Encompass Health

Quick takes from the call: guidance is conservative, typical for EHC

Reiterate Rating: BUY | PO: 83.00 USD | Price: 74.00 USD

Q4 beat even ex items. Guide conservative, as typical

Despite Q4 coming in better than internal expectations, EHC guided to 2024 EBITDA only slightly better as it assumes labor costs are stable (not much improvement) and denovo losses are worse y/y. Historically, EHC has been very conservative: beat its initial EBITDA guide by 4% on avg over the last 13 years or 6% ex 2020 (impacted by COVID). With the free cash flow after growth capex reaching breakeven faster than expected while net leverage of 2.7x is below its long-term targets, EHC's Board might consider share repurchases. Reiterate Buy as we expect upside from execution.

Q4 EBITDA ex items 12% above consensus

EBITDA included $6.8m in favorable reserve adj for EHC's self-insured programs ($11m for the full yr), more than offset by $16m bad debt reserve after NCI. Excluding the 2 items, EBITDA was $29m or 12% above consensus and $25m above the higher end of the guide range. The outperformance was due to the much better volumes and better denovos contribution (+$1m vs -$2.5-4.5m losses expected) which was driven by denovos in joint ventures with hospital systems.

Labor improving but costs to grow faster than prior view

While the labor market is generally improving, the cost of the full-time labor is higher: when new nurses are hired at higher wages, existing staff wages need to get market adjustments. EHC expects wages to be up +4-5% y/y, 100bps higher than they thought at the end of Q3. The company is willing to pay up for labor to meet demand.

Guide is conservative

Margins to be down 50bps y/y due to: 1) -$10m y/y headwind due to the higher startup losses; 2) labor per FTE to grow +4-5% y/y while Medicare rates are +3% and managed care +2-3%; 3) EHC assumes employees per occupied bed (EPOB) normalizes at 3.4 vs 3.38 avg in 2023, which is a -$14-15m impact to EBITDA.

Volume strength was broad based

EHC saw vols strength across all regions and all clinical programs (stroke and neuro were each up 5%). Some outsized growth in small categories like ortho. Also, flagged brain injury vols (10-12% of total) were up 10.5% in Q4. EHC believes it continues to benefit from taking share from nursing homes, also noting strong acute hospital vols have a downstream impact. Of note, same store vols grew at a 5% CAGR in 2019-2023.

MA is fastest growing payor

Medicare Advantage (MA) ss vols grew at a 15.2% CAGR in 2019-2023, well above the +5% for all payors. Importantly, the rate delta vs FFS remains below 5% as EHC continues to improve contracting (90% of MA contracts are episodic, 10% per diem). EHC believes it is well positioned to grow MA vols especially as new requirements put more focus on MA to authorize care based on the best expected outcomes.

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Equity

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Stock Data

Price	74.00 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
Mrkt Val (mn) / Shares Out (mn)	7,511 USD / 101.5
Free Float	98.1%
Average Daily Value (mn)	39.30 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™	Medium

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EHC = Encompass Health

FTE = Full-time equivalent

SS = Same store

FFS = Medicare fee for service

Refer to important disclosures on page 3 to 5. Analyst Certification on page 2. Price Objective Basis/Risk on page 2. **12657418**

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.

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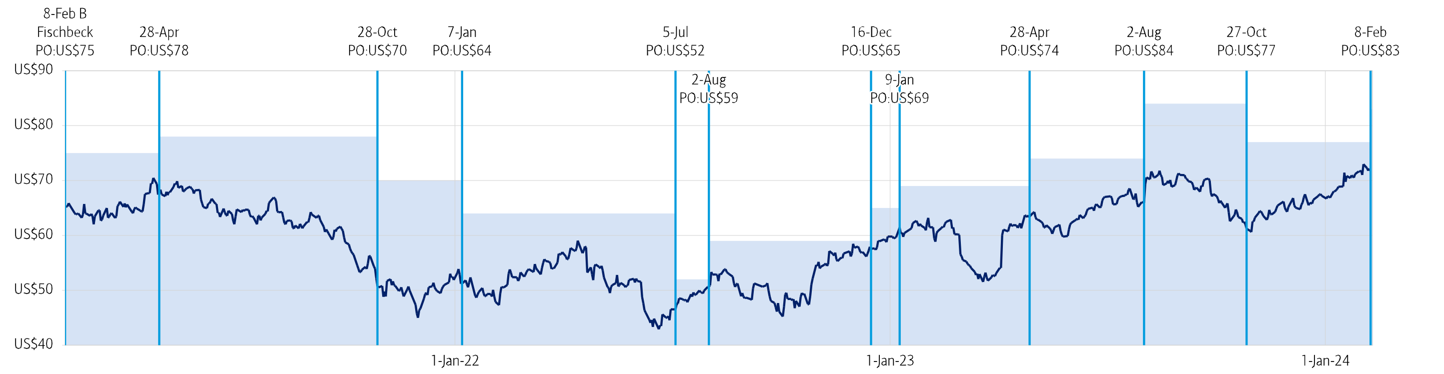
Encompass Health (EHC) Price Chart



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Hold	80	20.83%	Hold	36	45.00%
Sell	70	18.23%	Sell	29	41.43%

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