KINDRED HEALTHCARE, INC
Form 10-Q
November 09, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2011

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from______to______.

Commission file number: 001-14057

KINDRED HEALTHCARE, INC.

(Exact name of registrant as specified in its charter)

Delaware	**61-1323993**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
680 South Fourth Street	
Louisville, KY	**40202-2412**
(Address of principal executive offices)	**(Zip Code)**

(502) 596-7300

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	þ
Non-accelerated filer	¨	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No þ

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class of Common Stock	**Outstanding at October 31, 2011**
Common stock, $0.25 par value	52,121,641 shares

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(Unaudited)

(In thousands, except per share amounts)

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Revenues	$ 1,514,062	$ 1,053,012	$ 3,999,075	$ 3,224,213
Salaries, wages and benefits	900,570	613,607	2,344,398	1,852,987
Supplies	107,514	83,753	294,254	255,094
Rent	105,511	89,295	292,641	266,595
Other operating expenses	332,017	234,968	878,518	707,859
Other income	(2,815)	(2,794)	(8,480)	(8,735)
Depreciation and amortization	46,947	29,167	117,367	90,140
Interest expense	25,790	1,642	54,675	4,247
Investment income	(37)	(403)	(789)	(903)
	1,515,497	1,049,235	3,972,584	3,167,284
Income (loss) from continuing operations before income taxes	(1,435)	3,777	26,491	56,929
Provision (benefit) for income taxes	(2,342)	(1,323)	9,848	20,538
Income from continuing operations	907	5,100	16,643	36,391
Discontinued operations, net of income taxes:				
Income (loss) from operations	1,119	(260)	1,527	(327)
Gain on divestiture of operations		86		3
Income (loss) from discontinued operations	1,119	(174)	1,527	(324)
Net income	2,026	4,926	18,170	36,067
(Earnings) loss attributable to noncontrolling interests	(241)		180	
Income attributable to Kindred	$ 1,785	$ 4,926	$ 18,350	$ 36,067
Amounts attributable to Kindred stockholders:				
Income from continuing operations	$ 666	$ 5,100	$ 16,823	$ 36,391
Income (loss) from discontinued operations	1,119	(174)	1,527	(324)
Net income	$ 1,785	$ 4,926	$ 18,350	$ 36,067
Earnings per common share:				
Basic:				
Income from continuing operations	$ 0.01	$ 0.13	$ 0.37	$ 0.92
Discontinued operations:				
Income (loss) from operations	0.02	(0.01)	0.03	(0.01)
Gain on divestiture of operations				
Net income	$ 0.03	$ 0.12	$ 0.40	$ 0.91

Diluted:								
Income from continuing operations	$	0.01	$	0.13	$	0.37	$	0.92
Discontinued operations:								
Income (loss) from operations		0.02		(0.01)		0.03		(0.01)
Gain on divestiture of operations								
Net income	$	0.03	$	0.12	$	0.40	$	0.91
Shares used in computing earnings per common share:								
Basic		51,329		38,778		44,577		38,720
Diluted		51,406		38,838		44,934		38,855

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEET

(Unaudited)

(In thousands, except per share amounts)

	September 30, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$ 34,095	$ 17,168
Cash restricted	5,402	5,494
Insurance subsidiary investments	64,846	76,753
Accounts receivable less allowance for loss of $22,631 September 30, 2011 and $13,584 December 31, 2010	972,340	631,877
Inventories	30,821	24,327
Deferred tax assets	28,799	13,439
Income taxes	18,039	42,118
Other	30,796	24,862
	1,185,138	836,038
Property and equipment	1,926,726	1,754,170
Accumulated depreciation	(875,885)	(857,623)
	1,050,841	896,547
Goodwill	1,123,699	242,420
Intangible assets less accumulated amortization of $11,169 September 30, 2011 and $3,731 December 31, 2010	506,066	92,883
Assets held for sale	7,094	7,167
Insurance subsidiary investments	104,298	101,210
Deferred tax assets		88,816
Other	198,441	72,334
Total assets	$ 4,175,577	$ 2,337,415
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable	$ 218,523	$ 174,495
Salaries, wages and other compensation	392,297	291,116
Due to third party payors	41,436	27,115
Professional liability risks	41,728	41,555
Other accrued liabilities	140,840	87,012
Long-term debt due within one year	10,539	91
	845,363	621,384
Long-term debt	1,489,359	365,556
Professional liability risks	224,903	207,669
Deferred tax liabilities	26,678	
Deferred credits and other liabilities	189,814	111,047
Noncontrolling interests-redeemable	9,626	

Commitments and contingencies		
Equity:		
Stockholders equity:		
Common stock, $0.25 par value; authorized 175,000 shares; issued 52,112 shares September 30, 2011 and 39,495 shares December 31, 2010	13,028	9,874
Capital in excess of par value	1,135,032	828,593
Accumulated other comprehensive income (loss)	(1,000)	135
Retained earnings	211,003	193,157
	1,358,063	1,031,759
Noncontrolling interests-nonredeemable	31,771	
Total equity	1,389,834	1,031,759
Total liabilities and equity	$ 4,175,577	$ 2,337,415

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(Unaudited)

(In thousands)

	Three months ended September 30, 2011	Three months ended September 30, 2010	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Cash flows from operating activities:				
Net income	$ 2,026	$ 4,926	$ 18,170	$ 36,067
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	46,947	29,167	117,367	90,140
Amortization of stock-based compensation costs	3,505	2,593	9,611	8,114
Payment of lender fees related to debt issuance			(46,232)	
Provision for doubtful accounts	7,793	6,110	22,049	18,387
Deferred income taxes	(2,286)	(3,017)	(4,975)	(13,744)
Impairment charges	26,712		26,712	
Gain on divestiture of discontinued operations		(86)		(3)
Other	(922)	(2,792)	1,465	(1,866)
Change in operating assets and liabilities:				
Accounts receivable	(27,497)	8,146	(108,072)	(21,379)
Inventories and other assets	6,304	(1,088)	3,649	(7,574)
Accounts payable	(831)	(7,515)	386	(15,693)
Income taxes	(6,881)	3,981	20,792	25,734
Due to third party payors	1,143	12,123	4,698	10,099
Other accrued liabilities	10,505	15,361	52,186	22,573
Net cash provided by operating activities	66,518	67,909	117,806	150,855
Cash flows from investing activities:				
Routine capital expenditures	(36,595)	(28,623)	(95,263)	(69,108)
Development capital expenditures	(44,152)	(20,364)	(69,570)	(40,219)
Acquisitions, net of cash acquired	(50,928)	(38,379)	(710,907)	(87,869)
Sale of assets			1,714	
Purchase of insurance subsidiary investments	(8,867)	(10,566)	(25,904)	(34,684)
Sale of insurance subsidiary investments	10,398	11,138	37,587	72,971
Net change in insurance subsidiary cash and cash equivalents	(826)	(3,111)	(4,870)	(10,612)
Change in other investments			1,000	2
Other	(663)	698	(692)	1,279
Net cash used in investing activities	(131,633)	(89,207)	(866,905)	(168,240)
Cash flows from financing activities:				
Proceeds from borrowings under revolving credit	533,200	457,900	1,633,300	1,109,900
Repayment of borrowings under revolving credit	(474,700)	(432,800)	(1,749,800)	(1,092,400)
Proceeds from issuance of senior unsecured notes			550,000	
Proceeds from issuance of term loan, net of discount			693,000	
Repayment of other long-term debt	(2,545)	(22)	(348,233)	(64)
Payment of deferred financing costs	(1,855)	(1,361)	(8,715)	(1,414)
Issuance of common stock			3,019	35

