

## Encompass Health

# Guidance slightly above despite a big beat – typical EHC conservatism

Reiterate Rating: BUY | PO: 83.00 USD | Price: 72.76 USD

## Beat on margins, EBITDA guide 1% better

In typical EHC fashion, Q4 results came in much better than expected (above the higher end of the guide) but the company guided to 2024 roughly in line with consensus. The guidance looks like the typical EHC conservatism, especially in light of the \$22m bad debt reserve boost in 4Q23, and we expect numbers to move up through the year. We raise our 2024/25E and roll out 2026 ests. We raise our PO to \$83 (11.2x 2024E EBITDA vs 10.3x prior) on the higher est and higher multiple given the continued outperformance. Reiterate Buy given the attractive top line growth driven by denovos and bed additions.

## Start-up losses, labor y/y headwinds in 2024

Rev and Adj EBITDA guide midpoint is 1% above consensus/ our est. Margins to be 19.5-19.9%, in line with our est and 10bps below consensus at the midpoint. Margins to be down 50bps y/y: 1) startup losses of \$15-18m vs \$6.6m in 2023, and 2) SWB per FTE +4-5% y/y (vs +3% y/y in 2023) while Medicare rates are +3% and managed care +2-3%.

## SS volumes accelerated and came in better

Ex \$22m reserve, Q4 revs were 3% above our est/consensus on 2% better vols. SS discharges accelerated to +5.3% from +4.3% in Q3 and were better than consensus est. of +3.7%. This implies vols were 12% above 2019 (vs +13% above in 3Q23).

## Adj EBITDA 18% better ex \$22m reserve

Excluding \$22m bad debt reserve (appeals related to claims denied prior to 2018), Q4 Adj EBITDA was \$42m or 18% above consensus on much better margins (280bps above consensus), and \$38m above the higher end of the guide range. De novos contributed +\$1m in EBITDA, much better than the \$2.5-4.5m net cost expected.

## Contract labor continued to decline aiding margins

Margins ex. \$22m reserve increased 140bps y/y as Agency staffing costs combined with sign-on/shift bonuses fell -14% y/y and -8% q/q. Contract labor declined 6% q/q on lower utilization (-3% q/q) and lower rates (-3% q/q). As a percent of total FTEs, contract FTEs declined q/q to 1.4%. EHC added 55 net new nurse hires, down from 202 in Q3 due to typical seasonality.

Estimates (Dec) (US\$)	2022A	2023A	2024E	2025E	2026E
EPS	2.79	3.57	4.03	4.60	5.24
GAAP EPS	2.69	3.48	4.03	4.60	5.24
EPS Change (YoY)	-34.0%	28.0%	12.9%	14.1%	13.9%
Consensus EPS (Bloomberg)			3.84	4.27	4.64
DPS	0.85	0.60	0.60	0.60	0.60
Valuation (Dec)					
P/E	26.1x	20.4x	18.1x	15.8x	13.9x
GAAP P/E	27.0x	20.9x	18.1x	15.8x	13.9x
Dividend Yield	1.2%	0.8%	0.8%	0.8%	0.8%
EV / EBITDA*	12.5x	11.7x	10.9x	10.0x	9.1x
Free Cash Flow Yield*	2.5%	3.6%	2.7%	3.6%	4.5%

\* For full definitions of *IQmethod*<sup>SM</sup> measures, see page 4.

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Timestamp: 08 February 2024 12:05AM EST

08 February 2024

### Equity

#### Key Changes

(US\$)	Previous	Current
Price Obj.	77.00	83.00
2024E Rev (m)	5,193.6	5,261.1
2025E Rev (m)	5,657.7	5,730.2
2026E Rev (m)	NA	6,241.9
2024E EPS	3.76	4.03
2025E EPS	4.32	4.60
2026E EPS	NA	5.24
2024E EBITDA (m)	1,022.7	1,041.0
2025E EBITDA (m)	1,119.1	1,138.5
2026E EBITDA (m)	NA	1,247.2

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### Stock Data

Price	72.76 USD
Price Objective	83.00 USD
Date Established	8-Feb-2024
Investment Opinion	B-1-7
52-Week Range	51.15 USD - 73.65 USD
Mkt Val (mn) / Shares Out (mn)	7,385 USD / 101.5
Free Float	98.1%
Average Daily Value (mn)	37.75 USD
BofA Ticker / Exchange	EHC / NYS
Bloomberg / Reuters	EHC US / EHC.N
ROE (2024E)	24.9%
Net Dbt to Eqty (Dec-2023A)	115.1%
ESGMeter <sup>TM</sup>	Medium

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "BofA ESGMeter Methodology".

