KINDRED HEALTHCARE, INC
Form 10-Q
May 08, 2009
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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 March 31, 2009

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 **(State or other jurisdiction of incorporation or organization)**	**61-1323993** **(I.R.S. Employer Identification No.)**
680 South Fourth Street	
Louisville, KY **(Address of principal executive offices)**	**40202-2412** **(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 ¨ 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 þ Accelerated filer ¨ 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 April 30, 2009**
Common stock, $0.25 par value	39,005,825 shares

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(Unaudited)

(In thousands, except per share amounts)

	Three months ended March 31, 2009	Three months ended March 31, 2008
Revenues	$ 1,083,312	$ 1,048,523
Salaries, wages and benefits	624,173	601,251
Supplies	81,159	78,632
Rent	86,779	85,180
Other operating expenses	224,179	227,303
Other income	(2,872)	(4,717)
Depreciation and amortization	30,805	31,055
Interest expense	2,478	4,921
Investment income	(1,476)	(3,248)
	1,045,225	1,020,377
Income from continuing operations before income taxes	38,087	28,146
Provision for income taxes	15,734	11,639
Income from continuing operations	22,353	16,507
Income (loss) from discontinued operations, net of income taxes	407	(1,817)
Net income	$ 22,760	$ 14,690
Earnings per common share:		
Basic:		
Income from continuing operations	$ 0.57	$ 0.43
Income (loss) from discontinued operations	0.01	(0.05)
Net income	$ 0.58	$ 0.38
Diluted:		
Income from continuing operations	$ 0.57	$ 0.42
Income (loss) from discontinued operations	0.01	(0.05)
Net income	$ 0.58	$ 0.37
Shares used in computing earnings per common share:		
Basic	38,184	37,444
Diluted	38,315	38,061

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEET

(Unaudited)

(In thousands, except per share amounts)

	March 31, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 143,450	$ 140,795
Cash restricted	5,502	5,104
Insurance subsidiary investments	159,041	196,983
Accounts receivable less allowance for loss of $25,809 March 31, 2009 and $27,548 December 31, 2008	690,431	611,032
Inventories	22,531	22,325
Deferred tax assets	57,777	58,296
Income taxes	3,827	47,257
Other	30,080	20,843
	1,112,639	1,102,635
Property and equipment	1,433,630	1,392,636
Accumulated depreciation	(687,101)	(656,676)
	746,529	735,960
Goodwill	72,806	72,244
Intangible assets less accumulated amortization of $2,006 March 31, 2009 and $1,817 December 31, 2008	64,177	64,367
Assets held for sale	7,790	7,786
Insurance subsidiary investments	46,927	48,610
Deferred tax assets	103,910	100,751
Other	50,126	49,408
	$ 2,204,904	$ 2,181,761
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 154,078	$ 178,246
Salaries, wages and other compensation	265,282	281,542
Due to third party payors	42,523	33,122
Professional liability risks	53,204	55,447
Other accrued liabilities	76,910	76,832
Long-term debt due within one year	82	81
	592,079	625,270
Long-term debt	368,612	349,433
Professional liability risks	199,823	187,804
Deferred credits and other liabilities	105,519	104,279
Commitments and contingencies		
Stockholders equity:		
	9,763	9,727

Common stock, $0.25 par value; authorized 175,000 shares; issued 39,053 shares March 31, 2009 and 38,909 shares December 31, 2008		
Capital in excess of par value	814,095	812,141
Accumulated other comprehensive loss	(4,473)	(3,619)
Retained earnings	119,486	96,726
	938,871	914,975
	$ 2,204,904	$ 2,181,761

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(Unaudited)

(In thousands)

	Three months ended March 31, 2009	Three months ended March 31, 2008
Cash flows from operating activities:		
Net income	$ 22,760	$ 14,690
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	30,805	31,405
Amortization of stock-based compensation costs	2,439	3,769
Provision for doubtful accounts	7,016	8,372
Deferred income taxes	(2,179)	(4,718)
Other	204	(576)
Change in operating assets and liabilities:		
Accounts receivable	(86,415)	(102,143)
Inventories and other assets	(7,535)	(7,172)
Accounts payable	(7,885)	352
Income taxes	43,223	41,596
Due to third party payors	9,401	(3,491)
Other accrued liabilities	(8,070)	8,122
Net cash provided by (used in) operating activities	3,764	(9,794)
Cash flows from investing activities:		
Purchase of property and equipment	(39,986)	(24,940)
Acquisitions	(15,604)	(2,080)
Sale of assets		6,479
Purchase of insurance subsidiary investments	(36,257)	(35,233)
Sale of insurance subsidiary investments	54,092	38,899
Net change in insurance subsidiary cash and cash equivalents	20,458	39,953
Other	(953)	1,094
Net cash provided by (used in) investing activities	(18,250)	24,172
Cash flows from financing activities:		
Proceeds from borrowings under revolving credit	390,800	375,000
Repayment of borrowings under revolving credit	(371,600)	(394,200)
Repayment of long-term debt	(20)	(294)
Payment of deferred financing costs	(309)	(131)
Issuance of common stock		722
Other	(1,730)	(11,460)
Net cash provided by (used in) financing activities	17,141	(30,363)
Change in cash and cash equivalents	2,655	(15,985)
Cash and cash equivalents at beginning of period	140,795	32,877

Cash and cash equivalents at end of period	$ 143,450	$ 16,892
Supplemental information:		
Interest payments	$ 2,070	$ 5,087
Income tax refunds	25,170	26,331

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 hospitals, nursing centers and a contract rehabilitation services business across the United States (collectively, the Company). At March 31, 2009, the Company s hospital division operated 82 long-term acute care (LTAC) hospitals in 24 states. The Company s health services division operated 228 nursing centers in 27 states. The Company also operated a contract rehabilitation services business that provides rehabilitative services primarily in long-term care settings.

In recent years, the Company has completed several transactions related to the divestiture of unprofitable hospitals and nursing centers to improve its future operating results. For accounting purposes, the operating results of these businesses and the gains, losses or impairments 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 March 31, 2009 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 2 for a summary of discontinued operations.

Impact of recent accounting pronouncements

In April 2009, the Financial Accounting Standards Board (the FASB) issued the following guidance related to fair value measurements and disclosures and the recognition of other-than-temporary impairments of financial instruments:

- FASB Staff Position (FSP) Statement of Financial Accounting Standards (SFAS) No. 157-4 (SFAS 157-4), Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, which provides additional guidance for determining whether the market for a security is inactive and whether transactions in inactive markets are distressed.

- FSP SFAS No. 115-2 (SFAS 115-2) and SFAS No. 124-2 (SFAS 124-2), Recognition and Presentation of Other-Than-Temporary Impairments, which clarify the recognition and measurement of other-than-temporary impairments of debt and equity securities.

- FSP SFAS No. 107-1 (SFAS 107-1) and Accounting Principles Board (APB) No. 28-1 (APB 28-1), Interim Disclosures about Fair Value of Financial Instruments, which require an entity to provide disclosures about fair value of financial instruments in both interim and annual financial statements.

The provisions above will be effective for all interim and annual reporting periods beginning after June 15, 2009 and early adoption is permitted only if all pronouncements above are adopted at the same time. The adoption of these provisions is not expected to have a material impact on the Company s business, financial position, results of operations or liquidity.

On January 1, 2009, the Company adopted FASB Staff Position Emerging Issues Task Force 03-6-1 (EITF 03-6-1), 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 which allocates earnings to the participating securities in the calculation. The adoption of EITF 03-6-1 has been applied retrospectively in the accompanying unaudited condensed consolidated financial statements and did not have a material impact on the Company s earnings per common share calculation. See Note 4.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 BASIS OF PRESENTATION (Continued)

Impact of recent accounting pronouncements (Continued)

In December 2007, the FASB issued SFAS No. 141 (revised 2007) (SFAS 141R), Business Combinations, which significantly changes the accounting for business combinations, including, among other changes, new accounting concepts in determining the fair value of assets and liabilities acquired, recording the fair value of contingent considerations and contingencies at the acquisition date and expensing acquisition and restructuring costs. SFAS 141R is applied prospectively and is effective for business combinations which occur during fiscal years beginning after December 15, 2008. The Company s adoption of SFAS 141R on January 1, 2009 did not have a material impact on the Company s business, financial position, results of operations or liquidity at March 31, 2009 or for the three months ended March 31, 2009. However, any future business combination may significantly impact the Company s financial position and results of operations when compared to acquisitions accounted for under the previous generally accepted accounting principles and may result in more earnings volatility and generally lower earnings due to the expensing of acquisition costs and restructuring costs.