Purchase of noncontrolling interests in subsidiaries	(7,292)		(7,292)	
Other	3		747	346
Net cash provided by financing activities	46,811	23,717	766,026	16,403
Change in cash and cash equivalents	(18,304)	2,419	16,927	(982)
Cash and cash equivalents at beginning of period	52,399	12,902	17,168	16,303
Cash and cash equivalents at end of period	$ 34,095	$ 15,321	$ 34,095	$ 15,321
Supplemental information:				
Issuance of common stock in RehabCare acquisition	$	$	$ 300,426	$
Financing costs paid in connection with RehabCare acquisition			13,074	
Interest payments	5,839	1,110	12,783	3,376
Income tax payments (refunds)	10,848	468	(2,435)	11,021

See accompanying notes.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 BASIS OF PRESENTATION

Business

Kindred Healthcare, Inc. is a healthcare services company that through its subsidiaries operates long-term acute care (LTAC) hospitals, inpatient rehabilitation hospitals, nursing and rehabilitation centers, assisted living facilities and a contract rehabilitation services business across the United States (collectively, the Company or Kindred). At September 30, 2011, the Company s hospital division operated 120 LTAC hospitals and five inpatient rehabilitation hospitals in 26 states. The Company s nursing center division operated 224 nursing and rehabilitation centers and six assisted living facilities in 27 states. The Company s rehabilitation division provides rehabilitative services primarily in hospital and long-term care settings in 46 states.

In recent years, the Company has completed several transactions related to the divestiture of unprofitable hospitals and nursing and rehabilitation centers to improve its future operating results. For accounting purposes, the operating results of these businesses and the gains associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at September 30, 2011 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet. See Note 5 for a summary of discontinued operations.

Recently issued accounting requirements

In September 2011, the Financial Accounting Standards Board (the FASB) issued authoritative guidance related to testing goodwill for impairment. The main provisions of the guidance state that an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step goodwill impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform Step 1 of the goodwill impairment test. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. Early adoption is permitted. The adoption of the guidance is not expected to have a material impact on the Company s business, financial position, results of operations or liquidity.

In July 2011, the FASB issued authoritative guidance related to the presentation and disclosure of patient service revenue, provision for bad debts, and the allowance for doubtful accounts for certain healthcare entities. The provisions of the guidance require healthcare entities that recognize significant amounts of patient service revenue at the time services are rendered, even though they do not assess a patient s ability to pay, to present the provision for bad debts related to those revenues as a deduction from patient service revenue (net of contractual allowances and discounts), as opposed to an operating expense. All other entities would continue to present the provision for bad debts as an operating expense. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. Early adoption is permitted, but full retrospective application is required. The adoption of the guidance is not expected to have a material impact on the Company s business, financial position, results of operations or liquidity.

In June 2011, the FASB issued authoritative guidance related to the presentation of other comprehensive income. The provisions of the guidance state that an entity has the option to present the total of comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The statement(s) should be presented with equal prominence to the other primary financial

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 BASIS OF PRESENTATION (Continued)

Recently issued accounting requirements (Continued)

statements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. Early adoption is permitted, but full retrospective application is required. The adoption of the guidance will not have a material impact on the Company s business, financial position, results of operations or liquidity.

In May 2011, the FASB issued authoritative guidance related to fair value measurements. The provisions of the guidance result in applying common fair value measurement and disclosure requirements in both United States generally accepted accounting principles and International Financial Reporting Standards. The amendments primarily change the wording used to describe many of the requirements in generally accepted accounting principles for measuring and disclosing information about fair value measurements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance is not expected to have a material impact on the Company s business, financial position, results of operations or liquidity.

In December 2010, the FASB issued authoritative guidance related to goodwill and other intangibles. The provisions of the guidance modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining if it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2010. The adoption of the guidance did not, and is not expected to, have a material impact on the Company s business, financial position, results of operations or liquidity.

In December 2010, the FASB issued authoritative guidance related to business combinations. The provisions of the guidance specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during a particular year had occurred as of the beginning of the comparable prior year annual reporting period. Supplemental pro forma disclosures also have been expanded to include a description of the nature and amount of material, non-recurring pro forma adjustments included in the pro forma financial statements. The guidance is effective prospectively for business combinations with an acquisition date on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

In August 2010, the FASB issued authoritative guidance related to the presentation of insurance claims and related insurance recoveries, which addresses the diversity in practice related to the accounting by healthcare entities for medical malpractice claims and similar liabilities and their related anticipated insurance recoveries. The provisions clarify that a healthcare entity should not net insurance recoveries against the related claim liability and the amount of the claim liability should be determined without consideration of insurance recoveries. The guidance is effective for all interim periods beginning after December 15, 2010. The adoption of the guidance did not have a material impact on the Company s business, financial position, results of operations or liquidity.

In January 2010, the FASB issued authoritative guidance related to fair value measurements and disclosures. The provisions of the guidance require new disclosures related to transfers in and out of Levels 1 and 2 classifications (as described in Note 14). The provisions also require a reconciliation of the activity in Level 3 recurring fair value measurements (as described in Note 14). Existing disclosures also were expanded to include Level 2 fair value measurement valuation techniques and inputs. The guidance is effective for all interim and

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 BASIS OF PRESENTATION (Continued)

Recently issued accounting requirements (Continued)

annual reporting periods beginning after December 15, 2009, except for the disclosures for Level 3 activity which is effective for fiscal years beginning after December 15, 2010. The adoption of the guidance did not, and is not expected to, have a material impact on the Company s business, financial position, results of operations or liquidity.

Comprehensive income

The following table sets forth the computation of comprehensive income (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2011	**2010**	**2011**	**2010**
Net income	$ 2,026	$ 4,926	$ 18,170	$ 36,067
Net unrealized investment gains (losses), net of income taxes	(1,317)	786	(1,135)	585
Comprehensive income	709	5,712	17,035	36,652
Earnings attributable to noncontrolling interests redeemable	(374)		(346)	
Loss attributable to noncontrolling interests nonredeemable	133		526	
Comprehensive income attributable to Kindred	$ 468	$ 5,712	$ 17,215	$ 36,652

Equity

The following table sets forth a reconciliation of the carrying amount of equity attributable to Kindred, equity attributable to nonredeemable noncontrolling interests and total equity (in thousands):

	Amounts attributable to Kindred stockholders	Nonredeemable noncontrolling interests	Total equity
Balance at December 31, 2010	$ 1,031,759	$	$ 1,031,759
Acquired noncontrolling interests nonredeemable		23,990	23,990
Comprehensive income:			
Net income (loss)	18,350	(526)	17,824
Net unrealized investment losses, net of income taxes	(1,135)		(1,135)

Comprehensive income (loss)	17,215	(526)	16,689
Issuance of common stock in connection with employee benefit plans	3,019		3,019
Shares tendered by employees for statutory tax withholdings upon issuance of common stock	(3,360)		(3,360)
Income tax benefit in connection with the issuance of common stock under employee benefit plans	403		403
Stock-based compensation amortization	9,611		9,611
Equity consideration for acquisition (See Note 2)	300,426		300,426
Purchase of noncontrolling interests in subsidiaries	(1,010)	(6,282)	(7,292)
Reclassification from noncontrolling interests-redeemable		14,589	14,589
Balance at September 30, 2011	$ 1,358,063	$ 31,771	$ 1,389,834

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 BASIS OF PRESENTATION (Continued)

Equity (Continued)

The reclassification from noncontrolling interests-redeemable resulted from minority ownership interests containing put rights in connection with the Merger (as defined) that expired by September 30, 2011.