# iQprofile<sup>SM</sup> Encompass Health

## iQmethod<sup>SM</sup> – Bus Performance\*

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Return on Capital Employed	9.4%	10.9%	11.1%	11.2%	23.5%
Return on Equity	17.4%	24.4%	24.9%	28.5%	65.2%
Operating Margin	13.8%	15.3%	15.3%	15.6%	15.8%
Free Cash Flow	181	268	202	264	335

## iQmethod<sup>SM</sup> – Quality of Earnings\*

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash Realization Ratio	2.7x	2.4x	1.9x	1.8x	1.8x
Asset Replacement Ratio	2.2x	2.1x	2.0x	1.9x	1.9x
Tax Rate	22.0%	21.8%	21.2%	21.7%	22.2%
Net Debt-to-Equity Ratio	148.8%	115.1%	112.1%	102.8%	NA
Interest Cover	3.8x	5.1x	5.6x	6.0x	6.5x

## Income Statement Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Sales	4,891	4,801	5,261	5,730	6,242
% Change	-4.5%	-1.8%	9.6%	8.9%	8.9%
Gross Profit	2,121	2,201	2,412	2,627	2,865
% Change	-5.1%	3.8%	9.6%	8.9%	9.0%
EBITDA	910	971	1,041	1,139	1,247
% Change	-11.4%	6.7%	7.2%	9.4%	9.5%
Net Interest & Other Income	(182)	(128)	(128)	(132)	(136)
<b>Net Income (Adjusted)</b>	<b>281</b>	<b>361</b>	<b>410</b>	<b>469</b>	<b>537</b>
<b>% Change</b>	<b>-33.7%</b>	<b>28.7%</b>	<b>13.4%</b>	<b>14.6%</b>	<b>14.4%</b>

## Free Cash Flow Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Net Income from Cont Operations (GAAP)	291	364	410	469	537
Depreciation & Amortization	260	274	303	311	319
Change in Working Capital	(30)	50	(95)	(100)	(100)
Deferred Taxation Charge	28	4	0	0	0
Other Adjustments, Net	197	159	179	183	188
Capital Expenditure	(565)	(583)	(595)	(600)	(609)
<b>Free Cash Flow</b>	<b>181</b>	<b>268</b>	<b>202</b>	<b>264</b>	<b>335</b>
<b>% Change</b>	<b>-3.0%</b>	<b>47.7%</b>	<b>-24.7%</b>	<b>31.2%</b>	<b>26.8%</b>
Share / Issue Repurchase	0	0	0	0	0
Cost of Dividends Paid	(99)	(60)	(61)	(61)	(62)
Change in Debt	522	83	49	112	183

## Balance Sheet Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Cash & Equivalents	22	69	69	69	0
Trade Receivables	537	612	623	692	0
Other Current Assets	159	161	221	229	0
Property, Plant & Equipment	2,939	3,301	3,666	4,099	0
Other Non-Current Assets	1,980	1,960	1,960	1,960	0
<b>Total Assets</b>	<b>5,637</b>	<b>6,102</b>	<b>6,538</b>	<b>7,048</b>	<b>0</b>
Short-Term Debt	51	25	25	25	0
Other Current Liabilities	525	632	574	493	0
Long-Term Debt	2,742	2,688	2,617	2,403	0
Other Non-Current Liabilities	457	461	1,027	1,834	0
<b>Total Liabilities</b>	<b>3,775</b>	<b>3,805</b>	<b>4,242</b>	<b>4,755</b>	<b>0</b>
<b>Total Equity</b>	<b>1,862</b>	<b>2,297</b>	<b>2,296</b>	<b>2,294</b>	<b>0</b>
<b>Total Equity &amp; Liabilities</b>	<b>5,637</b>	<b>6,102</b>	<b>6,538</b>	<b>7,048</b>	<b>0</b>

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 4.

