

## **APPENDIX 3**

### **FACTOR 4 FINANCIAL FEASIBILITY REPORT**

**Encompass Health Corporation**

**Analysis of the Reasonableness of  
Assumptions Used For and  
Feasibility of Projected Financials of  
Encompass Health Rehabilitation Hospital of  
Western Massachusetts, LLC  
For the Years Ending December 31, 2025  
Through December 31, 2029**

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May 25, 2023

Mr. Carey B. McRae  
Associate General Counsel, State Regulatory &  
Compliance  
Encompass Health Corporation  
9001 Liberty Parkway  
Birmingham, AL 35242

**RE: Analysis of the Reasonableness of Assumptions and Projections Used to Support the Financial Feasibility and Sustainability of the Proposed Addition of Seventeen (17) Beds to Encompass Health Rehabilitation Hospital of Western Massachusetts, LLC in Ludlow, MA.**

Dear Mr. McRae:

I have performed an analysis of the financial projections prepared by Encompass Health Corporation (“Encompass”) detailing the projected operations related to the 17-bed addition project at Encompass Health Rehabilitation Hospital of Western Massachusetts, LLC in Ludlow, Massachusetts (“Encompass Western Mass” or the “Hospital”). This report details my analysis and findings with regards to the reasonableness of assumptions used in the preparation and feasibility of the projected financial information of Encompass Western Mass, as prepared by the management of Encompass (“Management”). This report is to be used by Encompass in its Determination of Need (“DoN”) Application – Factor 4(a) and should not be distributed or relied upon for any other purpose.

**I. EXECUTIVE SUMMARY**

The scope of my analysis was limited to the five-year financial projections (the “Projections”) prepared by Encompass for the operations of Encompass Western Mass as well as the actual operating results for Encompass and Encompass Western Mass for the fiscal years ended December 31, 2021 and 2022, and the supporting documentation in order to render an opinion as to the reasonableness of assumptions used in the preparation and feasibility of the Projections with regards to the impact of the 17-bed addition project at Encompass Health Rehabilitation Hospital of Western Massachusetts, LLC in Ludlow, Massachusetts.

Within the projected financial information, the Projections exhibit a net pre-tax profit margin ranging from 23.7% to 20.2% for years ending December 31, 2025 through 2029. The impact of the proposed capital project at Encompass Western Mass in Ludlow, MA, which is the subject of this DoN application, represents a relatively insignificant component of the actual operating revenues (approximately 1%) and actual financial position (approximately 0.4%) of Encompass Health Corporation as of and for the year ended December 31, 2022. Based on my review of the relevant documents and analysis of the projected financial statements, I determined the continued operating surplus is a reasonable expectation and based

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on feasible financial assumptions. Accordingly, I determined that the Projections are reasonable and feasible, and not likely to have a negative impact of the Applicant's (Encompass) patient panel or result in a liquidation of Encompass' assets. A detailed explanation of the basis for my determination of reasonableness and feasibility is contained within this report.

## **II. RELEVANT BACKGROUND INFORMATION**

Encompass Health Corporation is a national provider of inpatient rehabilitation services with 157 inpatient rehabilitation hospitals in 37 states and Puerto Rico. Encompass Health Rehabilitation Hospital of Western Massachusetts, LLC is a 53-bed rehabilitation hospital located in Ludlow, Massachusetts. The Hospital is a wholly owned subsidiary of Encompass Health Corporation. The resulting 17-bed addition will result in 70 total beds at the Ludlow, MA location.

Please refer to the DoN application for a further description of the proposed project and the rationale for the expenditures.

## **III. SCOPE OF REPORT**

The scope of this report is limited to an analysis of the Projections, prior year financials and the supporting documentation in order to render an opinion as to the reasonableness of assumptions used in the preparation and feasibility of the Projections with regards to the impact of the capital project involving and ancillary to Encompass Western Mass. My analysis of the Projections and conclusions contained within this report are based upon my detailed review of all relevant information (see Section IV which references the sources of information). I have gained an understanding of Encompass Health and Encompass Western Mass through my review of the information provided as well as a review of the Encompass website, annual reports, and the DoN application.