Other information

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q of Regulation S-X and do not include all of the disclosures normally required by generally accepted accounting principles or those normally required in annual reports on Form 10-K. Accordingly, these financial statements should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2010 filed with the Securities and Exchange Commission (the SEC) on Form 10-K. The accompanying condensed consolidated balance sheet at December 31, 2010 was derived from audited consolidated financial statements, but does not include all disclosures required by generally accepted accounting principles.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the Company s customary accounting practices. Management believes that financial information included herein reflects all adjustments necessary for a fair presentation of interim results and, except as otherwise disclosed, all such adjustments are of a normal and recurring nature.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles and include amounts based upon the estimates and judgments of management. Actual amounts may differ from those estimates.

Reclassifications

Certain prior period amounts have been reclassified to conform with the current period presentation.

NOTE 2 REHABCARE ACQUISITION

On June 1, 2011, the Company completed the acquisition of RehabCare Group, Inc. (RehabCare) (the Merger). Upon consummation of the Merger, each issued and outstanding share of RehabCare common stock was converted into the right to receive 0.471 of a share of Kindred common stock and $26 per share in cash, without interest (the Merger Consideration). Kindred issued approximately 12 million shares of its common stock in connection with the Merger. The purchase price totaled $963 million and was comprised of $662 million in cash and $301 million of Kindred common stock at fair value. The Company also assumed $356 million of long-term debt in the Merger, of which $345 million was refinanced on June 1, 2011. The operating results of RehabCare have been included in the accompanying unaudited condensed consolidated financial statements of the Company since June 1, 2011.

At the Merger date, the Company acquired 32 LTAC hospitals, five inpatient rehabilitation hospitals, approximately 1,200 rehabilitation therapy sites of service and 102 hospital-based inpatient rehabilitation units. The Merger expanded the Company s service offerings, positioned the Company for future growth and should provide for significant operating synergies. RehabCare reported consolidated revenues of approximately $1.3 billion and net income from continuing operations of approximately $65 million in fiscal 2010.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 REHABCARE ACQUISITION (Continued)

Operating results for the third quarter of 2011 included transaction costs totaling $4.0 million and severance costs totaling $1.3 million related to the Merger. Operating results for the nine months ended September 30, 2011 included transaction costs totaling $27.0 million, financing costs totaling $13.8 million and severance costs totaling $16.2 million related to the Merger. In the accompanying unaudited condensed consolidated statement of operations, transaction costs were included in other operating expenses, financing costs were included in interest expense and severance costs were included in salaries, wages and benefits.

New credit facilities and notes

In connection with the Merger, the Company entered into a new $650 million senior secured asset-based revolving credit facility (the ABL Facility), a new $700 million senior secured term loan facility (the Term Loan Facility) and successfully completed the private placement of $550 million of senior notes due 2019 (the Notes). The Company used proceeds from the ABL Facility, the Term Loan Facility and the Notes to pay the Merger Consideration, repay all amounts outstanding under Kindred s and RehabCare s previous credit facilities and to pay transaction costs. The amounts outstanding under Kindred s and RehabCare s former credit facilities that were repaid at the Merger closing were $390 million and $345 million, respectively. The ABL Facility and the Term Loan Facility have incremental facility capacity in an aggregate amount between the two facilities of $200 million, subject to meeting certain conditions, including a specified senior secured leverage ratio. In connection with these new credit arrangements, the Company paid $46 million of lender fees related to debt issuance that were capitalized as deferred financing costs and paid $13 million of other financing costs that were charged to interest expense.

All obligations under the ABL Facility and the Term Loan Facility are fully and unconditionally guaranteed, subject to certain exceptions, by substantially all of the Company s existing and future direct and indirect domestic 100% owned subsidiaries, as well as certain non-100% owned domestic subsidiaries as the Company may determine from time to time in its sole discretion. The Notes are guaranteed by substantially all of the Company s domestic 100% owned subsidiaries.

The agreements governing the ABL Facility, the Term Loan Facility and the Notes include a number of restrictive covenants that, among other things and subject to certain exceptions and baskets, impose operating and financial restrictions on the Company and certain of its subsidiaries. In addition, the Company is required to comply with a minimum fixed charge coverage ratio and a maximum total leverage ratio. These financing agreements also contain customary affirmative covenants and events of default.

ABL Facility

The ABL Facility has a five-year tenor and is secured by a first priority lien on eligible accounts receivable, cash, deposit accounts, and certain other assets and property and proceeds from the foregoing (the First Priority ABL Collateral). The ABL Facility has a second priority lien on substantially all of the other assets and properties of the Company. As of September 30, 2011, the Company had $248.5 million outstanding under the ABL Facility. In addition, approximately $13 million of letters of credit were issued under the ABL Facility to backstop outstanding letters of credit previously issued by RehabCare under its terminated credit facility.

Borrowings under the ABL Facility bear interest at a rate per annum equal to the applicable margin plus, at the Company s option, either (1) the London Interbank Offered Rate (LIBOR) determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 REHABCARE ACQUISITION (Continued)

ABL Facility (Continued)

Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR as described in subclause (1) plus 1.00%. The initial applicable margin for borrowings under the ABL Facility was 2.75% with respect to LIBOR borrowings and 1.75% with respect to base rate borrowings. The applicable margin is subject to adjustment each fiscal quarter, based upon average historical excess availability during the preceding quarter.

Term Loan Facility

The Term Loan Facility has a tenor of seven years and is secured by a first priority lien on substantially all of the Company s assets and properties other than the First Priority ABL Collateral and a second priority lien on the First Priority ABL Collateral. The Term Loan Facility net proceeds totaled $693 million, net of a $7 million original issue discount that will be amortized over the tenor of the Term Loan Facility.

Borrowings under the Term Loan Facility bear interest at a rate per annum equal to an applicable margin plus, at the Company s option, either (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR described in subclause (1) plus 1.00%. LIBOR is subject to an interest rate floor of 1.50%. The initial applicable margin for borrowings under the Term Loan Facility was 3.75% with respect to LIBOR borrowings and 2.75% with respect to base rate borrowings.

Notes

In connection with the Merger, the Company completed a private placement of the Notes.

The Notes bear interest at an annual rate equal to 8.25% and are senior unsecured obligations of the Company and the subsidiary guarantors, ranking *pari passu* with all of their respective existing and future senior unsubordinated indebtedness. The indenture contains certain restrictive covenants that will, among other things, limit the Company and certain of its subsidiaries ability to incur, assume or guarantee additional indebtedness; pay dividends; make distributions or redeem or repurchase stock; restrict dividends, loans or asset transfers from its subsidiaries; sell or otherwise dispose of assets; and enter into transactions with affiliates. These covenants are subject to a number of limitations and exceptions. The indenture also contains customary events of default.

Pursuant to a registration rights agreement, the Company filed with the SEC a registration statement relating to an offer to exchange the Notes for an issue of SEC-registered notes with substantially identical terms. The exchange offer commenced on October 13, 2011 and is currently scheduled to expire on November 10, 2011.

Purchase price allocation

The Merger purchase price of $963 million was allocated on a preliminary basis to the estimated fair value of the tangible and intangible assets, and goodwill.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 REHABCARE ACQUISITION (Continued)

Purchase price allocation (Continued)

The following is the preliminary Merger purchase price allocation (in thousands):

Cash and cash equivalents	$ 19,932
Accounts receivable	244,642
Deferred income taxes and other current assets	48,253
Property and equipment	114,079
Identifiable intangible assets:	
Customer relationships	188,900
Trade names (indefinite life)	115,400
Medicare certifications (indefinite life)	75,900
Trade name	16,600
Certificates of need (indefinite life)	7,900
Non-compete agreements	2,800
Total identifiable intangible assets	407,500
Other assets	11,023
Accounts payable and other current liabilities	(169,512)
Long-term debt, including amounts due within one year	(355,650)
Deferred income taxes and other liabilities	(155,575)
Noncontrolling interests redeemable	(23,869)
Noncontrolling interests nonredeemable	(23,990)
Total identifiable net assets	116,833
Goodwill	845,975
Net assets	$ 962,808

The fair value allocation was measured primarily using a discounted cash flows methodology, which is considered a Level 3 input (as described in Note 14).