In April 2009, the FASB issued FSP SFAS No. 141(R)-1 (SFAS 141(R)-1), Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies, which will amend the provisions related to the initial recognition and measurement, subsequent measurement and disclosure of assets and liabilities arising from contingencies in a business combination under SFAS 141R. SFAS 141(R)-1 is effective for all business combinations which occur during fiscal years beginning after December 15, 2008. The Company s adoption of SFAS 141(R)-1 retroactive to January 1, 2009 did not 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 March 31, 2009	Three months ended March 31, 2008
Net income	$ 22,760	$ 14,690
Net unrealized investment losses, net of income taxes	(854)	(717)
Comprehensive income	$ 21,906	$ 13,973

Other information

The accompanying unaudited condensed consolidated financial statements are 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, 2008 filed with the Securities and Exchange Commission (the SEC) on Form 10-K. The accompanying condensed consolidated balance sheet at December 31, 2008 was derived from audited 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

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 BASIS OF PRESENTATION (Continued)

Other information (Continued)

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. These changes did not have any impact on the Company s business, financial position, results of operations or liquidity.

NOTE 2 DISCONTINUED OPERATIONS

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the divestiture 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, losses or impairments related to these divestitures have been classified as discontinued operations, net of income taxes, in the accompanying unaudited condensed consolidated statement of operations.

At March 31, 2009, the Company held for sale two hospitals. The Company expects to generate approximately $7.8 million in proceeds from the sales of these two hospitals.

A summary of discontinued operations follows (in thousands):

	Three months ended March 31,	
	2009	**2008**
Revenues	$ 1,115	$ 22,780
Salaries, wages and benefits	155	13,731
Supplies	170	2,113
Rent	91	977
Other operating expenses	38	8,584
Depreciation		350
Interest expense		2
Investment income		(24)
	454	25,733
Income (loss) from operations before income taxes	661	(2,953)
Provision (benefit) for income taxes	254	(1,136)

Income (loss) from operations	$ 407	$ (1,817)

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 DISCONTINUED OPERATIONS (Continued)

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

	Three months ended March 31, 2009	Three months ended March 31, 2008
Revenues:		
Hospital division	$ 1,063	$ 15,580
Health services division	52	7,200
	$ 1,115	$ 22,780
Operating income (loss):		
Hospital division	$ (850)	$ (1,089)
Health services division	1,602	(559)
	$ 752	$ (1,648)
Rent:		
Hospital division	$ 90	$ 959
Health services division	1	18
	$ 91	$ 977
Depreciation:		
Hospital division	$	$ 350
Health services division		
	$	$ 350

A summary of the net assets held for sale follows (in thousands):

	March 31, 2009	December 31, 2008
Long-term assets:		
Property and equipment, net	$ 7,734	$ 7,730
Other	56	56
	7,790	7,786
Current liabilities (included in other accrued liabilities)	(101)	(111)

	$ 7,689	$ 7,675

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 3 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 March 31,	
	2009	2008
Medicare	$ 466,259	$ 459,306
Medicaid	274,082	266,221
Medicare Advantage	80,714	62,093
Other	334,041	327,839
	1,155,096	1,115,459
Eliminations	(71,784)	(66,936)
	$ 1,083,312	$ 1,048,523

NOTE 4 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. On January 1, 2009, the Company adopted EITF 03-6-1, 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 which allocates earnings to the participating securities in the calculation.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4 EARNINGS PER SHARE (Continued)

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

	Three months ended March 31,			
	2009		2008	
	Basic	Diluted	Basic	Diluted
Earnings:				
Income from continuing operations:				
As reported in Statement of Operations	$ 22,353	$ 22,353	$ 16,507	$ 16,507
Allocation to participating unvested restricted stockholders	(422)	(421)	(421)	(415)
Available to common stockholders	$ 21,931	$ 21,932	$ 16,086	$ 16,092
Income (loss) from discontinued operations, net of income taxes:				
As reported in Statement of Operations	$ 407	$ 407	$ (1,817)	$ (1,817)
Allocation to participating unvested restricted stockholders	(8)	(8)		
Available to common stockholders	$ 399	$ 399	$ (1,817)	$ (1,817)
Net income:				
As reported in Statement of Operations	$ 22,760	$ 22,760	$ 14,690	$ 14,690
Allocation to participating unvested restricted stockholders	(430)	(429)	(421)	(415)
Available to common stockholders	$ 22,330	$ 22,331	$ 14,269	$ 14,275
Shares used in the computation:				
Weighted average shares outstanding basic computation	38,184	38,184	37,444	37,444
Dilutive effect of employee stock options		131		617
Adjusted weighted average shares outstanding diluted computation		38,315		38,061
Earnings per common share:				
Income from continuing operations	$ 0.57	$ 0.57	$ 0.43	$ 0.42
Income (loss) from discontinued operations	0.01	0.01	(0.05)	(0.05)
Net income	$ 0.58	$ 0.58	$ 0.38	$ 0.37
Number of antidilutive stock options excluded from shares used in the diluted earnings per share computation		3,031		557

NOTE 5 BUSINESS SEGMENT DATA

At March 31, 2009, the Company operated three business segments: the hospital division, the health services division and the rehabilitation division. The hospital division operates LTAC hospitals. The health services division operates nursing centers. The rehabilitation division provides rehabilitation services primarily in long-term care settings. 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.

The Company identifies its segments in accordance with the aggregation provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. This information is consistent with information used by the Company in managing its businesses and aggregates businesses with similar economic characteristics.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 BUSINESS SEGMENT DATA (Continued)

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

	Three months ended March 31,	
	2009	2008
Revenues:		
Hospital division	$ 492,509	$ 476,167
Health services division	544,940	534,793
Rehabilitation division	117,647	104,499
	1,155,096	1,115,459
Eliminations	(71,784)	(66,936)
	$ 1,083,312	$ 1,048,523
Income from continuing operations:		
Operating income (loss):		
Hospital division	$ 100,899	$ 96,802
Health services division	75,860	74,200
Rehabilitation division	15,453	11,486
Corporate:		
Overhead	(34,087)	(34,931)
Insurance subsidiary	(1,452)	(1,503)
	(35,539)	(36,434)
Operating income	156,673	146,054
Rent	(86,779)	(85,180)
Depreciation and amortization	(30,805)	(31,055)
Interest, net	(1,002)	(1,673)
Income from continuing operations before income taxes	38,087	28,146
Provision for income taxes	15,734	11,639
	$ 22,353	$ 16,507

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 BUSINESS SEGMENT DATA (Continued)

	Three months ended March 31, 2009	2008
Rent:		
Hospital division	$ 36,445	$ 35,907
Health services division	48,852	47,883
Rehabilitation division	1,451	1,358
Corporate	31	32
	$ 86,779	$ 85,180
Depreciation and amortization:		
Hospital division	$ 12,512	$ 11,303
Health services division	12,000	14,389
Rehabilitation division	547	387
Corporate	5,746	4,976
	$ 30,805	$ 31,055
Capital expenditures, excluding acquisitions (including discontinued operations):		
Hospital division	$ 14,330	$ 13,556
Health services division	21,840	7,135
Rehabilitation division	190	282
Corporate:		
Information systems	3,453	3,832
Other	173	135
	$ 39,986	$ 24,940

	March 31, 2009	December 31, 2008
Assets at end of period:		
Hospital division	$ 898,944	$ 847,394
Health services division	611,176	574,710
Rehabilitation division	45,709	45,733
Corporate	649,075	713,924
	$ 2,204,904	$ 2,181,761
Goodwill:		
Hospital division	$ 68,577	$ 68,577
Health services division	889	639
Rehabilitation division	3,340	3,028

	$	72,806	$	72,244

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6 INSURANCE RISKS

The Company insures a substantial portion of its professional liability risks and workers compensation risks through a 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 March 31, 2009	2008
Professional liability:		
Continuing operations	$ 15,405	$ 15,922
Discontinued operations	(647)	282
Workers compensation:		
Continuing operations	$ 10,043	$ 10,338
Discontinued operations	(1,044)	268

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

	March 31, 2009			December 31, 2008		
	Professional liability	Workers compensation	Total	Professional liability	Workers compensation	Total
Assets:						
Current:						
Insurance subsidiary investments	$ 77,767	$ 81,274	$ 159,041	$ 109,494	$ 87,489	$ 196,983
Reinsurance recoverables	89		89	89		89
	77,856	81,274	159,130	109,583	87,489	197,072
Non-current:						
Insurance subsidiary investments	46,927		46,927	48,610		48,610
Reinsurance recoverables	20,826	507	21,333	17,167		17,167
Deposits	2,000	1,469	3,469	2,000	1,466	3,466
Other		131	131		142	142
	69,753	2,107	71,860	67,777	1,608	69,385

	$ 147,609	$ 83,381	$ 230,990	$ 177,360	$ 89,097	$ 266,457
Liabilities:						
Allowance for insurance risks:						
Current	$ 53,204	$ 24,286	$ 77,490	$ 55,447	$ 25,348	$ 80,795
Non-current	199,823	59,678	259,501	187,804	57,993	245,797
	$ 253,027	$ 83,964	$ 336,991	$ 243,251	$ 83,341	$ 326,592

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6 INSURANCE RISKS (Continued)

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 3% for the 2009 and 2008 policy years and 5% for all prior policy years. 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 $261.0 million at March 31, 2009 and $251.8 million at December 31, 2008.