Reasonableness is defined within the context of this report as supportable and proper, given the underlying information. Feasibility is defined as based on the assumptions used, the plan is not likely to result in insufficient "funds available for capital and ongoing operating costs necessary to support the proposed project without negative impacts or consequences to Encompass' existing patient panel" (per Determination of Need, Factor 4(a)).

This report is based upon historical and prospective financial information provided to me by Management. I have not audited or performed any other form of attestation services on the projected financial information. If I had audited the underlying data, matters may have come to my attention that would have resulted in my using amounts that differ from those provided. Accordingly, I do not express an opinion or any other assurances on the underlying data or projections presented or relied upon in this report. I do not provide assurance on the achievability of the results forecasted by Encompass because events and circumstances frequently do not occur as expected, and the achievement of the forecasted results is dependent on the actions, plans, and assumptions of Management. I reserve the right to update my analysis in the event that I am provided with additional information.

Encompass Health Corporation capital stock is traded on the New York Stock Exchange under the stock symbol EHC. As a company whose stock is publicly traded, Encompass is restricted by securities laws from providing forward-looking guidance or projections. Providing projections for use in this DoN application would constitute material nonpublic information under the Securities Act of 1933 and the

Securities Exchange Act of 1934. If Encompass does provide forward-looking guidance or projections, the security laws, specifically Regulation FD (“fair disclosure”) would require the company to provide the projected information to all investors simultaneously by means of a public SEC filing. Therefore, financial projections for Encompass as a whole were not provided to us and are not included as part of our analysis in this Factor 4 report.

Since we do not have projected financials for Encompass, we have analyzed the historical financials of Encompass and the projections, including the 17-bed addition, for Encompass Western Mass. We have drawn conclusions concerning the potential impact of the 17-bed addition project on Encompass as a whole assuming that Encompass continues to operate as it has for the past 2 years for which we have received financial statements.

#### **IV. PRIMARY SOURCES OF INFORMATION UTILIZED**

In formulating my conclusions contained in this report, I reviewed documents produced by Management. The documents and information upon which I relied are identified below or are otherwise referenced in this report:

1. Five-Year Financial Forecast (Projections), including related assumptions for Encompass Health Rehabilitation Hospital of Western Massachusetts, LLC for the years ending 2025 through 2029, initially provided May 8, 2023 and updated May 18, 2023;
2. Balance sheet, income statement and statement of cash flow analysis for Encompass Western Mass, including detailed assumptions for historical years 2021 and 2022 and projected for the years 2023 through 2029, initially provided May 8, 2023 and updated May 18, 2023;
3. Schedule of Estimated Total Capital Expenditure initially provided May 8, 2023;
4. Massachusetts Department of Public Health Determination of Need Application Form for the Encompass Western Mass project, provided May 19, 2023;
5. Audited Financial Statements of Encompass Health Corporation as of and for the year ended December 31, 2022 and as of and for the year ended December 31, 2021, provided March 8, 2023;
6. Encompass Health Rehabilitation Hospital of Western Massachusetts, LLC website – <https://www.encompasshealth.com/westernmassrehab>;
7. Encompass Health Corporation website – <https://www.encompasshealth.com>;
8. Various news publications and other public information about the hospital;
9. Determination of Need Application Instructions dated March 2017; and
10. Determination of Need Narrative, provided May 19, 2023.

## V. REVIEW OF THE PROJECTIONS

This section of my report summarizes my review of the reasonableness of the assumptions used and feasibility of the Projections. The following tables present the Key Metrics, as defined below, of Encompass Health Corporation which includes historical results for the years ended December 31, 2021 and 2022. The second table is for Encompass Western Mass which compares the results of the Projections for the years ending 2025 through 2029 to Encompass Western Mass' historical results for the years ended 2021 and 2022.