The value of gross contractual accounts receivable before determining uncollectable amounts totaled $261 million. Accounts estimated to be uncollectable totaled $16 million.

The weighted average life of the definite lived intangible assets consisting primarily of customer relationships is 13 years.

The aggregate goodwill arising from the Merger is based upon the expected future cash flows of the RehabCare operations, which reflect both growth expectations and cost savings from combining the operations of the Company and RehabCare. Goodwill is not amortized and is not deductible for income tax purposes. Goodwill was preliminarily assigned to the Company s hospital reporting unit ($587 million), skilled nursing rehabilitation services reporting unit ($121 million) and hospital rehabilitation services reporting unit ($138 million).

The valuation technique used to measure the value of the noncontrolling interests was an average of the implied equity value of the noncontrolling interests based upon the Merger Consideration and market multiple methodologies. Redeemable noncontrolling interests as of September 30, 2011 represent the minority ownership interests containing put rights in connection with the Merger.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 REHABCARE ACQUISITION (Continued)

Purchase price allocation (Continued)

The unaudited pro forma net effect of the Merger assuming the acquisition occurred as of January 1, 2010 is as follows (in thousands, except per share amounts):

	Three months ended September 30, 2011	Three months ended September 30, 2010	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Revenues	$ 1,514,062	$ 1,390,493	$ 4,604,597	$ 4,214,312
Income (loss) from continuing operations attributable to Kindred	4,509	5,951	66,536	(1,294)
Income (loss) attributable to Kindred	5,628	6,318	71,106	(1,054)
Earnings (loss) per common share:				
Basic:				
Income (loss) from continuing operations	$ 0.09	$ 0.12	$ 1.28	$ (0.02)
Net income (loss)	$ 0.11	$ 0.12	$ 1.37	$ (0.02)
Diluted:				
Income (loss) from continuing operations	$ 0.09	$ 0.12	$ 1.27	$ (0.02)
Net income (loss)	$ 0.11	$ 0.12	$ 1.36	$ (0.02)

The unaudited pro forma financial data has been derived by combining the historical financial results of the Company and the operations acquired in the Merger for the periods presented. The unaudited pro forma financial data includes transaction, financing and severance costs totaling $79.8 million incurred by both the Company and RehabCare related to the Merger. These costs have been eliminated from the results of operations for 2011 and have been reflected as expenses incurred as of January 1, 2010 for purposes of the pro forma financial presentation. Revenues and operating income associated with RehabCare aggregated $343 million and $56 million, respectively, for the three months ended September 30, 2011. Revenues and operating income associated with RehabCare aggregated $457 million and $73 million, respectively, since the date of the Merger.

NOTE 3 OTHER ACQUISITIONS

The following is a summary of the Company s other significant acquisition activities. The operating results of the acquired businesses have been included in the accompanying unaudited condensed consolidated financial statements of the Company from the respective acquisition dates. The purchase price of the acquired businesses and acquired leased facilities resulted from negotiations with each of the sellers that were based upon both the historical and expected future cash flows of the respective businesses and real estate values. All of these acquisitions were financed through operating cash flows or borrowings under the Company s revolving credit facility. Unaudited pro forma financial data related to the acquired businesses have not been presented because the acquisitions are not material, either individually or in the aggregate, to the Company s consolidated financial statements.

In September 2011, the Company acquired a home health and hospice company for $50.9 million, including $9.8 million of accounts receivable, $1.4 million of other assets, $0.9 million of property and equipment, $33.9 million of goodwill, $11.2 million of identifiable intangible assets and $6.3 million of deferred income taxes and other liabilities.

In April 2011, the Company acquired a home health company for $9.5 million, including $0.1 million of property and equipment, $7.5 million of goodwill and $1.9 million of identifiable intangible assets.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 3 OTHER ACQUISITIONS (Continued)

In March 2011, the Company acquired the real estate of a previously leased hospital for $8.0 million. Annual rent associated with the hospital aggregated $0.9 million.

In September 2010, the Company acquired three nursing and rehabilitation centers for $37.7 million, including $30.4 million of property and equipment, $5.0 million of goodwill, $2.5 million of identifiable intangible assets and $0.2 million of other assets.

In March 2010, the Company acquired a combined nursing and rehabilitation center and assisted living facility for $16.6 million, including $0.2 million of goodwill, $2.2 million of identifiable intangible assets and $14.2 million of property and equipment and other assets.

In January 2010, the Company acquired the real estate of two previously leased hospitals and two previously leased nursing and rehabilitation centers for $31.1 million in cash and $2.4 million in unamortized prepaid rent. Annual rents associated with these four facilities aggregated $2.9 million.

The fair value of each of the acquisitions noted above was measured primarily using discounted cash flow methodologies which are considered Level 3 inputs (as described in Note 14).

NOTE 4 IMPAIRMENT CHARGES

On July 29, 2011, the Centers for Medicare and Medicaid Services (CMS) issued final rules which, among other things, significantly reduced Medicare payments to nursing centers and changed the reimbursement for the provision of group rehabilitation therapy services to Medicare beneficiaries beginning October 1, 2011 (the 2011 CMS Rules). As a result of these rules, the Company tested the recoverability of its nursing and rehabilitation centers reporting unit goodwill and intangible assets and property and equipment within asset groups impacted by the reduced payments. The Company determined that pretax impairment charges aggregating $26.7 million were necessary. The charges included $6.1 million of goodwill (which represented the entire nursing and rehabilitation centers reporting unit goodwill) and $20.6 million of property and equipment. These charges reflected the amount by which the carrying value of certain assets exceeded their estimated fair value. The impairment charges did not impact the Company s cash flows or liquidity.

The impairment charges are recorded in other operating expenses in the accompanying unaudited condensed consolidated statement of operations.

NOTE 5 DISCONTINUED OPERATIONS

In accordance with the authoritative guidance for the impairment or disposal of long-lived assets, the divestitures of unprofitable businesses discussed in Note 1 have been accounted for as discontinued operations. Accordingly, the results of operations of these businesses for all periods presented and the gains related to these divestitures have been classified as discontinued operations, net of income taxes, in the accompanying unaudited condensed consolidated statement of operations. At September 30, 2011, the Company held for sale two hospitals reported as discontinued operations.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 DISCONTINUED OPERATIONS (Continued)

A summary of discontinued operations follows (in thousands):

	Three months ended September 30, 2011	Three months ended September 30, 2010	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Revenues	$ 848	$ 2,508	$ 1,025	$ 9,956
Salaries, wages and benefits	(77)	2,348	(393)	7,359
Supplies	2	161	(1)	556
Rent	28	31	86	103
Other operating expenses (income)	(924)	390	(1,149)	2,495
Depreciation				
Interest expense		1		1
Investment income		(1)		(27)
	(971)	2,930	(1,457)	10,487
Income (loss) from operations before income taxes	1,819	(422)	2,482	(531)
Provision (benefit) for income taxes	700	(162)	955	(204)
Income (loss) from operations	1,119	(260)	1,527	(327)
Gain on divestiture of operations, net of income taxes		86		3
	$ 1,119	$ (174)	$ 1,527	$ (324)

The following table sets forth certain discontinued operating data by business segment (in thousands):

	Three months ended September 30, 2011	Three months ended September 30, 2010	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Revenues:				
Hospital division	$ 846	$ (196)	$ 822	$ (89)
Nursing center division	2	2,704	203	10,045
	$ 848	$ 2,508	$ 1,025	$ 9,956
Operating income (loss):				
Hospital division	$ 633	$ (348)	$ (65)	$ (1,185)
Nursing center division	1,214	(43)	2,633	731

	$ 1,847	$ (391)	$ 2,568	$ (454)
Rent:				
Hospital division	$ 28	$ 29	$ 86	$ 93
Nursing center division		2		10
	$ 28	$ 31	$ 86	$ 103

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 DISCONTINUED OPERATIONS (Continued)

A summary of the net assets held for sale, including certain assets included in continuing operations, follows (in thousands):

	September 30, 2011	December 31, 2010
Long-term assets:		
Property and equipment, net	$ 7,086	$ 7,062
Other	8	105
	7,094	7,167
Current liabilities (included in other accrued liabilities)	(127)	(72)
	$ 6,967	$ 7,095

NOTE 6 REVENUES

Revenues are recorded based upon estimated amounts due from patients and third party payors for healthcare services provided, including anticipated settlements under reimbursement agreements with Medicare, Medicaid, Medicare Advantage and other third party payors.