## Company Sector

Medical Specialty

## Company Description

Encompass is the largest provider of inpatient rehabilitative health care services in the US, operating 147 inpatient rehabilitation hospitals (including joint venture hospitals) across 35 states and Puerto Rico. The company accounts for 24% of licensed IRF beds in the US.

## Investment Rationale

We rate EHC Buy as we like the attractive top line growth (irrespective of the economy) driven by denovos and bed additions, and while the free cash flow is earmarked for expansions, we see this strategy as low risk and high return.

## Stock Data

Average Daily Volume

531,017

## Quarterly Earnings Estimates

	2023	2024
Q1	0.88A	0.94E
Q2	0.95A	1.04E
Q3	0.86A	0.95E
Q4	0.87A	1.09E

## Price objective basis & risk

### Encompass Health (EHC)

Our PO of \$83 is based on 11.2x 2024E EBITDA, a premium to the multiple the legacy stock was trading at when HealthSouth announced plans to acquire the home health/hospice business in late 2014 to reflect the faster growth and the more favorable demographics. EHC's facilities are defensive given their acuity level and focus on Medicare reimbursement.

Upside risks to our PO are: 1) labor cost pressures dissipate faster than expected, 2) volume growth is faster than expected, 3) the company deploys capital accretively beyond what's included in the guidance, 4) executes better on offsetting reimbursement headwinds.

Downside risks to our PO are: 1) Labor cost inflation worse than expected, 2) Medicare rate cuts are deeper than we expect, 3) the company fails to offset the reimbursement pressures, 4) volumes slow down, 5) startup costs associated with JV and de novo growth strategies are worse than expected.

## Analyst Certification

I, Kevin Fischbeck, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

### US - Facilities, Hospitals and Managed Healthcare Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	Acadia Healthcare	ACHC	ACHC US	Kevin Fischbeck, CFA
	Addus HomeCare	ADUS	ADUS US	Joanna Gajuk
	Agilon Health	AGL	AGL US	Adam Ron
	Chemed Corporation	CHE	CHE US	Joanna Gajuk
	Elevance Health Inc	ELV	ELV US	Kevin Fischbeck, CFA
	Encompass Health	EHC	EHC US	Kevin Fischbeck, CFA
	HCA	HCA	HCA US	Kevin Fischbeck, CFA
	Humana Inc	HUM	HUM US	Kevin Fischbeck, CFA
	Option Care Health	OPCH	OPCH US	Joanna Gajuk
	Oscar Health	OSCR	OSCR US	Adam Ron
	Privia Health	PRVA	PRVA US	Adam Ron
	Select Medical Corp.	SEM	SEM US	Kevin Fischbeck, CFA
	Service Corp.	SCI	SCI US	Joanna Gajuk
	Surgery Partners, Inc	SGRY	SGRY US	Kevin Fischbeck, CFA
	Tenet Healthcare	THC	THC US	Kevin Fischbeck, CFA
	The Cigna Group	CI	CI US	Kevin Fischbeck, CFA
	UnitedHealth Group	UNH	UNH US	Kevin Fischbeck, CFA
	Universal Health Services	UHS	UHS US	Kevin Fischbeck, CFA
	US Physical Therapy	USPH	USPH US	Joanna Gajuk
<b>NEUTRAL</b>				
	Alignment Healthcare	ALHC	ALHC US	Adam Ron
	AMN Healthcare	AMN	AMN US	Kevin Fischbeck, CFA
	Apollo Medical	AMEH	AMEH US	Adam Ron
	Brookdale	BKD	BKD US	Joanna Gajuk
	Centene Corporation	CNC	CNC US	Kevin Fischbeck, CFA
	Molina Healthcare, Inc.	MOH	MOH US	Kevin Fischbeck, CFA
<b>UNDERPERFORM</b>				
	AdaptHealth Corp.	AHCO	AHCO US	Joanna Gajuk