<b>Encompass Health</b>	<b>As Reported</b>	
(\$ in millions)	<b>2021</b>	<b>2022</b>
EBITDA (\$)	1,003	885
EBITDA Margin ( %)	25.0%	20.4%
Operating Margin (%)	12.6%	10.4%
Total Margin (%)	12.9%	8.4%
Current Ratio	1.2	1.2
Cash Days on Hand	13.0	5.6
Cash (\$)	112	53
Days in Accounts Receivable	46.9	45.1
Total Assets (\$)	6,865	5,637
Total Equity (\$)	2,357	1,826

<b>Encompass Western Mass</b>	<b>As Reported</b>		<b>Key Metrics for Projected Periods</b>				
(\$ in thousands)	<b>2021</b>	<b>2022</b>	<b>2025</b>	<b>2026</b>	<b>2027</b>	<b>2028</b>	<b>2029</b>
EBITDA (\$)	10,162	8,761	9,400	9,371	9,316	9,301	8,947
EBITDA Margin ( %)	31.8%	27.7%	26.2%	25.4%	24.5%	23.8%	22.7%
Operating Margin (%)	30.7%	26.6%	23.7%	22.9%	22.1%	21.4%	20.2%
Total Margin (%)	23.0%	19.9%	17.8%	17.2%	16.6%	16.1%	15.2%
Current Ratio	3.5	2.9	3.6	3.7	3.7	3.7	3.7
Cash Days on Hand	113.5	94.5	120.0	120.0	120.0	120.0	120.0
Cash (\$)	6,793	5,925	8,724	9,069	9,419	9,743	10,012
Days in Account Receivable	43.7	46.4	53.0	53.0	53.0	53.0	53.0
Total Assets (\$)	22,176	20,333	36,983	34,260	31,466	28,559	25,455
Total Equity (\$)	12,596	12,363	20,268	19,961	19,632	19,242	18,718

The Key Metrics fall into three primary categories: profitability, liquidity, and solvency. Profitability metrics, such as EBITDA, EBITDA Margin, Operating Margin and Total Margin are used to assist in the evaluation of management performance in how efficiently resources are utilized. Liquidity metrics, such as Current Ratio, Cash Days on Hand and Days in Accounts Receivable measure the quality and adequacy of assets to meet current obligations as they come due. Solvency metrics, such as Total Assets and Total Equity measure the company's ability to service debt obligations. Additionally, certain metrics can be applicable in multiple categories.

The following table shows how each of the Key Metrics is calculated.

Key Metric	Definition
EBITDA (\$)	(Earnings before interest, taxes, depreciation and amortization expenses) - Operating income (loss) + interest expense + depreciation expense + amortization expense
EBITDA Margin (%)	EBITDA expressed as a % of total operating revenues. EBITDA / net operating revenues
Operating Margin (%)	Income (loss) from operations / net operating revenues
Total Margin (%)	Net income / net operating revenues
Current Ratio	Current assets divided by current liabilities
Cash Days on Hand	(Cash and equivalents) / ((Total operating expenses - depreciation & amortization) / YTD days)
Cash (\$)	Cash and cash equivalents
Days in Accounts Receivables	Accounts receivables divided by (net patient service revenue divided by 365 days)
Total Assets (\$)	Total assets of the company
Total Equity (\$)	Total shareholders' equity of the company

## 1. Revenues

The only revenue category on which the proposed project would have an impact is Net Patient Service Revenue (NPSR). Therefore, I have analyzed Net Patient Service Revenue identified by Encompass Western Mass in both their historical and projected financial information. The proposed project includes the addition of seventeen (17) beds to Encompass Western Mass. Total licensed beds would increase to seventy (70). The creation of 17 additional private rooms will provide more accessibility and availability for patients in Western Massachusetts. In order to determine the reasonableness of the projected NPSR, I reviewed the underlying assumptions upon which management relied.

I first reviewed the projections to determine the reasonableness of the projected volume. Encompass Western Mass provided historical data of patient days and cases. The ramp up of patient days and cases was done starting with the historical patient case information and adding a one-time increase of 5.8% for 2025, the year the 17 additional beds come on line. From 2026 to 2029, a general increase of 1.7% per year was added. The average daily census is projected to grow from 54.9 in 2025 to 57.9 in 2029.

Next, I reviewed the projections to determine the reasonableness of the payer mix and reimbursement rate selected for the first five years of operations after completion of the project. I compared the payor mix in the projection years to the historical data and found that it was similar. The reimbursement rate used in the projection years was based on the historical data. I compared the NPSR to the historical financial information for 2021 and 2022. The payment rate was then calculated by dividing the NPSR by the number of cases, to obtain an average payment rate per case. The payment rate was then inflated by 1% each of the succeeding years.