A summary of revenues by payor type follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2011	2010	2011	2010
Medicare	$ 629,279	$ 438,931	$ 1,761,847	$ 1,382,368
Medicaid	269,804	265,143	791,933	794,967
Medicare Advantage	111,322	82,116	304,777	255,939
Other	583,406	343,165	1,378,835	1,020,285
	1,593,811	1,129,355	4,237,392	3,453,559
Eliminations	(79,749)	(76,343)	(238,317)	(229,346)
	$ 1,514,062	$ 1,053,012	$ 3,999,075	$ 3,224,213

NOTE 7 EARNINGS PER SHARE

Earnings per common share are based upon the weighted average number of common shares outstanding during the respective periods. The diluted calculation of earnings per common share includes the dilutive effect of stock options. The Company follows the provisions of the authoritative guidance for determining whether instruments granted in share-based payment transactions are participating securities, which requires that unvested restricted stock that entitles the holder to receive nonforfeitable dividends before vesting be included as a participating security in the basic and diluted earnings per common share calculation pursuant to the two-class method.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7 EARNINGS PER SHARE (Continued)

A computation of earnings per common share follows (in thousands, except per share amounts):

	Three months ended September 30,				Nine months ended September 30,			
	2011		2010		2011		2010	
	Basic	Diluted	Basic	Diluted	Basic	Diluted	Basic	Diluted
Earnings:								
Amounts attributable to Kindred stockholders:								
Income from continuing operations:								
As reported in Statement of Operations	$ 666	$ 666	$ 5,100	$ 5,100	$ 16,823	$ 16,823	$ 36,391	$ 36,391
Allocation to participating unvested restricted stockholders	(10)	(10)	(91)	(91)	(287)	(284)	(664)	(662)
Available to common stockholders	$ 656	$ 656	$ 5,009	$ 5,009	$ 16,536	$ 16,539	$ 35,727	$ 35,729
Discontinued operations, net of income taxes:								
Income (loss) from operations:								
As reported in Statement of Operations	$ 1,119	$ 1,119	$ (260)	$ (260)	$ 1,527	$ 1,527	$ (327)	$ (327)
Allocation to participating unvested restricted stockholders	(17)	(17)	5	5	(26)	(26)	6	6
Available to common stockholders	$ 1,102	$ 1,102	$ (255)	$ (255)	$ 1,501	$ 1,501	$ (321)	$ (321)
Gain on divestiture of operations:								
As reported in Statement of Operations	$	$	$ 86	$ 86	$	$	$ 3	$ 3
Allocation to participating unvested restricted stockholders			(2)	(2)				
Available to common stockholders	$	$	$ 84	$ 84	$	$	$ 3	$ 3
Net income:								
As reported in Statement of Operations	$ 1,785	$ 1,785	$ 4,926	$ 4,926	$ 18,350	$ 18,350	$ 36,067	$ 36,067
Allocation to participating unvested restricted stockholders	(27)	(27)	(88)	(88)	(313)	(310)	(658)	(656)
Available to common stockholders	$ 1,758	$ 1,758	$ 4,838	$ 4,838	$ 18,037	$ 18,040	$ 35,409	$ 35,411
Shares used in the computation:								
Weighted average shares outstanding basic computation	51,329	51,329	38,778	38,778	44,577	44,577	38,720	38,720
Dilutive effect of employee stock options		77		60		357		135

Adjusted weighted average shares outstanding diluted computation				51,406				38,838				44,934				38,855
Earnings per common share:																
Income from continuing operations	$	0.01	$	0.01	$	0.13	$	0.13	$	0.37	$	0.37	$	0.92	$	0.92
Discontinued operations:																
Income (loss) from operations		0.02		0.02		(0.01)		(0.01)		0.03		0.03		(0.01)		(0.01)
Gain on divestiture of operations																
Net income	$	0.03	$	0.03	$	0.12	$	0.12	$	0.40	$	0.40	$	0.91	$	0.91
Number of antidilutive stock options excluded from shares used in the diluted earnings per common share computation				2,769				2,959				1,226				2,496

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA

At September 30, 2011, the Company operated three divisions consisting of hospitals, nursing centers and rehabilitation services. Based upon the authoritative guidance for business segments and after giving consideration to the Company s business segments after the Merger, the divisions represent four reportable operating segments, which consist of (i) LTAC hospitals, (ii) skilled nursing and rehabilitation centers, (iii) skilled nursing-based rehabilitation contract therapy services, and (iv) hospital-based rehabilitation contract therapy services. The Company includes operating data for its home health and hospice businesses in the skilled nursing-based rehabilitation contract therapy services segment. These segments are consistent with information used by the Company s Chief Executive Officer and Chief Operating Officer to assess performance and allocate resources. The accounting policies of the segments are the same as those described in the summary of significant accounting policies. Prior period segment information has been conformed to the current period presentation.

For segment purposes, the Company defines operating income as earnings before interest, income taxes, depreciation, amortization and rent. Operating income reported for each of the Company s business segments excludes the allocation of corporate overhead.

Operating income for the three and nine months ended September 30, 2011 included impairment charges approximating $3.1 million for the hospital division and $23.6 million for the nursing center division.

Operating income for the nine months ended September 30, 2010 included severance and retirement costs approximating $1.1 million for the hospital division, $0.5 million for the nursing center division and $1.3 million for corporate.

Transaction costs for the three and nine months ended September 30, 2010 have been reclassified to conform with the current period presentation and are excluded from business segment operating income (loss).

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA (Continued)

The following table sets forth certain data by business segment (in thousands):

	Three months ended September 30, 2011	Three months ended September 30, 2010	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Revenues:				
Hospital division	$ 684,781	$ 465,198	$ 1,837,180	$ 1,465,661
Nursing center division	571,226	539,914	1,706,897	1,621,450
Rehabilitation division:				
Skilled nursing rehabilitation services	267,993	103,807	562,723	303,952
Hospital rehabilitation services	69,811	20,436	130,592	62,496
	337,804	124,243	693,315	366,448
	1,593,811	1,129,355	4,237,392	3,453,559
Eliminations:				
Skilled nursing rehabilitation services	(59,221)	(56,841)	(175,858)	(169,584)
Hospital rehabilitation services	(20,528)	(19,502)	(62,459)	(59,762)
	(79,749)	(76,343)	(238,317)	(229,346)
	$ 1,514,062	$ 1,053,012	$ 3,999,075	$ 3,224,213
Income from continuing operations:				
Operating income (loss):				
Hospital division	$ 122,599	$ 75,784	$ 339,449	$ 263,014
Nursing center division	65,982	69,363	246,864	216,506
Rehabilitation division:				
Skilled nursing rehabilitation services	28,682	9,486	53,362	28,330
Hospital rehabilitation services	15,606	4,728	28,971	14,667
	44,288	14,214	82,333	42,997
Corporate:				
Overhead	(48,806)	(34,329)	(130,922)	(100,959)
Insurance subsidiary	(750)	(783)	(1,772)	(2,054)
	(49,556)	(35,112)	(132,694)	(103,013)
Transaction costs	(6,537)	(771)	(45,567)	(2,496)
Operating income	176,776	123,478	490,385	417,008
Rent	(105,511)	(89,295)	(292,641)	(266,595)

