared to 58 bps SEM) and 75 bps (THC) respectively. SEM is more of a direct comparison with EHC within the IRF industry, but we feel that EHC is the more attractive investment because they are trading tighter at 245 bps compared to 332 bps, currently hold a lower Debt/EBITDA of 3.38x compared to 5.69x, and hold a higher spread/turn of leverage at 72 bps compared to 58 bps. Additionally, EHC market share within the IRF industry is roughly 10% whereas SEM is just a mere 2.1%. In a highly fragmented industry this is a huge head start and we expect EHC to continue to capitalize on its position in the coming years. For these reasons, we feel that EHC is the most advantageous investment as we expect the OAS on their 2028 Notes to tighten around 30-50 bps.

Figure 6: Comparable Companies Analysis

Comp (in millions)	EHC	HCA	SEM	THC
Market Cap	**5,266**	71,673	3,261	5,930
Debt	**2,767**	40,331	5,158	16,596
Cash	**22**	908	98	888
EV	**8,011**	113,790	8,590	25,104
LTM Revenue	**4,718**	60,233	6,334	19,174
LTM Adj. EBITDA	**818**	12,022	907	3,495
Net Debt/Adj. EBITDA	**3.38x**	3.35x	5.69x	4.75x
LTM FCF	**(35)**	4,127	95	321
FCF/Debt	**-0.01x**	0.10x	0.02x	0.02x
Individual Securities	EHC	HCA	SEM	THC
Rating	**B+**	BBB-	B-	B-
Coupon	**4.500%**	5.625%	6.250%	6.125%
Maturity	**2/1/2028**	9/1/2028	8/15/2026	10/1/2028
Price	**92.41**	100.09	96.69	93.90
YTW	**6.38%**	5.60%	7.40%	7.51%
Z-Spread	**278 bps**	204 bps	362 bps	398 bps
OAS	**245 bps**	179 bps	332 bps	358 bps
Spread/Turn of Leverage	**72 bps**	53 bps	58 bps	75 bps