It is my opinion that the revenue growth projected by Management reflects a reasonable estimation based primarily on historical operations of Encompass Western Mass.



## **2. Operating Expenses**

I analyzed the Salaries and Benefits, as well as the Other Operating Expenses and Depreciation Expense for reasonableness and feasibility as related to the projection of Encompass Western Mass. Salaries were calculated as a function of the historical Full Time Equivalents (FTE's) per occupied bed at Encompass Western Mass. Thus, as the patient population increases, the number of FTE's required will also be increased. Salary amounts were based on historical data. Benefits were calculated as a percentage of salaries using historical data. Salaries costs were increased each year by a rate of 2.5%. Benefits were increased each year as a percentage of salaries.

Supplies and Other Operating Expenses were calculated as an historical cost per patient day at Encompass Western Mass, and then inflated by 2 to 3% per year during the projection years. Included in Other Operating Expenses are management fees and the facility lease. Management fees are calculated at 5% of NPSR and remain as such through the projection years. The facility is leased from Encompass Health Mass Real Estate, LLC. Lease expense is inflated by 2% per year during the projection years. The remaining Other Operating Expenses were calculated as an historical cost per patient day inflated by 2% per year during the projection period.

Depreciation expense reflects the incremental expense related to the proposed project. The projections reflect building and building improvements depreciated over an average life of 30 years, equipment depreciated over an average life of 8 years, and intangibles amortized over an average life of either 5 or 10 years.

It is my opinion that the growth in operating expenses projected by Management reflects a reasonable estimation based primarily upon the historical operations of Encompass Western Mass.

## **3. Other Income and Income Tax Expense**

The final categories of Encompass Ludlow Projections are Other Income and Income Tax Expense. There were no increases projected for Other Income items. Income Tax Expense was calculated at a rate of 25%, using historical data. Projected Operating Income (income before income tax expense) was then multiplied by 25% each year, which represents a combined federal and state corporate tax rate. Accordingly, it is my opinion that the pro-forma Other Income and Income Tax Expense are reasonable.

## **4. Capital Expenditures and Cash Flows**

I reviewed the projected capital expenditures and future cash flows of Encompass Western Mass in order to determine whether sufficient funds would be available to support the payment of the project and whether the cash flow would be able to support the continued operations of Encompass Western Mass. The project will be financed by the annual cash flows of Encompass Health Rehabilitation Hospital of Western Massachusetts, LLC.

Based upon my discussions with Management and my review of the information provided, I considered the current and projected capital projects and loan financing obligations included within the Projections and the impact of those projected expenditures on Encompass Health Rehabilitation Hospital of Western Massachusetts, LLC's cash flow. Based upon my analysis, it is my opinion that the pro-forma capital expenditures and resulting impact on the cash flows of Encompass Western Mass are reasonable.

**VI. FEASIBILITY**

I analyzed the projected operations for Encompass Health Rehabilitation Hospital of Western Massachusetts, LLC and the Key Metrics as well as the impact of the proposed project at Encompass Western Mass upon the Projections and Key Metrics. In performing my analysis, I considered multiple sources of information including historical and projected financial information for Encompass Western Mass and historical information and Key Metrics for Encompass Health Corporation for the years ended December 31, 2021 and 2022. It is important to note that the Projections do not account for any potential future changes in accounting standards.

Because the impact of the proposed 17-bed addition project at Encompass Health Rehabilitation Hospital of Western Massachusetts, LLC in Ludlow, Massachusetts represents a relatively insignificant portion of the operations and financial position of Encompass Health Corporation, I determined that the Projections are not likely to result in insufficient funds available for capital and ongoing operating costs necessary to support the proposed project. Based on my review of the Projections and relevant supporting documentation, I determined the project and continued operating surplus are reasonable and based upon feasible financial assumptions. Therefore, the proposed 17-bed addition project at Encompass Health Rehabilitation Hospital of Western Massachusetts, LLC is financially feasible and within the financial capability of Encompass Health Corporation.

Respectively submitted,

A handwritten signature in black ink that reads "Bernard L. Donohue, III, CPA". The signature is written in a cursive style with a stylized 'B' and 'D'.

Bernard L. Donohue, III, CPA