Depreciation and amortization	(46,947)	(29,167)	(117,367)	(90,140)
Interest, net	(25,753)	(1,239)	(53,886)	(3,344)
Income (loss) from continuing operations before income taxes	(1,435)	3,777	26,491	56,929
Provision (benefit) for income taxes	(2,342)	(1,323)	9,848	20,538
	$ 907	$ 5,100	$ 16,643	$ 36,391

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA (Continued)

	Three months ended September 30, 2011	Three months ended September 30, 2010	Nine months ended September 30, 2011	Nine months ended September 30, 2010
Rent:				
Hospital division	$ 52,737	$ 38,122	$ 137,033	$ 113,580
Nursing center division	49,862	49,627	148,808	148,458
Rehabilitation division:				
Skilled nursing rehabilitation services	2,169	1,474	5,658	4,368
Hospital rehabilitation services	95	28	156	79
	2,264	1,502	5,814	4,447
Corporate	648	44	986	110
	$ 105,511	$ 89,295	$ 292,641	$ 266,595
Depreciation and amortization:				
Hospital division	$ 21,612	$ 12,655	$ 52,462	$ 38,218
Nursing center division	12,655	10,527	37,486	33,825
Rehabilitation division:				
Skilled nursing rehabilitation services	3,023	591	5,121	1,672
Hospital rehabilitation services	2,372	77	3,288	207
	5,395	668	8,409	1,879
Corporate	7,285	5,317	19,010	16,218
	$ 46,947	$ 29,167	$ 117,367	$ 90,140
Capital expenditures, excluding acquisitions (including discontinued operations):				
Hospital division:				
Routine	$ 12,919	$ 9,113	$ 36,872	$ 23,132
Development	39,964	12,900	54,164	28,883
	52,883	22,013	91,036	52,015
Nursing center division:				
Routine	10,572	11,548	26,727	24,732
Development	4,113	7,464	15,140	11,336
	14,685	19,012	41,867	36,068
Rehabilitation division:				
Skilled nursing rehabilitation services:				
Routine	296	328	768	814
Development	75		266	

	371	328	1,034	814
Hospital rehabilitation services:				
Routine	81	23	178	85
Development				
	81	23	178	85
Corporate:				
Information systems	11,516	6,625	29,089	18,624
Other	1,211	986	1,629	1,721
	$ 80,747	$ 48,987	$ 164,833	$ 109,327

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA (Continued)

	September 30, 2011	December 31, 2010
Assets at end of period:		
Hospital division	$ 2,151,650	$ 1,100,138
Nursing center division	629,734	647,355
Rehabilitation division:		
Skilled nursing rehabilitation services	546,388	87,055
Hospital rehabilitation services	319,995	798
	866,383	87,853
Corporate	527,810	502,069
	$ 4,175,577	$ 2,337,415
Goodwill:		
Hospital division	$ 800,053	$ 213,200
Nursing center division		6,080
Rehabilitation division:		
Skilled nursing rehabilitation services	185,668	23,140
Hospital rehabilitation services	137,978	
	323,646	23,140
	$ 1,123,699	$ 242,420

NOTE 9 INSURANCE RISKS

The Company insures a substantial portion of its professional liability risks and workers compensation risks through its wholly owned limited purpose insurance subsidiary. Provisions for loss for these risks are based upon management s best available information including actuarially determined estimates.

The allowance for professional liability risks includes an estimate of the expected cost to settle reported claims and an amount, based upon past experiences, for losses incurred but not reported. These liabilities are necessarily based upon estimates and, while management believes that the provision for loss is adequate, the ultimate liability may be in excess of, or less than, the amounts recorded. To the extent that expected ultimate claims costs vary from historical provisions for loss, future earnings will be charged or credited.

The provision for loss for insurance risks, including the cost of coverage maintained with unaffiliated commercial insurance carriers, follows (in thousands):

	Three months ended September 30,	Nine months ended September 30,

	2011	2010	2011	2010
Professional liability:				
Continuing operations	$ 15,953	$ 13,123	$ 50,584	$ 45,961
Discontinued operations	(897)	(934)	(1,718)	(1,763)
Workers compensation:				
Continuing operations	$ 15,908	$ 10,049	$ 43,057	$ 31,763
Discontinued operations	(120)	(103)	(640)	(1,104)

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 INSURANCE RISKS (Continued)

A summary of the assets and liabilities related to insurance risks included in the accompanying unaudited condensed consolidated balance sheet follows (in thousands):

	September 30, 2011			December 31, 2010		
	Professional liability	Workers compensation	Total	Professional liability	Workers compensation	Total
Assets:						
Current:						
Insurance subsidiary investments	$ 40,403	$ 24,443	$ 64,846	$ 54,162	$ 22,591	$ 76,753
Reinsurance recoverables	263		263	265		265
Other		319	319		319	319
	40,666	24,762	65,428	54,427	22,910	77,337
Non-current:						
Insurance subsidiary investments	40,246	64,052	104,298	38,635	62,575	101,210
Reinsurance and other recoverables	43,778	63,775	107,553	41,752	3,222	44,974
Deposits	3,643	1,623	5,266	3,000	1,313	4,313
Other		43	43		44	44
	87,667	129,493	217,160	83,387	67,154	150,541
	$ 128,333	$ 154,255	$ 282,588	$ 137,814	$ 90,064	$ 227,878
Liabilities:						
Allowance for insurance risks:						
Current	$ 41,728	$ 30,063	$ 71,791	$ 41,555	$ 24,676	$ 66,231
Non-current	224,903	136,315	361,218	207,669	59,504	267,173
	$ 266,631	$ 166,378	$ 433,009	$ 249,224	$ 84,180	$ 333,404

Provisions for loss for professional liability risks retained by the Company s limited purpose insurance subsidiary have been discounted based upon actuarial estimates of claim payment patterns using a discount rate of 1% to 5% depending upon the policy year. The discount rate was 1% for the 2011 and 2010 policy years. The discount rates are based upon the risk free interest rate for the respective year. Amounts equal to the discounted loss provision are funded annually. The Company does not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated $269.5 million at September 30, 2011 and $252.6 million at December 31, 2010.

Provisions for loss for workers compensation risks retained by the Company s limited purpose insurance subsidiary are not discounted and amounts equal to the loss provision are funded annually.

NOTE 10 INSURANCE SUBSIDIARY INVESTMENTS

The Company maintains investments, consisting principally of cash and cash equivalents, debt securities, equities and commercial paper for the payment of claims and expenses related to professional liability and workers compensation risks. These investments have been categorized as available-for-sale and are reported at fair value.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 10 INSURANCE SUBSIDIARY INVESTMENTS (Continued)

The amortized cost and estimated fair value of the Company s insurance subsidiary investments follows (in thousands):

	September 30, 2011				December 31, 2010			
	Amortized cost	Unrealized gains	Unrealized losses	Fair value	Amortized cost	Unrealized gains	Unrealized losses	Fair value
Cash and cash equivalents (a)	$ 109,534	$	$	$ 109,534	$ 104,664	$	$	$ 104,664
Debt securities:								
Corporate bonds	23,115	192	(55)	23,252	32,174	542	(40)	32,676
Debt securities issued by U.S. government agencies	17,380	128	(6)	17,502	17,906	113	(27)	17,992
U.S. Treasury notes	2,864	12	(2)	2,874	2,482	11		2,493
Debt securities issued by foreign governments	874	10		884	2,081	15		2,096
Commercial mortgage-backed securities	206	11		217	307	19		326
	44,439	353	(63)	44,729	54,950	700	(67)	55,583
Equities by industry:								
Healthcare	1,474	17	(148)	1,343	1,572	20	(235)	1,357
Financial services	1,150	42	(173)	1,019	1,284	209	(66)	1,427
Oil and gas	921	51	(165)	807	921	142	(37)	1,026
Other	7,594	453	(840)	7,207	7,594	876	(269)	8,201
	11,139	563	(1,326)	10,376	11,371	1,247	(607)	12,011
Commercial paper	4,505	1	(1)	4,505	5,705	2	(2)	5,705
	$ 169,617	$ 917	$ (1,390)	$ 169,144	$ 176,690	$ 1,949	$ (676)	$ 177,963

(a) Includes $2.9 million and $2.6 million of money market funds at September 30, 2011 and December 31, 2010, respectively.