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 7 INSURANCE SUBSIDIARY INVESTMENTS

The Company maintains investments, consisting principally of cash and cash equivalents, corporate bonds, asset backed securities, equities, commercial paper and U.S. Treasury notes 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.

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

	March 31, 2009				December 31, 2008			
	Amortized cost	Unrealized gains	Unrealized losses	Fair value	Amortized cost	Unrealized gains	Unrealized losses	Fair value
Cash and cash equivalents (a)	$ 97,690	$	$	$ 97,690	$ 118,148	$	$	$ 118,148
Corporate bonds	45,227	440	(499)	45,168	35,110	314	(698)	34,726
Asset backed securities	41,305	564	(198)	41,671	59,509	886	(292)	60,103
Equities	13,986	272	(4,496)	9,762	13,750	402	(3,307)	10,845
Commercial paper	7,199	8		7,207	9,825	34		9,859
U.S. Treasury notes	4,385	85		4,470	11,760	152		11,912
	$ 209,792	$ 1,369	$ (5,193)	$ 205,968	$ 248,102	$ 1,788	$ (4,297)	$ 245,593

(a) Includes $4.3 million and $13.2 million of money market funds at March 31, 2009 and December 31, 2008, 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 unrealized losses at March 31, 2009 to be temporary and did not record any impairment losses related to these securities in the first quarter of 2009.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7   INSURANCE SUBSIDIARY INVESTMENTS (Continued)

The decrease in total fair value of insurance subsidiary investments at March 31, 2009 from December 31, 2008 was primarily attributable to a $34 million distribution from the insurance subsidiary to the Company during the first quarter of 2009. This distribution was the result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary.

NOTE 8   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 claims 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 loss 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 6.

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.

Litigation   The Company is a party to various legal actions (some of which are not insured), and regulatory and other government investigations and sanctions in the ordinary course of business. The Company is unable to predict the ultimate outcome of pending litigation and regulatory and other government investigations. The U.S. Department of Justice (the DOJ), the Centers for Medicare and Medicaid Services (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.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 FAIR VALUE OF ASSETS AND LIABILITIES

On January 1, 2008, the Company adopted SFAS No. 157 (SFAS 157), 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.

SFAS 157 defines fair value 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. SFAS 157 also 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 standard 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 9 FAIR VALUE OF ASSETS AND LIABILITIES (Continued)

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

	Fair value measurements			Assets/liabilities
	Level 1	Level 2	Level 3	at fair value
March 31, 2009:				
Recurring:				
Assets:				
Available-for-sale securities	$ 18,579	$ 94,046	$	$ 112,625
Deposits held in money market funds	124,154			124,154
	$ 142,733	$ 94,046	$	$ 236,779
Liabilities	$	$	$	$
Non-recurring:				
Assets:				
Acquired previously leased hospital	$	$ 18,000	$	$ 18,000
Liabilities	$	$	$	$
December 31, 2008:				
Recurring:				
Assets:				
Available-for-sale securities	$ 35,960	$ 104,688	$	$ 140,648
Deposits held in money market funds	124,539			124,539
	$ 160,499	$ 104,688	$	$ 265,187
Liabilities	$	$	$	$

Recurring measurements

The Company s available-for-sale securities are held by its wholly owned limited purpose insurance subsidiary and are comprised of money market funds, corporate bonds, asset backed securities, equities, commercial paper and U.S. Treasury notes. These available-for-sale securities and the insurance subsidiary s cash and cash equivalents of $93.4 million, classified as insurance subsidiary investments, are maintained for the payment of claims and expenses related to professional liability and workers compensation risks.

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 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 estimated fair value of the Company s long-term debt at March 31, 2009 and December 31, 2008 approximated the respective carrying amounts.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 FAIR VALUE OF ASSETS AND LIABILITIES (Continued)

Non-recurring measurements

In March 2009, the Company acquired a previously leased hospital for approximately $16 million in cash and approximately $2 million in unamortized prepaid rent. The fair value of the assets was measured using Level 2 observable inputs, including replacement costs and direct sales comparisons of similar properties in the same geographic market or region.

NOTE 10 SUBSEQUENT EVENTS

On April 30, 2009, the Company entered into agreements with Ventas, Inc. (Ventas) to renew the master lease agreements for an additional five years for 87 nursing centers and 22 LTAC hospitals (collectively, the Renewal Facilities). The initial lease term for the Renewal Facilities was scheduled to expire in April 2010. In addition, the Company entered into definitive agreements with Ventas to purchase for resale six under-performing nursing centers currently leased from Ventas.

Facility renewals

The Renewal Facilities contain 10,745 licensed nursing center beds and 1,754 licensed hospital beds. The Company s option to renew the leases on the Renewal Facilities would have expired on April 30, 2009. No additional rent or other consideration was paid in connection with these renewals. The effectiveness of the renewals is contingent upon there being no events of default under the master lease agreements upon the renewal effective date in April 2010.

Facility acquisitions

The Company agreed to acquire the real estate related to six nursing centers currently leased from Ventas (the Nursing Centers) for $55.7 million. In addition, the Company will pay a lease termination fee of $2.3 million. The current aggregate annual rent for the Nursing Centers is approximately $6 million.

The Nursing Centers, which contain 777 licensed beds, generated pretax losses of approximately

$3 million for the year ended December 31, 2008 and approximately $2 million for the three months ended March 31, 2009. Upon the purchase of the Nursing Centers, the Company expects to account for the operations of the Nursing Centers and the loss on these transactions as discontinued operations.

Following the transactions with Ventas, the Company intends to dispose of the Nursing Centers as soon as practicable. The Company expects to generate approximately $10 million to $15 million in proceeds from the sale of the Nursing Centers and the related operations. The Company expects to record a net loss of approximately $30 million to $35 million in the second quarter of 2009 relating to these divestitures.

The closing of the facility acquisitions is subject to the satisfaction of customary conditions to closing.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Cautionary Statement

This Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). All statements regarding the Company s expected future financial position, results of operations, cash flows, financing plans, business strategy, budgets, capital expenditures, competitive positions, growth opportunities, plans and objectives of management and statements containing the words such as anticipate, approximate, believe, plan, estimate, expect, project, could, should, will, intend, may and other similar expressions, are forward-looking statements.

Such forward-looking statements are inherently uncertain, and stockholders and other potential investors must recognize that actual results may differ materially from the Company s expectations as a result of a variety of factors, including, without limitation, those discussed below. Such forward-looking statements are based upon management s current expectations and include known and unknown risks, uncertainties and other factors, many of which the Company is unable to predict or control, that may cause the Company s actual results or performance to differ materially from any future results or performance expressed or implied by such forward-looking statements. These statements involve risks, uncertainties and other factors discussed below and detailed from time to time in the Company s filings with the SEC. Factors that may affect the Company s plans or results include, without limitation:

- changes in the reimbursement rates or the methods or timing of payment from third party payors, including the Medicare and Medicaid programs, changes arising from and related to the Medicare prospective payment system for LTAC hospitals (LTAC PPS), including potential changes in the Medicare payment rules, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, and changes in Medicare and Medicaid reimbursements for the Company s nursing centers,

- the impact of the Medicare, Medicaid and SCHIP Extension Act of 2007 (the SCHIP Extension Act), including the ability of the Company s hospitals to adjust to potential LTAC certification, medical necessity reviews and the three-year moratorium on future hospital development,

- the effects of healthcare reform and government regulations, interpretation of regulations and changes in the nature and enforcement of regulations governing the healthcare industry,

- failure of the Company s facilities to meet applicable licensure and certification requirements,

- the further consolidation of managed care organizations and other third party payors,

- the Company s ability to meet its rental and debt service obligations,

- the Company s ability to operate pursuant to the terms of its debt obligations and its master lease agreements with Ventas,

- the condition of the financial markets, including volatility and deterioration in the equity, capital and credit markets, which could limit the availability and terms of debt and equity financing sources to fund the requirements of the Company s businesses, or which could negatively impact the Company s investment portfolio, national and regional economic, financial, business and political conditions, including their effect on the availability and cost of labor, credit, materials and other services,

the Company s ability to control costs, particularly labor and employee benefit costs,

increased operating costs due to shortages in qualified nurses, therapists and other healthcare personnel,

the Company s ability to attract and retain key executives and other healthcare personnel,

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Cautionary Statement (Continued)

the increase in the costs of defending and insuring against alleged professional liability claims and the Company s ability to predict the estimated costs related to such claims, including the impact of differences in actuarial assumptions and estimates compared to eventual outcomes,

the Company s ability to successfully reduce (by divestiture of operations or otherwise) its exposure to professional liability claims,

the Company s ability to successfully pursue its development activities and successfully integrate new operations, including the realization of anticipated revenues, economies of scale, cost savings and productivity gains associated with such operations,

the Company s ability to successfully dispose of unprofitable facilities,

events or circumstances which could result in impairment of an asset or other charges,

changes in generally accepted accounting principles or practices, and

the Company s ability to maintain an effective system of internal control over financial reporting.