**US - Facilities, Hospitals and Managed Healthcare Coverage Cluster**

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
	Agility Health Inc	AGTI	AGTI US	Kevin Fischbeck, CFA
	Cross Country Healthcare	CCRN	CCRN US	Kevin Fischbeck, CFA
	DaVita Inc	DVA	DVA US	Kevin Fischbeck, CFA
	Enhabit Home Health & Hospice	EHAB	EHAB US	Joanna Gajuk
	Pediatric Medical Group, Inc.	MD	MD US	Kevin Fischbeck, CFA

**iQmethod<sup>SM</sup> Measures Definitions****Business Performance**

Return On Capital Employed

Return On Equity

Operating Margin

Earnings Growth

Free Cash Flow

**Quality of Earnings**

Cash Realization Ratio

Asset Replacement Ratio

Tax Rate

Net Debt-To-Equity Ratio

Interest Cover

**Valuation Toolkit**

Price / Earnings Ratio

Price / Book Value

Dividend Yield

Free Cash Flow Yield

Enterprise Value / Sales

EV / EBITDA

**Numerator**

NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization

Net Income

Operating Profit

Expected 5 Year CAGR From Latest Actual

Cash Flow From Operations – Total Capex

**Numerator**

Cash Flow From Operations

Capex

Tax Charge

Net Debt = Total Debt – Cash &amp; Equivalents

EBIT

**Numerator**

Current Share Price

Current Share Price

Annualised Declared Cash Dividend

Cash Flow From Operations – Total Capex

EV = Current Share Price × Current Shares + Minority Equity + Net Debt +

Other LT Liabilities

Enterprise Value

**Denominator**

Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill

Amortization

Shareholders' Equity

Sales

N/A

N/A

**Denominator**

Net Income

Depreciation

Pre-Tax Income

Total Equity

Interest Expense

**Denominator**

Diluted Earnings Per Share (Basis As Specified)

Shareholders' Equity / Current Basic Shares

Current Share Price

Market Cap = Current Share Price × Current Basic Shares

Sales

Basic EBIT + Depreciation + Amortization

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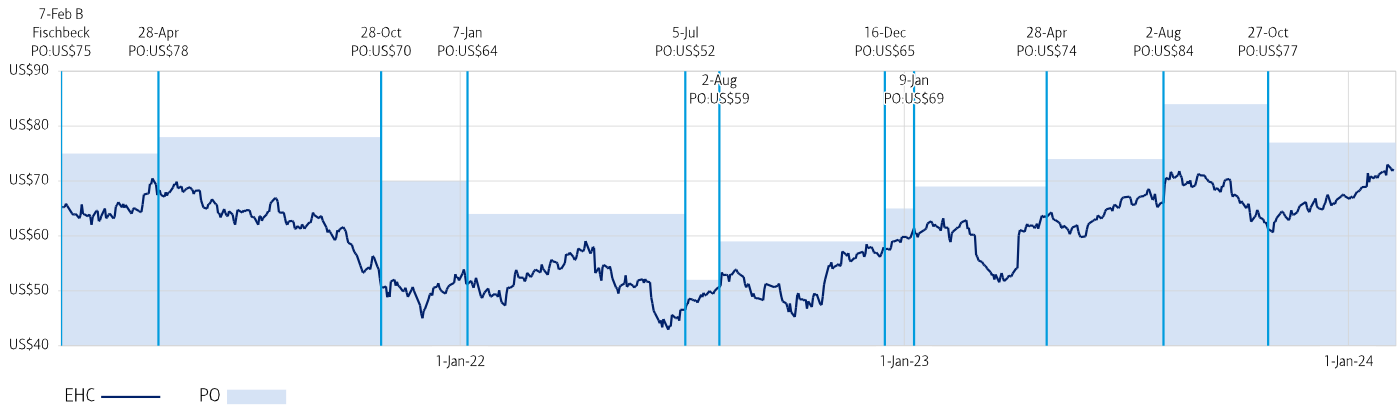
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B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

### Equity Investment Rating Distribution: Health Care Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	234	60.94%	Buy	115	49.15%
Hold	80	20.83%	Hold	36	45.00%
Sell	70	18.23%	Sell	29	41.43%

### Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

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