Source: Company Filings, Bloomberg, MFIF Analysis

Figure 7: Comparable OAS



Source: Bloomberg, MFIF Analysis

Summary Model

Encompass Health (NYSE: EHC)						Projections					
Fiscal Year	FY22A	1Q22A	2Q22A	3Q22A	4Q22A	1Q23P	2Q23P	3Q23P	4Q23P	FY23P	FY24P
EOP Date	12/31/2022	3/31/2024	6/30/2024	9/30/2024	12/31/2024	3/31/2023	12/31/2019	12/31/2020	12/31/2021	12/31/2023	12/31/2023
Income Statement:											
Net operating revenues	**4,891**	**1,334**	**1,331**	**1,090**	**1,137**	**1,161**	**1,182**	**1,204**	**1,226**	**4,773**	**5,143**
Operating expenses:											
Salaries and benefits	2,770	776	774	606	614	627	639	650	663	2,578	2,778
Other operating expenses	718	182	193	172	171	174	177	180	184	716	771
Occupancy costs	66	21	19	12	13	13	14	14	14	55	59
Supplies	214	56	53	51	54	55	56	57	58	225	243
General and administrative expenses	214	48	60	38	67	58	59	60	61	239	257
Depreciation and amortization	261	66	69	62	64	91	93	95	97	377	413
Total operating expenses	**4,242**	**1,150**	**1,168**	**941**	**957**	**1,018**	**1,037**	**1,057**	**1,077**	**4,190**	**4,521**
Interest expense and amortization of debt discounts and fees	176	40	61	38	37	46	9	46	9	110	110
Other (income) expense	5	4	6	4	(8)	(7)	(7)	(7)	(7)	(28)	(28)
Income from continuing operations before income tax expense	**451**	**141**	**95**	**107**	**127**	**103**	**142**	**108**	**147**	**501**	**540**
Provision for income tax expense	100	31	24	22	27	22	30	23	31	105	113
Income from continuing operations	351	110	71	86	99	81	113	85	116	396	426
Net and comprehensive income	366	110	71	67	118	81	113	85	116	396	426
Less: Net and comprehensive income attributable to noncontrolling interests	(95)	(23)	(23)	(22)	(28)	(10)	(10)	(10)	(10)	(40)	(40)
Net Income	**271**	**88**	**49**	**45**	**89**	**71**	**103**	**75**	**106**	**356**	**386**
Revenue Growth											
Annual % Increase in Medicare	-3.17%					1.5%	1.5%	1.5%	1.5%	1.5%	1.5%
Annual % Increase in Medicare Advantage	-5.13%					2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Annual % Increase in Managed Care	-8.45%					4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Annual % Increase in Medicaid	-2.18%					3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Annual % Increase (-) in Other third-party payors	-21.87%					-3.6%	-3.6%	-3.6%	-3.6%	-3.6%	-3.6%
Annual % Increase in Worker's Compensation	-4.50%					1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Annual % Increase (-) in Patients	-23.60%					-4.2%	-4.2%	-4.2%	-4.2%	-4.2%	-4.2%
Annual % Increase in Other income	-9.28%					2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Gross profit margin	13.3%	13.8%	12.2%	13.6%	15.9%	12.3%	12.2%	12.2%	12.2%	12.2%	12.1%
SG&A/Sales	4.4%	3.6%	4.5%	3.5%	5.9%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
D&A/Sales	5.3%	5.0%	5.2%	5.7%	5.6%	5.5%	5.5%	5.5%	5.5%	7.9%	8.0%
Tax rate	22.2%	22.1%	25.0%	20.3%	21.6%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%
Balance Sheet											
Cash and cash equivalents	22	94	187	60	22	82	131	114	130	130	135
Accounts Receivable	537	684	659	500	537	518	502	514	524	524	564
Total Current Assets	**717**	**950**	**1,032**	**734**	**717**	**761**	**797**	**795**	**823**	**823**	**878**
PP&E	2,939	2,667	2,730	2,807	2,939	2,993	3,047	3,103	3,158	3,158	3,388
Total Assets	**5,637**	**6,944**	**7,082**	**5,476**	**5,637**	**5,749**	**5,852**	**5,919**	**6,017**	**6,017**	**6,363**
Total Liabilities	**3,775**	**4,452**	**4,538**	**3,728**	**3,775**	**3,799**	**3,815**	**3,823**	**3,831**	**3,831**	**3,858**
Net Debt	2,742	3,221	3,234	2,719	2,742	2,767	2,767	2,767	2,767	2,767	2,767
Operating Metrics											
Gross Margin	13.3%	13.8%	12.2%	13.6%	15.9%	12.3%	12.2%	12.2%	12.2%	12.2%	12.1%
Operating Margin	9.22%	10.60%	7.15%	9.85%	11.12%	8.88%	12.06%	8.96%	12.01%	10.49%	10.49%
Tax Rate	22.2%	22.1%	25.0%	20.3%	21.6%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%
EBITDA Reconciliation											
(+) Net Income	271	88	49	45	89	71	103	75	106	356	386
(+) Interest	176	40	61	38	37	46	9	46	9	110	110
(+) Taxes	104	31	24	22	27	22	30	23	31	105	113
(+) D&A	244	66	69	45	63	91	93	95	97	377	413
EBITDA	**794**	**225**	**202**	**151**	**217**	**231**	**235**	**239**	**244**	**948**	**1,023**
FCF Reconciliation											
(+)CFFO	706	219	245	80	162	211	216	161	198	741	777
(-)Capex	565	115	115	145	190	145	148	150	153	597	643
(-)Interest Expense	176	40	61	38	37	46	9	46	9	110	110
FCF to Firm	**(35)**	**64**	**69**	**(103)**	**(65)**	**20**	**59**	**(35)**	**35**	**34**	**24**
Credit Metrics											
Debt	2,742	3,221	3,234	2,719	2,742	2,767	2,767	2,767	2,767	2,767	2,767
EBITDA	794	225	202	168	218	231	235	239	244	948	1,023
Debt/EBITDA	3.45x	3.39x	3.62x	3.30x	3.45x	3.38x	3.25x	3.00x	2.92x	2.92x	2.71x
EBITDA/Interest	4.62x	5.89x	4.96x	4.61x	4.62x	4.49x	6.52x	6.66x	8.60x	8.60x	9.28x