Many of these factors are beyond the Company s control. The Company cautions investors that any forward-looking statements made by the Company are not guarantees of future performance. The Company disclaims any obligation to update any such factors or to announce publicly the results of any revisions to any of the forward-looking statements to reflect future events or developments.

General

The accompanying unaudited condensed consolidated financial statements, including the notes thereto, should be read in conjunction with the following discussion and analysis.

The Company is a healthcare services company that through its subsidiaries operates hospitals, nursing centers and a contract rehabilitation services business across the United States. At March 31, 2009, the Company s hospital division operated 82 LTAC hospitals (6,520 licensed beds) in 24 states. The Company s health services division operated 228 nursing centers (28,400 licensed beds) in 27 states. The Company also operated a contract rehabilitation services business that provides rehabilitative services primarily in long-term care settings.

In recent years, the Company has completed several strategic divestitures to improve its future operating results. For accounting purposes, the operating results of these businesses and the gains, losses or impairments 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 March 31, 2009 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.

Critical Accounting Policies

Management s discussion and analysis of financial condition and results of operations are based upon the Company s consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that affect the reported amounts and related disclosures of commitments and contingencies. The Company relies on historical experience and on various other assumptions that management believes to be reasonable under the circumstances to make judgments about the carrying values of assets and

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Critical Accounting Policies (Continued)

liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates.

The Company believes the following critical accounting policies, among others, affect the more significant judgments and estimates used in the preparation of its consolidated financial statements.

Revenue recognition

The Company has agreements with third party payors that provide for payments to each of its operating divisions. These payment arrangements may be based upon prospective rates, reimbursable costs, established charges, discounted charges or per diem payments. Net patient service revenue is recorded at the estimated net realizable amounts from Medicare, Medicaid, Medicare Advantage, other third party payors and individual patients for services rendered. Retroactive adjustments that are likely to result from future examinations by third party payors are accrued on an estimated basis in the period the related services are rendered and adjusted as necessary in future periods based upon new information or final settlements.

Collectibility of accounts receivable

Accounts receivable consist primarily of amounts due from the Medicare and Medicaid programs, other government programs, managed care health plans, commercial insurance companies and individual patients and customers. Estimated provisions for doubtful accounts are recorded to the extent it is probable that a portion or all of a particular account will not be collected.

In evaluating the collectibility of accounts receivable, the Company considers a number of factors, including the age of the accounts, changes in collection patterns, the composition of patient accounts by payor type, the status of ongoing disputes with third party payors and general industry conditions. Actual collections of accounts receivable in subsequent periods may require changes in the estimated provision for loss. Changes in these estimates are charged or credited to the results of operations in the period of the change.

The provision for doubtful accounts totaled $7 million in the first quarter of both 2009 and 2008.

Allowances for insurance risks

The Company insures a substantial portion of its professional liability risks and workers compensation risks through a 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.

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 3% for the 2009 and 2008 policy years and 5% for all prior policy years. 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. The

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Critical Accounting Policies (Continued)

Allowances for insurance risks (Continued)

allowance for professional liability risks aggregated $253 million at March 31, 2009 and $243 million at December 31, 2008. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated $261 million at March 31, 2009 and $252 million at December 31, 2008.

As a result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary, the Company received distributions of $34 million and $39 million during the first quarter of 2009 and 2008, respectively, from its limited purpose insurance subsidiary. These proceeds were used to repay borrowings under the Company s revolving credit facility and had no impact on earnings.

Changes in the number of professional liability claims and the cost to settle these claims significantly impact the allowance for professional liability risks. A relatively small variance between the Company s estimated and actual number of claims or average cost per claim could have a material impact, either favorable or unfavorable, on the adequacy of the allowance for professional liability risks. For example, a 1% variance in the allowance for professional liability risks at March 31, 2009 would impact the Company s operating income by approximately $3 million.

The provision for professional liability risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated $15 million and $16 million in the first quarter of 2009 and 2008, respectively.

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. The allowance for workers compensation risks aggregated $84 million at March 31, 2009 and $83 million at December 31, 2008. The provision for workers compensation risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated $10 million in the first quarter of both 2009 and 2008.

Accounting for income taxes

The provision for income taxes is based upon the Company s estimate of annual taxable income or loss for each respective accounting period. The Company recognizes an asset or liability for the deferred tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements. These temporary differences will result in taxable or deductible amounts in future years when the reported amounts of the assets are recovered or liabilities are settled. The Company also recognizes as deferred tax assets the future tax benefits from net operating and capital loss carryforwards. A valuation allowance is provided for these deferred tax assets if it is more likely than not that some portion or all of the net deferred tax assets will not be realized.

The Company s effective income tax rate was 41.3% and 41.4% in the first quarter of 2009 and 2008, respectively.

There are significant uncertainties with respect to capital loss carryforwards that could affect materially the realization of certain deferred tax assets. Accordingly, the Company has recognized deferred tax assets to the extent it is more likely than not they will be realized and a valuation allowance is provided for deferred tax assets to the extent that it is uncertain that the deferred tax asset will be realized. The Company recognized net deferred tax assets totaling $162 million at March 31, 2009 and $159 million at December 31, 2008.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Critical Accounting Policies (Continued)

Accounting for income taxes (Continued)

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. While the Company believes its tax positions are appropriate, there can be no assurance that the various authorities engaged in the examination of its income tax returns will not challenge the Company s positions.

Valuation of long-lived assets and goodwill

The Company regularly reviews the carrying value of certain long-lived assets and identifiable intangible assets with respect to any events or circumstances that indicate an impairment or an adjustment to the amortization period is necessary. If circumstances suggest the recorded amounts cannot be recovered based upon estimated future undiscounted cash flows, the carrying values of such assets are reduced to fair value.

In assessing the carrying values of long-lived assets, the Company estimates future cash flows at the lowest level for which there are independent, identifiable cash flows. For this purpose, these cash flows are aggregated based upon the contractual agreements underlying the operation of the facility or group of facilities. Generally, an individual facility is considered the lowest level for which there are independent, identifiable cash flows. However, to the extent that groups of facilities are leased under a master lease agreement in which the operations of a facility and compliance with the lease terms are interdependent upon other facilities in the agreement (including the Company s ability to renew the lease or divest a particular property), the Company defines the group of facilities under a master lease agreement as the lowest level for which there are independent, identifiable cash flows. Accordingly, the estimated cash flows of all facilities within a master lease agreement are aggregated for purposes of evaluating the carrying values of long-lived assets.

The Company s other intangible assets with finite lives are amortized under SFAS No. 142 (SFAS 142), Goodwill and Other Intangible Assets, using the straight-line method over their estimated useful lives ranging from one to five years.

In accordance with SFAS 142, the Company is required to perform an impairment test for goodwill and indefinite lived intangible assets at least annually or more frequently if adverse events or changes in circumstances indicate that the asset may be impaired. The Company performs its annual goodwill impairment test at the end of each fiscal year for each of its reporting units. A reporting unit is either an operating segment or one level below the operating segment, referred to as a component. Because the components within the Company s operating segments have similar economic characteristics, the Company aggregates the components of its operating segments into one reporting unit. Accordingly, the Company has determined that its reporting units are hospitals, nursing centers, and rehabilitation services.

The goodwill impairment test involves a two-step process. The first step is a comparison of each reporting unit s fair value to its carrying value. If the carrying value of the reporting unit is greater than its fair value, there is an indication that impairment may exist and the second step must be performed to measure the amount of impairment loss. Based upon the results of the step one impairment test for goodwill and the impairment test of indefinite lived intangible assets, no impairment charges were recorded in connection with the Company s annual impairment tests at December 31, 2008.

Since quoted market prices for the Company s reporting units are not available, the Company applies judgment in determining the fair value of these reporting units for purposes of performing the goodwill

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Critical Accounting Policies (Continued)

Valuation of long-lived assets and goodwill (Continued)

impairment test. The Company relies on widely accepted valuation techniques, including equally weighted discounted cash flow and market multiple analyses approaches, which capture both the future income potential of the reporting unit and the market behaviors and actions of market participants in the industry that includes the reporting unit. These types of analyses require the Company to make assumptions and estimates regarding future cash flows, industry-specific economic factors and the profitability of future business strategies. The discounted cash flow approach uses a projection of estimated operating results and cash flows that are discounted using a weighted average cost of capital. Under the discounted cash flow approach, the projection uses management s best estimates of economic and market conditions over the projected period including growth rates in the number of admissions, patient days, reimbursement rates, operating costs, rent expense and capital expenditures. Other significant estimates and assumptions include terminal value growth rates, changes in working capital requirements and weighted average cost of capital. The market multiple analysis estimates fair value by applying cash flow multiples to the reporting unit s operating results. The multiples are derived from comparable publicly traded companies with similar operating and investment characteristics to the reporting units.