The Company s investment policy governing insurance subsidiary investments precludes the investment portfolio managers from selling any security at a loss without prior authorization from the Company. The investment managers also limit the exposure to any one issue, issuer or type of investment. The Company intends, and has the ability, to hold insurance subsidiary investments for a long duration without the necessity of selling securities to fund the underwriting needs of its insurance subsidiary. This ability to hold securities allows sufficient time for recovery of temporary declines in the market value of equity securities and the par value of debt securities as of their stated maturity date.

The Company considered the severity and duration of its unrealized losses at September 30, 2011 and recognized a $0.2 million pretax other-than-temporary impairment in the third quarter of 2011 for various investments held in its insurance subsidiary investment portfolio. The Company recognized a $0.7 million pretax other-than-temporary impairment for the nine months ended September 30, 2010 for various investments held in its insurance subsidiary investment portfolio.

As a result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary, the Company received distributions of $3 million and $22 million during the nine months ended September 30, 2011 and 2010, respectively, from its limited purpose insurance subsidiary in accordance with applicable regulations. These distributions had no impact on earnings and the proceeds were used primarily to repay borrowings under the Company s revolving credit facility.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 11 INCOME TAXES

The provision for income taxes for the third quarter and nine months ended September 30, 2011 included a favorable adjustment of $3.3 million related to the resolution of certain income tax contingencies from prior years. As a result, the Company reduced its unrecognized tax benefits and related accrued interest by $3.5 million. The deferred tax asset associated with unrecognized tax benefits also was reduced by $0.2 million. As of September 30, 2011, the Company s unrecognized tax benefits totaled $1.1 million and accrued interest related to uncertain tax positions totaled $0.1 million.

The provision for income taxes for the third quarter and nine months ended September 30, 2010 included a favorable adjustment of $2.9 million related to the resolution of certain income tax contingencies from prior years.

The federal statute of limitations remains open for tax years 2008 through 2010. In July 2011, the Company resolved federal income tax audits for the 2007 through 2009 tax years. The Company has been notified by the Internal Revenue Service (the IRS) that an examination will be conducted for the 2010 tax year.

State jurisdictions generally have statutes of limitations ranging from three to five years. The state impact of federal income tax changes remains subject to examination by various states for a period of up to one year after formal notification to the states. Currently, the Company has various state income tax returns under examination.

During the nine months ended September 30, 2010, the Company received approval from the IRS for an accounting method change for income tax purposes that resulted in a non-recurring reduction in income tax payments of approximately $25 million during 2010. The Company s earnings were not impacted by this transaction.

NOTE 12 CONTINGENCIES

Management continually evaluates contingencies based upon the best available information. In addition, allowances for losses are provided currently for disputed items that have continuing significance, such as certain third party reimbursements and deductions that continue to be claimed in current cost reports and tax returns.

Management believes that allowances for losses have been provided to the extent necessary and that its assessment of contingencies is reasonable.

Principal contingencies are described below:

Revenues Certain third party payments are subject to examination by agencies administering the various reimbursement programs. The Company is contesting certain issues raised in audits of prior year cost reports.

Professional liability risks The Company has provided for losses for professional liability risks based upon management s best available information including actuarially determined estimates. Ultimate claims costs may differ from the provisions for loss. See Note 9.

Income taxes The Company is subject to various federal and state income tax audits in the ordinary course of business. Such audits could result in increased tax payments, interest and penalties. In addition, the Company is a party to a tax matters agreement with PharMerica Corporation, which sets forth the Company s rights and obligations related to taxes for periods before and after the Company s spin-off of its former institutional pharmacy business in 2007 and the related merger transaction which created PharMerica Corporation.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 12 CONTINGENCIES (Continued)

Litigation The Company is a party to various legal actions (some of which are not insured), and regulatory and other governmental audits and investigations in the ordinary course of business. The Company cannot predict the ultimate outcome of pending litigation and regulatory and other governmental audits and investigations. These matters could potentially subject the Company to sanctions, damages, recoupments, fines and other penalties. The U.S. Department of Justice (the DOJ), CMS or other federal and state enforcement and regulatory agencies may conduct additional investigations related to the Company s businesses in the future which may, either individually or in the aggregate, have a material adverse effect on the Company s business, financial position, results of operations and liquidity.

Other indemnifications In the ordinary course of business, the Company enters into contracts containing standard indemnification provisions and indemnifications specific to a transaction, such as a disposal of an operating facility. These indemnifications may cover claims related to employment-related matters, governmental regulations, environmental issues and tax matters, as well as patient, third party payor, supplier and contractual relationships. Obligations under these indemnities generally are initiated by a breach of the terms of a contract or by a third party claim or event.

NOTE 13 CAPITAL STOCK

In May 2011, the shareholders of the Company approved an additional 3,000,000 shares of common stock that could be issued under the Company s incentive compensation plans.

NOTE 14 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

The Company follows the provisions of the authoritative guidance for fair value measurements, which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles.

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The guidance related to fair value measures establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury, other U.S. Government and agency asset-backed debt securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 14 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

The Company s assets and liabilities measured at fair value on a recurring and non-recurring basis and any associated losses are summarized below (in thousands):

	Fair value measurements			Assets/liabilities	Total
	Level 1	**Level 2**	**Level 3**	**at fair value**	**losses**
September 30, 2011:					
Recurring:					
Assets:					
Available-for-sale debt securities:					
Corporate bonds	$	$ 23,252	$	$ 23,252	$
Debt securities issued by U.S. government agencies		17,502		17,502	
U.S. Treasury notes	2,874			2,874	
Debt securities issued by foreign governments		884		884	
Commercial mortgage-backed securities		217		217	
	2,874	41,855		44,729	
Available-for-sale equity securities	10,376			10,376	
Commercial paper		4,505		4,505	
Money market funds	6,787			6,787	
Total available-for-sale investments	20,037	46,360		66,397	
Deposits held in money market funds	562	3,645		4,207	
	$ 20,599	$ 50,005	$	$ 70,604	$
Liabilities	$	$	$	$	$
Non-recurring:					
Assets:					
Goodwill nursing and rehabilitation centers	$	$	$	$	$ (6,080)
Property and equipment			6,372	6,372	(20,632)
	$	$	$ 6,372	$ 6,372	$ (26,712)
Liabilities	$	$	$	$	$
December 31, 2010:					
Recurring:					
Assets:					
Available-for-sale debt securities:					
Corporate bonds	$	$ 32,676	$	$ 32,676	$
Debt securities issued by U.S. government agencies		17,992		17,992	
U.S. Treasury notes	2,493			2,493	
Debt securities issued by foreign governments		2,096		2,096	

Commercial mortgage-backed securities		326		326	
	2,493	53,090		55,583	
Available-for-sale equity securities	12,011			12,011	
Commercial paper		5,705		5,705	
Money market funds	2,581			2,581	
Total available-for-sale investments	17,085	58,795		75,880	
Deposits held in money market funds	7,238	3,001		10,239	
	$ 24,323	$ 61,796	$	$ 86,119	$
Liabilities	$	$	$	$	$
Non-recurring:					
Assets:					
Hospitals available for sale	$	$	$ 5,605	$ 5,605	$ (1,880)
Liabilities	$	$	$	$	$

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 14 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

Recurring measurements

The Company s available-for-sale investments are primarily held by its limited purpose insurance subsidiary and consist of debt securities, equities, commercial paper and money market funds. These available-for-sale investments and the insurance subsidiary s cash and cash equivalents of $106.6 million as of September 30, 2011 and $102.1 million as of December 31, 2010, classified as insurance subsidiary investments, are maintained for the payment of claims and expenses related to professional liability and workers compensation risks.