The fair values of the Company s indefinite lived intangible assets, primarily hospital certificates of need, are estimated using an excess earnings method, a form of discounted cash flow, which is based upon the concept that net after-tax cash flows provide a return supporting all of the assets of a business operation. The fair values of the Company s indefinite lived intangible assets are derived from projections which include management s best estimates of economic and market conditions over the projected period including growth rates in the number of admissions, patient days, reimbursement rates, operating costs, rent expense and capital expenditures. Other significant estimates and assumptions include terminal value growth rates, changes in working capital requirements and weighted average cost of capital.

The Company has determined that during the first quarter of 2009 there were no events or changes in circumstances since December 31, 2008 requiring an interim impairment test. Although the Company has determined that there was no goodwill or other indefinite lived intangible asset impairments as of March 31, 2009 and December 31, 2008, continued declines in the value of the Company s common stock or adverse changes in the operating environment and related key assumptions used to determine the fair value of the Company s reporting units and indefinite lived intangible assets may result in future impairment charges for a portion or all of these assets. An impairment charge could have a material adverse effect on the Company s business, financial position and results of operations, but would not be expected to have an impact on the Company s cash flows or liquidity.

Recently Issued Accounting Pronouncements

In April 2009, the FASB issued the following guidance related to fair value measurements and disclosures and the recognition of other-than-temporary impairments of financial instruments:

SFAS 157-4, which provides additional guidance for determining whether the market for a security is inactive and whether transactions in inactive markets are distressed.

SFAS 115-2 and SFAS 124-2, which clarify the recognition and measurement of other-than-temporary impairments of debt and equity securities.

SFAS 107-1 and APB 28-1, which require an entity to provide disclosures about fair value of financial instruments in both interim and annual financial statements.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Recently Issued Accounting Pronouncements (Continued)

The provisions above will be effective for all interim and annual reporting periods beginning after June 15, 2009 and early adoption is permitted only if all pronouncements above are adopted at the same time. The adoption of these provisions is not expected to have a material impact on the Company s business, financial position, results of operations or liquidity.

On January 1, 2009, the Company adopted EITF 03-6-1, 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 which allocates earnings to the participating securities in the calculation. The adoption of EITF 03-6-1 has been applied retrospectively in the accompanying unaudited condensed consolidated financial statements and did not have a material impact on the Company s earnings per common share calculation.

In December 2007, the FASB issued SFAS 141R, which significantly changes the accounting for business combinations, including, among other changes, new accounting concepts in determining the fair value of assets and liabilities acquired, recording the fair value of contingent considerations and contingencies at the acquisition date and expensing acquisition and restructuring costs. SFAS 141R is applied prospectively and is effective for business combinations which occur during fiscal years beginning after December 15, 2008. The Company s adoption of SFAS 141R on January 1, 2009 did not have a material impact on the Company s business, financial position, results of operations or liquidity at March 31, 2009 or for the three months ended March 31, 2009. However, any future business combination may significantly impact the Company s financial position and results of operations when compared to acquisitions accounted for under the previous generally accepted accounting principles and may result in more earnings volatility and generally lower earnings due to the expensing of acquisition costs and restructuring costs.

In April 2009, the FASB issued SFAS 141(R)-1, which will amend the provisions related to the initial recognition and measurement, subsequent measurement and disclosure of assets and liabilities arising from contingencies in a business combination under SFAS 141R. SFAS 141(R)-1 is effective for all business combinations which occur during fiscal years beginning after December 15, 2008. The Company s adoption of SFAS 141(R)-1 retroactive to January 1, 2009 did not have a material impact on the Company s business, financial position, results of operations or liquidity.

Results of Operations Continuing Operations

Hospital division

Revenues increased 3% in the first quarter of 2009 to $493 million compared to $476 million in the first quarter of 2008, primarily from reimbursement rate increases resulting from higher average patient acuity levels, increases in non-government same-store volumes and ongoing development of new hospitals. Reported total admissions declined 2% from last year partly resulting from leap year in 2008. On a same-store basis, aggregate admissions declined 1% in the first quarter of 2009 compared to the first quarter of 2008, while non-government same-store admissions increased 12% in the first quarter of 2009 compared to the first quarter of 2008.

Hospital operating margins improved in the first quarter of 2009 primarily because increases in reimbursement rates exceeded growth in wage, benefit and other operating expenses. Hospital wage and benefit costs increased 2% to $218 million in the first quarter of 2009 compared to $214 million in the first quarter of 2008. Average hourly wage rate increases moderated to 2% in the first quarter of 2009 compared to the first quarter of 2008, while employee benefit costs increased 3% in the first quarter of 2009 compared to the first quarter of 2008.

Professional liability costs were $6 million in the first quarter of both 2009 and 2008.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Results of Operations Continuing Operations (Continued)

Health services division

Revenues increased 2% in the first quarter of 2009 to $545 million compared to $535 million in the first quarter of 2008. Revenue growth in the first quarter of 2009 was primarily attributable to reimbursement rate increases that reflected both inflationary adjustments and higher average patient acuity. On a same-store basis, aggregate patient days declined 3% in the first quarter of 2009 compared to the first quarter of 2008. Medicare same-store patient days declined 7% and non-government same-store patient days were relatively unchanged in the first quarter of 2009 compared to the first quarter of 2008.

Nursing center operating margins in the first quarter of 2009 were the same as last year since revenue and operating expenses each grew approximately 2% in the first quarter of 2009 compared to the same period in 2008. Nursing center wage and benefit costs increased 2% to $282 million in the first quarter of 2009 compared to $275 million in the first quarter of 2008. Average hourly wage rate increases moderated to 3% in the first quarter of 2009 compared to the first quarter of 2008, while employee benefit costs increased 5% in the first quarter of 2009 compared to the first quarter of 2008.

Professional liability costs were $9 million and $10 million in the first quarter of 2009 and 2008, respectively.

Rehabilitation division

Revenues increased 13% to $117 million in the first quarter of 2009 compared to $105 million in the first quarter of 2008. The increase in revenues in the first quarter of 2009 was primarily attributable to growth in both new contracts and the volume of services provided to existing customers. Revenues derived from unaffiliated customers aggregated $45 million in the first quarter of 2009 compared to $38 million in the first quarter of 2008.

Operating margins in the first quarter of 2009 increased primarily due to growth in new contracts, the volume of services provided to existing customers and improvements in therapist productivity levels.

Corporate overhead

Operating income for the Company s operating divisions excludes allocations of corporate overhead. These costs aggregated $34 million in the first quarter of 2009 compared to $35 million in the first quarter of 2008. As a percentage of consolidated revenues, corporate overhead totaled 3.1% in the first quarter of 2009 compared to 3.3% in the first quarter of 2008.

Corporate expenses included the operating losses from the Company s limited purpose insurance subsidiary of $1 million in the first quarter of both 2009 and 2008.

Capital costs

Rent expense increased 2% to $87 million in the first quarter of 2009 compared to $85 million in the first quarter of 2008. The increase resulted primarily from contractual inflation and contingent rent increases.

Depreciation and amortization expense was relatively unchanged at $31 million in the first quarter of 2009 compared to the first quarter of 2008.

Interest expense aggregated $2 million in the first quarter of 2009 compared to $5 million in the first quarter of 2008. The decline was primarily attributable to lower interest rates under the Company s revolving credit facility compared to the same period last year.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Results of Operations Continuing Operations (Continued)

Capital costs (Continued)

Investment income related primarily to the Company s insurance subsidiary investments totaled $1 million in the first quarter of 2009 compared to $3 million in the first quarter of 2008. The decline was primarily attributable to lower investment yields in the Company s insurance subsidiary s investment portfolio compared to the same period last year.

Consolidated results

Income from continuing operations before income taxes increased 35% to $38 million in the first quarter of 2009 compared to $28 million in the first quarter of 2008. Income from continuing operations increased 35% to $22 million in the first quarter of 2009 compared to $17 million in the first quarter of 2008.

Results of Operations Discontinued Operations

Income from discontinued operations aggregated $0.4 million in the first quarter of 2009 compared to a loss of $2 million in the first quarter of 2008.

Liquidity

Operating cash flows and financing activities

Cash flows provided by operations (including discontinued operations) aggregated $4 million in the first quarter of 2009 compared to cash flows used in operations of $10 million in the first quarter of 2008. Operating cash flows in both periods were negatively impacted by the growth in accounts receivable. Operating cash flows in both periods were favorably impacted by federal income tax refunds of $25 million for each of the three months ended March 31, 2009 and 2008. During both periods, the Company maintained sufficient liquidity to fund its ongoing capital expenditure program and finance ongoing hospital development expenditures, as well as its acquisition and strategic divestiture activities.

Cash and cash equivalents totaled $144 million at March 31, 2009 compared to $141 million at December 31, 2008. The Company s long-term debt at March 31, 2009 aggregated $369 million (substantially all of which related to borrowings under the Company s revolving credit facility). Based upon the Company s existing cash levels, expected operating cash flows and capital spending (including planned acquisition and development activities), and the availability of borrowings under the Company s revolving credit facility, management believes that the Company has the necessary financial resources to satisfy its expected short-term and foreseeable long-term liquidity needs.

On April 30, 2009, the Company entered into agreements with Ventas to renew the master lease agreements for the Renewal Facilities. The initial lease term for the Renewal Facilities was scheduled to expire in April 2010. In addition, the Company entered into definitive agreements with Ventas to purchase for resale the Nursing Centers.

The Renewal Facilities contain 10,745 licensed nursing center beds and 1,754 licensed hospital beds. The Company s option to renew the leases on the Renewal Facilities would have expired on April 30, 2009. No additional rent or other consideration was paid in connection with these renewals. The effectiveness of the renewals is contingent upon there being no events of default under the master lease agreements upon the renewal effective date in April 2010.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Liquidity (Continued)

Operating cash flows and financing activities (Continued)

The Company agreed to acquire the real estate related to the Nursing Centers for approximately $56 million. In addition, the Company will pay a lease termination fee of approximately $2 million. The current aggregate annual rent for the Nursing Centers is approximately $6 million.

The Nursing Centers, which contain 777 licensed beds, generated pretax losses of approximately $3 million for the year ended December 31, 2008 and approximately $2 million for the three months ended March 31, 2009. Upon the purchase of the Nursing Centers, the Company expects to account for the operations of the Nursing Centers and the loss on these transactions as discontinued operations.

Following the transactions with Ventas, the Company intends to dispose of the Nursing Centers as soon as practicable. The Company expects to generate approximately $10 million to $15 million in proceeds from the sale of the Nursing Centers and the related operations. The Company expects to record a net loss of approximately $30 million to $35 million in the second quarter of 2009 relating to these divestitures.

As a result of improved professional liability underwriting results of the Company s limited purpose insurance subsidiary, the Company received distributions of $34 million and $39 million during the first quarter of 2009 and 2008, respectively, from its limited purpose insurance subsidiary. These proceeds were used to repay borrowings under the Company s revolving credit facility and had no impact on earnings.

Under the terms of the Company s $500 million revolving credit facility, the aggregate amount of the credit may be increased to $600 million at the Company s option subject to lender approval and certain other conditions. The term of the Company s revolving credit facility expires in July 2012.

Interest rates under the Company s revolving credit facility are based, at the Company s option, upon (a) the London Interbank Offered Rate (LIBOR) plus the applicable margin or (b) the applicable margin plus the higher of the prime rate or 0.5% over the federal funds rate. The Company s revolving credit facility is collateralized by substantially all of the Company s assets including certain owned real property and is guaranteed by substantially all of the Company s subsidiaries. The terms of the Company s revolving credit facility include a certain defined fixed payment ratio covenant and covenants which limit acquisitions and annual capital expenditures. The Company was in compliance with the terms of its revolving credit facility at March 31, 2009.

Despite the recent turmoil within the financial markets both nationally and globally, the Company is not aware of any individual lender limitations to extend credit under its revolving credit facility. However, the obligations of each of the lending institutions in the Company s revolving credit facility are separate and the availability of future borrowings under the Company s revolving credit facility could be impacted by the ongoing volatility and disruptions in the financial credit markets or other events.

Strategic divestitures

The Company expects to dispose of two hospitals in 2009 and generate approximately $8 million in proceeds from the sales.

During the first quarter of 2008, the Company sold two nursing centers for approximately $6 million.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Capital Resources

Excluding acquisitions, capital expenditures totaled $40 million in the first quarter of 2009 compared to $25 million in the first quarter of 2008. Excluding acquisitions, routine capital expenditures could approximate $100 million to $110 million in 2009, while hospital development could approximate $50 million to $60 million in 2009. Management believes that its capital expenditure program is adequate to improve and equip existing facilities. The Company s capital expenditure program is financed generally through the use of internally generated funds. At March 31, 2009, the estimated cost to complete and equip construction in progress approximated $48 million.

At March 31, 2009, the Company s remaining permitted acquisition amount under its revolving credit facility aggregated $284 million.

In March 2009, the Company acquired a previously leased hospital for approximately $16 million in cash and approximately $2 million in unamortized prepaid rent. Annual rent associated with this facility approximated $2 million.

Other Information

Effects of inflation and changing prices

The Company derives a substantial portion of its revenues from the Medicare and Medicaid programs. Congress and certain state legislatures have enacted or may enact additional significant cost containment measures limiting the Company s ability to recover its cost increases through increased pricing of its healthcare services. Medicare revenues in LTAC hospitals and nursing centers are subject to fixed payments under the Medicare prospective payment systems.

Medicaid reimbursement rates in many states in which the Company operates nursing centers also are based upon fixed payment systems. Generally, these rates are adjusted annually for inflation. However, these adjustments may not reflect the actual increase in the costs of providing healthcare services.

LTAC PPS maintains LTAC hospitals as a distinct provider type, separate from short-term acute care hospitals. Only providers certified as LTAC hospitals may be paid under this system. To maintain certification under LTAC PPS, a hospital s average length of stay for Medicare patients must be at least 25 days.

CMS is currently evaluating various certification criteria for designating a hospital as a LTAC hospital. If such certification criteria were developed and enacted into legislation, the Company s hospitals may not be able to maintain their status as LTAC hospitals or may need to adjust their operations.

The SCHIP Extension Act became law on December 29, 2007. This legislation provides for, among other things:

(1) a mandated study by the Secretary of Health and Human Services on the establishment of LTAC hospital certification criteria;

(2) enhanced medical necessity review of LTAC hospital cases;

(3) a three-year moratorium on the establishment of a LTAC hospital or satellite facility, subject to exceptions for facilities under development;

(4)

a three-year moratorium on an increase in the number of licensed beds at a LTAC hospital or satellite facility, subject to exceptions for states where there is only one other LTAC hospital and upon request following the closure or decrease in the number of licensed beds at a LTAC hospital within the state;

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Other Information (Continued)

Effects of inflation and changing prices (Continued)

(5) a three-year moratorium on the application of a one-time budget neutrality adjustment to payment rates to LTAC hospitals under LTAC PPS;

(6) a three-year moratorium on very short-stay outlier payment reductions to LTAC hospitals initially implemented on May 1, 2007;

(7) a three-year moratorium on the application of the so-called 25 Percent Rule to freestanding LTAC hospitals;

(8) a three-year period during which LTAC hospitals that are co-located with another hospital may admit up to 50% of their patients from their host hospitals and still be paid according to LTAC PPS;

(9) a three-year period during which LTAC hospitals that are co-located with an urban single hospital or a hospital that generates more than 25% of the Medicare discharges in a metropolitan statistical area (MSA Dominant hospital) may admit up to 75% of their patients from such urban single hospital or MSA Dominant hospital and still be paid according to LTAC PPS; and

(10) the elimination of the July 1, 2007 market basket increase in the standard federal payment rate of 0.71%, effective for discharges occurring on or after April 1, 2008.

On May 1, 2007, CMS issued regulatory changes regarding Medicare reimbursement for LTAC hospitals (the 2007 Final Rule) that became effective for discharges occurring on or after July 1, 2007. The 2007 Final Rule was amended on June 29, 2007 by revising the high cost outlier threshold. The 2007 Final Rule projected an overall decrease in payments to all Medicare certified LTAC hospitals of approximately 1.2%. Included in the 2007 Final Rule were (1) an increase to the standard federal payment rate of 0.71% (which was eliminated for discharges occurring on or after April 1, 2008 by the SCHIP Extension Act); (2) revisions to payment methodologies impacting short-stay outliers, which reduce payments by 0.9% (currently subject to a three-year moratorium pursuant to the SCHIP Extension Act); (3) adjustments to the wage index component of the federal payment resulting in projected reductions in payments of 0.5%; (4) an increase in the high cost outlier threshold per discharge to $20,707, resulting in projected reductions of 0.4%; and (5) an extension of the policy known as the 25 Percent Rule to all LTAC hospitals, with a three-year phase-in, which CMS projected would not result in payment reductions for the first year of implementation (also currently subject to a three-year moratorium pursuant to the SCHIP Extension Act).

In the 2007 Final Rule, the so-called 25 Percent Rule was expanded to all LTAC hospitals, regardless of whether they are co-located with another hospital. Under the 2007 Final Rule, all LTAC hospitals were to be paid the LTAC PPS rates for admissions from a single referral source up to 25% of aggregate Medicare admissions. Patients reaching high cost outlier status in the short-term hospital were not to be counted when computing the 25% limit. Admissions beyond the 25% threshold were to be paid at a lower amount based upon short-term acute care hospital rates. However, as set forth above, the SCHIP Extension Act has placed a three-year moratorium on the expansion of the 25 Percent Rule to freestanding hospitals. In addition, the SCHIP Extension Act provides for a three-year period during which (1) LTAC hospitals that are co-located with another hospital may admit up to 50% of their patients from their host hospitals and still be paid according to LTAC PPS, and (2) LTAC hospitals that are co-located with an urban single hospital or a MSA Dominant hospital may admit up to 75% of their patients from such urban single or MSA Dominant hospital and still be paid according to LTAC PPS.