The Company also has available-for-sale investments totaling $3.9 million related to a deferred compensation plan that is maintained for certain of the Company s current and former employees.

The Company s deposits held in money market funds consist primarily of cash and cash equivalents held for general corporate purposes.

The fair value of actively traded debt and equity securities and money market funds are based upon quoted market prices and are generally classified as Level 1. The fair value of inactively traded debt securities and commercial paper are based upon either quoted market prices of similar securities or observable inputs such as interest rates using either a market or income valuation approach and are generally classified as Level 2. The Company s investment advisors obtain and review pricing for each security. The Company is responsible for the determination of fair value and as such the Company reviews the pricing information from its advisors in determining reasonable estimates of fair value. Based upon the Company s internal review procedures, there were no adjustments to the prices during the three or nine months ended September 30, 2011 or September 30, 2010.

The following table presents the carrying amounts and estimated fair values of the Company s financial instruments. The carrying value is equal to fair value for financial instruments that are based upon quoted market prices or current market rates.

	September 30, 2011		December 31, 2010	
(In thousands)	Carrying value	Fair value	Carrying value	Fair value
Cash and cash equivalents	$ 34,095	$ 34,095	$ 17,168	$ 17,168
Cash restricted	5,402	5,402	5,494	5,494
Insurance subsidiary investments	169,144	169,144	177,963	177,963
Other marketable securities	3,882	3,882		
Tax refund escrow investments	214	214	213	213
Long-term debt, including amounts due within one year (excluding capital lease obligations totaling $4.8 million at September 30, 2011)	1,495,139	1,321,215	365,647	365,640

Non-recurring measurements

On July 29, 2011, CMS issued the 2011 CMS Rules. As a result of these rules, the Company tested the recoverability of its nursing and rehabilitation centers reporting unit goodwill and intangible assets and property and equipment within asset groups impacted by the reduced payments. The Company determined that pretax impairment charges aggregating $26.7 million were necessary. The charges included $6.1 million of goodwill (which represented the entire nursing and rehabilitation centers reporting unit goodwill) and $20.6 million of property and equipment. These charges reflected the amount by which the carrying value of certain assets exceeded their estimated fair value. The fair value of goodwill was measured using both Level 2 and Level 3 inputs such as discounted cash flows, market multiple analysis, replacement costs and sales comparison methodologies. The fair value of property and equipment was measured using Level 3 inputs such as replacement costs factoring in depreciation, economic obsolesce and inflation trends.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION

The accompanying condensed consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X, Rule 3-10, Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered. The Company s Notes issued on June 1, 2011, are fully and unconditionally guaranteed subject to certain customary release provisions on an unsecured, joint and severally liable basis by substantially all of the Company s domestic 100% owned subsidiaries. The equity method has been used with respect to the parent company s (Kindred) investment in subsidiaries.

The following unaudited condensed, consolidating financial data present the composition of the parent company/issuer, the guarantor subsidiaries and the non-guarantor subsidiaries as of September 30, 2011 and December 31, 2010 for the balance sheet, and the results of operations and cash flows for the three and nine months ended September 30, 2011 and September 30, 2010.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Operations

	Three months ended September 30, 2011				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Revenues	$	$ 1,424,647	$ 111,847	$ (22,432)	$ 1,514,062
Salaries, wages and benefits	130	860,448	39,992		900,570
Supplies		98,846	8,668		107,514
Rent		97,901	7,610		105,511
Other operating expenses	23	311,310	43,116	(22,432)	332,017
Other income		(2,815)			(2,815)
Depreciation and amortization		43,865	3,082		46,947
Management fees		(3,469)	3,469		
Intercompany interest (income) expense from affiliates	(26,379)	22,409	3,970		
Interest expense	25,454	123	213		25,790
Investment (income) loss		(4,621)	4,584		(37)
Equity in net income of consolidating affiliates	(1,282)			1,282	
	(2,054)	1,423,997	114,704	(21,150)	1,515,497
Income (loss) from continuing operations before income taxes	2,054	650	(2,857)	(1,282)	(1,435)
Provision (benefit) for income taxes	269	(2,621)	10		(2,342)
Income (loss) from continuing operations	1,785	3,271	(2,867)	(1,282)	907
Income from discontinued operations, net of income taxes		1,119			1,119
Net income (loss)	1,785	4,390	(2,867)	(1,282)	2,026
Earnings attributable to noncontrolling interest			(241)		(241)
Income (loss) attributable to Kindred	$ 1,785	$ 4,390	$ (3,108)	$ (1,282)	$ 1,785

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Operations (Continued)

	Three months ended September 30, 2010				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Revenues	$	$ 1,052,459	$ 19,342	$ (18,789)	$ 1,053,012
Salaries, wages and benefits	77	613,530			613,607
Supplies		83,753			83,753
Rent		89,295			89,295
Other operating expenses	600	233,585	19,572	(18,789)	234,968
Other income		(2,794)			(2,794)
Depreciation and amortization		29,167			29,167
Management fees	32	(32)			
Intercompany interest (income) expense from affiliates	(7,960)	7,960			
Interest expense	1,606	36			1,642
Investment income		(23)	(380)		(403)
Equity in net income of consolidating affiliates	(1,455)			1,455	
	(7,100)	1,054,477	19,192	(17,334)	1,049,235
Income (loss) from continuing operations before income taxes	7,100	(2,018)	150	(1,455)	3,777
Provision (benefit) for income taxes	2,174	(3,570)	73		(1,323)
Income from continuing operations	4,926	1,552	77	(1,455)	5,100
Discontinued operations, net of income taxes:					
Loss from operations		(260)			(260)
Gain on divestiture of operations		86			86
Loss from discontinued operations		(174)			(174)
Net income	$ 4,926	$ 1,378	$ 77	$ (1,455)	$ 4,926

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Operations (Continued)

	Nine months ended September 30, 2011				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Revenues	$	$ 3,879,843	$ 184,025	$ (64,793)	$ 3,999,075
Salaries, wages and benefits	401	2,290,765	53,232		2,344,398
Supplies		282,713	11,541		294,254
Rent	3	282,524	10,114		292,641
Other operating expenses	70	850,080	93,161	(64,793)	878,518
Other income		(8,480)			(8,480)
Depreciation and amortization		112,897	4,470		117,367
Management fees		(4,627)	4,627		
Intercompany interest (income) expense from affiliates	(61,317)	56,017	5,300		
Interest expense	54,228	144	303		54,675
Investment (income) loss		(6,212)	5,423		(789)
Equity in net income of consolidating affiliates	(14,225)			14,225	
	(20,840)	3,855,821	188,171	(50,568)	3,972,584
Income (loss) from continuing operations before income taxes	20,840	24,022	(4,146)	(14,225)	26,491
Provision for income taxes	2,490	7,194	164		9,848
Income (loss) from continuing operations	18,350	16,828	(4,310)	(14,225)	16,643
Income from discontinued operations, net of income taxes		1,527			1,527