On May 2, 2008, CMS issued regulatory changes regarding Medicare reimbursement for LTAC hospitals (the 2008 Final Rule) that became effective for discharges occurring on or after July 1, 2008. The 2008 Final

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Other Information (Continued)

Effects of inflation and changing prices (Continued)

Rule projected an overall increase in payments to all Medicare certified LTAC hospitals of approximately 2.5%. Included in the 2008 Final Rule were (1) an increase to the standard federal payment rate of 2.7% (as compared to the adjusted federal rate for discharges occurring on or after April 1, 2008 by the SCHIP Extension Act); (2) adjustments to the wage index component of the federal payment resulting in projected reductions in payments of 0.1%; (3) an increase in the high cost outlier threshold per discharge to $22,960; and (4) an extension of the rate year cycle for one year to September 30, 2009, in order to be consistent thereafter with the federal fiscal year that begins October 1 of each year.

CMS has regulations governing payments to LTAC hospitals that are co-located with another hospital, such as a hospital-in-hospital (HIH). The rules generally limit Medicare payments to the HIH if the Medicare admissions to the HIH from the host hospital exceed 25% of the total Medicare discharges for the HIH s cost reporting period. There are limited exceptions for admissions from rural, urban single and MSA Dominant hospitals. Admissions that exceed this 25 Percent Rule are paid using the short-term acute care inpatient payment system (IPPS). Patients transferred after they have reached the short-term acute care outlier payment status are not counted toward the admission threshold. Patients admitted prior to meeting the admission threshold, as well as Medicare patients admitted from a non-host hospital, are eligible for the full payment under LTAC PPS. If the HIH s admissions from the host hospital exceed the limit in a cost reporting period, Medicare will pay the lesser of (1) the amount payable under LTAC PPS or (2) the amount payable under IPPS. At March 31, 2009, the Company operated 16 HIHs with 692 licensed beds.

On August 1, 2007, CMS issued final regulations regarding Medicare hospital inpatient payments to short-term acute care hospitals as well as certain provisions affecting LTAC hospitals. These regulations adopt a new system for classifying patients into diagnostic categories called Medicare Severity Diagnosis Related Groups or more specifically, for LTAC hospitals, MS-LTC-DRGs. LTAC PPS is based upon discharged-based MS-LTC-DRGs similar to the system used to pay short-term acute care hospitals. This new MS-LTC-DRG system replaces the previous diagnostic related group system for LTAC hospitals and became effective for discharges occurring on or after October 1, 2007. The MS-LTC-DRG system creates additional severity-adjusted categories for most diagnoses, resulting in an expansion of the aggregate number of diagnostic groups from 538 to 745. CMS stated that MS-LTC-DRG weights were developed in a budget neutral manner and as such, the estimated aggregate payments under LTAC PPS would be unaffected by the annual recalibration of MS-LTC-DRG payment weights.

On July 31, 2008, CMS issued final regulations regarding the re-weighting of MS-LTC-DRGs for discharges occurring on or after October 1, 2008. CMS announced that this update was made in a budget neutral manner, and that estimated aggregate LTAC Medicare payments would be unaffected by these regulations. Based upon the Company s experience under these final regulations, it appears that the re-weighting increased payments for the care of higher acuity patients.

On May 1, 2009, CMS issued proposed regulations regarding Medicare reimbursement for LTAC hospitals for the fiscal year beginning October 1, 2009. These proposed regulations include a recalibration of the MS-LTC-DRG payment weights as well as updates to the payment rates. CMS indicated that these proposed changes will result in a 2.8% increase to average Medicare payments to LTAC hospitals. These proposed regulations are expected to be finalized in the third quarter of 2009.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Other Information (Continued)

Effects of inflation and changing prices (Continued)

The Company cannot predict the ultimate long-term impact of LTAC PPS. This payment system is subject to significant change. Slight variations in patient acuity or length of stay could significantly change Medicare revenues generated under LTAC PPS. In addition, the Company s hospitals may not be able to appropriately adjust their operating costs to changes in patient acuity and length of stay or to changes in reimbursement rates. In addition, there can be no assurance that LTAC PPS will not have a material adverse effect on revenues from non-government third party payors. Various factors, including a reduction in average length of stay, have negatively impacted revenues from non-government third party payors in recent years.

On July 31, 2008, CMS issued final regulations regarding Medicare reimbursement for nursing centers for the fiscal year beginning October 1, 2008. These regulations included, among other things, a market basket increase to the federal payment rates of 3.4% and updates to the wage indexes which adjust the federal payment. CMS estimates that the overall impact of these proposed changes will be a net increase in payments of 3.4%.

On May 1, 2009, CMS issued proposed regulations regarding Medicare reimbursement for nursing centers for the fiscal year beginning October 1, 2009. Included in these proposed regulations is (1) a market basket increase to the resource utilization grouping (RUG) payment rates of 2.1% and (2) a reduction in the RUG indexes attributed to a CMS forecast error in a prior year, resulting in a 3.3% reduction in payments. CMS estimated that these proposed changes will result in a net decrease in Medicare payments to nursing centers of 1.2%. These proposed regulations are expected to be finalized in the third quarter of 2009.

In addition, for the fiscal year beginning October 1, 2010, CMS proposed increasing the number of RUG categories for nursing centers from 53 to 66 and amending the criteria, including the provision of therapy services, currently used to classify patients into these categories. CMS has indicated that these changes will be enacted in a budget neutral manner.

On February 1, 2006, Congress passed the Deficit Reduction Act of 2005. This legislation provided for, among other things, an annual $1,740 Medicare Part B outpatient therapy cap that was effective on January 1, 2006. CMS subsequently increased the therapy cap to $1,780 on January 1, 2007, to $1,810 on January 1, 2008 and to $1,840 on January 1, 2009. The legislation also required CMS to implement a broad process for reviewing medically necessary therapy claims, creating an exception to the cap. The exception process, which was set to expire on January 1, 2007, was included in the Tax Relief and Health Care Act of 2006 and continued to function as an exception to the Medicare Part B outpatient therapy cap until January 1, 2008. The SCHIP Extension Act further extended the Medicare Part B outpatient therapy cap until June 30, 2008. The Medicare Improvements for Patients and Providers Act of 2008, enacted on July 15, 2008, extended the therapy cap exception process from July 1, 2008 to December 31, 2009.

The Company believes that its operating margins may continue to be under pressure because of deterioration in pricing flexibility, changes in payor mix, changes in length of stay and growth in operating expenses in excess of increases in payments by third party payors. In addition, as a result of competitive pressures, the Company s ability to maintain operating margins through price increases to private patients is limited.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Condensed Consolidated Statement of Operations

(Unaudited)

(In thousands, except per share amounts)

	2008 Quarters					First Quarter 2009
	First	Second	Third	Fourth	Year	
Revenues	$ 1,048,523	$ 1,041,911	$ 1,010,680	$ 1,050,282	$ 4,151,396	$ 1,083,312
Salaries, wages and benefits	601,251	596,161	606,468	605,793	2,409,673	624,173
Supplies	78,632	81,567	78,586	81,625	320,410	81,159
Rent	85,180	87,424	86,444	85,904	344,952	86,779
Other operating expenses	227,303	217,387	211,584	211,752	868,026	224,179
Other income	(4,717)	(5,167)	(4,313)	(3,210)	(17,407)	(2,872)
Depreciation and amortization	31,055	30,930	29,432	29,996	121,413	30,805
Interest expense	4,921	2,907	3,710	3,835	15,373	2,478
Investment income	(3,248)	(2,337)	(672)	(844)	(7,101)	(1,476)
	1,020,377	1,008,872	1,011,239	1,014,851	4,055,339	1,045,225
Income (loss) from continuing operations before income taxes	28,146	33,039	(559)	35,431	96,057	38,087
Provision (benefit) for income taxes	11,639	13,232	(1,345)	13,638	37,164	15,734
Income from continuing operations	16,507	19,807	786	21,793	58,893	22,353
Discontinued operations, net of income taxes:						
Income (loss) from operations	(1,817)	(858)	12	831	(1,832)	407
Gain (loss) on divestiture of operations		2,712	(22,058)	(1,430)	(20,776)	
Net income (loss)	$ 14,690	$ 21,661	$ (21,260)	$ 21,194	$ 36,285	$ 22,760
Earnings (loss) per common share:						
Basic:						
Income from continuing operations	$ 0.43	$ 0.51	$ 0.02	$ 0.56	$ 1.52	$ 0.57
Discontinued operations:						
Income (loss) from operations	(0.05)	(0.02)		0.02	(0.05)	0.01
Gain (loss) on divestiture of operations		0.07	(0.58)	(0.04)	(0.55)	
Net income (loss)	$ 0.38	$ 0.56	$ (0.56)	$ 0.54	$ 0.92	$ 0.58
Diluted:						
Income from continuing operations	$ 0.42	$ 0.50	$ 0.02	$ 0.56	$ 1.50	$ 0.57
Discontinued operations:						
Income (loss) from operations	(0.05)	(0.02)		0.02	(0.05)	0.01
Gain (loss) on divestiture of operations		0.07	(0.57)	(0.04)	(0.54)	

Net income (loss)	$	0.37	$	0.55	$	(0.55)	$	0.54	$	0.91	$	0.58
Shares used in computing earnings (loss) per common share:												
Basic		37,444		37,714		38,034		38,123		37,830		38,184
Diluted		38,061		38,474		38,894		38,265		38,397		38,315

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Operating Data

(Unaudited)

(In thousands)

	2008 Quarters					First Quarter 2009
	First	Second	Third	Fourth	Year	
Revenues:						
Hospital division	$ 476,167	$ 461,064	$ 434,774	$ 465,317	$ 1,837,322	$ 492,509
Health services division	534,793	542,207	535,737	542,680	2,155,417	544,940
Rehabilitation division	104,499	106,318	106,796	109,707	427,320	117,647
	1,115,459	1,109,589	1,077,307	1,117,704	4,420,059	1,155,096
Eliminations	(66,936)	(67,678)	(66,627)	(67,422)	(268,663)	(71,784)
	$ 1,048,523	$ 1,041,911	$ 1,010,680	$ 1,050,282	$ 4,151,396	$ 1,083,312
Income from continuing operations:						
Operating income (loss):						
Hospital division	$ 96,802	$ 85,886	$ 64,818	$ 97,861	$ 345,367	$ 100,899
Health services division	74,200	90,446	78,801	83,485	326,932	75,860
Rehabilitation division	11,486	10,178	7,448	8,959	38,071	15,453
Corporate:						
Overhead	(34,931)	(33,200)	(30,937)	(33,951)	(133,019)	(34,087)
Insurance subsidiary	(1,503)	(1,347)	(1,775)	(2,032)	(6,657)	(1,452)
	(36,434)	(34,547)	(32,712)	(35,983)	(139,676)	(35,539)
Operating income	146,054	151,963	118,355	154,322	570,694	156,673
Rent	(85,180)	(87,424)	(86,444)	(85,904)	(344,952)	(86,779)
Depreciation and amortization	(31,055)	(30,930)	(29,432)	(29,996)	(121,413)	(30,805)
Interest, net	(1,673)	(570)	(3,038)	(2,991)	(8,272)	(1,002)
Income (loss) from continuing operations before income taxes	28,146	33,039	(559)	35,431	96,057	38,087
Provision (benefit) for income taxes	11,639	13,232	(1,345)	13,638	37,164	15,734
	$ 16,507	$ 19,807	$ 786	$ 21,793	$ 58,893	$ 22,353

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Operating Data (Continued)

(Unaudited)

(In thousands)

	2008 Quarters					First Quarter 2009
	First	Second	Third	Fourth	Year	
Rent:						
Hospital division	$ 35,907	$ 37,750	$ 36,461	$ 36,198	$ 146,316	$ 36,445
Health services division	47,883	48,175	48,551	48,282	192,891	48,852
Rehabilitation division	1,358	1,393	1,405	1,399	5,555	1,451
Corporate	32	106	27	25	190	31
	$ 85,180	$ 87,424	$ 86,444	$ 85,904	$ 344,952	$ 86,779
Depreciation and amortization:						
Hospital division	$ 11,303	$ 11,455	$ 11,719	$ 13,673	$ 48,150	$ 12,512
Health services division	14,389	13,677	11,794	10,176	50,036	12,000
Rehabilitation division	387	485	547	546	1,965	547
Corporate	4,976	5,313	5,372	5,601	21,262	5,746
	$ 31,055	$ 30,930	$ 29,432	$ 29,996	$ 121,413	$ 30,805
Capital expenditures, excluding acquisitions (including discontinued operations):						
Hospital division	$ 13,556	$ 20,022	$ 19,736	$ 15,903	$ 69,217	$ 14,330
Health services division	7,135	10,744	19,746	12,468	50,093	21,840
Rehabilitation division	282	280	271	329	1,162	190
Corporate:						
Information systems	3,832	8,616	7,051	6,864	26,363	3,453
Other	135	258	489	960	1,842	173
	$ 24,940	$ 39,920	$ 47,293	$ 36,524	$ 148,677	$ 39,986

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Operating Data (Continued)

(Unaudited)

	2008 Quarters					First Quarter 2009
	First	Second	Third	Fourth	Year	
Hospital data:						
End of period data:						
Number of hospitals	81	81	82	82		82
Number of licensed beds	6,358	6,358	6,428	6,482		6,520
Revenue mix %:						
Medicare	57	56	54	55	55	56
Medicaid	9	9	11	11	10	10
Medicare Advantage	8	9	9	10	9	10
Commercial insurance and other	26	26	26	24	26	24
Admissions:						
Medicare	7,920	7,268	6,786	7,054	29,028	7,421
Medicaid	1,034	1,008	1,148	1,043	4,233	1,052
Medicare Advantage	901	849	869	968	3,587	1,094
Commercial insurance and other	1,814	1,799	1,748	1,727	7,088	1,921
	11,669	10,924	10,551	10,792	43,936	11,488
Admissions mix %:						
Medicare	68	67	64	65	66	65
Medicaid	9	9	11	10	10	9
Medicare Advantage	8	8	8	9	8	9
Commercial insurance and other	15	16	17	16	16	17
Patient days:						
Medicare	216,737	210,064	188,832	190,794	806,427	197,377
Medicaid	50,335	50,676	54,108	53,304	208,423	50,868
Medicare Advantage	28,453	29,219	28,529	31,744	117,945	35,229
Commercial insurance and other	66,270	67,847	64,449	63,688	262,254	65,509
	361,795	357,806	335,918	339,530	1,395,049	348,983
Average length of stay:						
Medicare	27.4	28.9	27.8	27.0	27.8	26.6
Medicaid	48.7	50.3	47.1	51.1	49.2	48.4
Medicare Advantage	31.6	34.4	32.8	32.8	32.9	32.2
Commercial insurance and other	36.5	37.7	36.9	36.9	37.0	34.1
Weighted average	31.0	32.8	31.8	31.5	31.8	30.4
Revenues per admission:						
Medicare	$ 34,128	$ 35,717	$ 34,721	$ 36,029	$ 35,127	$ 37,262
Medicaid	41,853	42,271	40,798	50,577	43,816	45,160
Medicare Advantage	42,167	46,448	45,679	46,305	45,148	46,387
Commercial insurance and other	68,691	66,385	64,431	65,774	66,345	61,286
Weighted average	40,806	42,206	41,207	43,117	41,818	42,872

Revenues per patient day:						
Medicare	$ 1,247	$ 1,236	$ 1,248	$ 1,332	$ 1,264	$ 1,401
Medicaid	860	841	866	990	890	934
Medicare Advantage	1,335	1,350	1,391	1,412	1,373	1,440
Commercial insurance and other	1,880	1,760	1,748	1,784	1,793	1,797
Weighted average	1,316	1,289	1,294	1,370	1,317	1,411
Medicare case mix index (discharged patients only)	1.12	1.16	1.14	1.17	1.15	1.22
Average daily census	3,976	3,932	3,651	3,691	3,812	3,878
Occupancy %	67.9	67.1	62.2	62.1	64.8	66.0
Annualized employee turnover %	25.0	25.9	25.7	25.2		21.3

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Operating Data (Continued)

(Unaudited)

	2008 Quarters					First Quarter
	First	Second	Third	Fourth	Year	2009
Nursing center data:						
End of period data:						
Number of nursing centers:						
Owned or leased	224	224	224	224		224
Managed	4	4	4	4		4
	228	228	228	228		228
Number of licensed beds:						
Owned or leased	28,371	28,251	28,210	28,040		27,915
Managed	485	485	485	485		485
	28,856	28,736	28,695	28,525		28,400
Revenue mix %:						
Medicare	35	35	33	34	34	35
Medicaid	42	43	44	43	43	42
Medicare Advantage	5	4	5	4	5	5
Private and other	18	18	18	19	18	18
Patient days (excludes managed facilities):						
Medicare	409,902	402,269	370,782	367,775	1,550,728	381,463
Medicaid	1,394,925	1,387,374	1,430,461	1,417,661	5,630,421	1,368,286
Medicare Advantage	61,724	65,258	64,616	61,737	253,335	74,368
Private and other	432,787	424,769	438,056	441,008	1,736,620	421,756
	2,299,338	2,279,670	2,303,915	2,288,181	9,171,104	2,245,873
Patient day mix %:						
Medicare	18	18	16	16	17	17
Medicaid	61	61	62	62	61	61
Medicare Advantage	3	3	3	3	3	3
Private and other	18	18	19	19	19	19
Revenues per patient day:						
Medicare Part A	$ 429	$ 431	$ 434	$ 456	$ 437	$ 457
Total Medicare (including Part B)	461	466	475	498	474	497
Medicaid	160	168	163	164	164	166
Medicare Advantage	390	394	395	413	398	403
Private and other	228	227	229	230	229	234
Weighted average	232	238	232	237	235	243
Average daily census	25,267	25,051	25,043	24,872	25,058	24,954
Admissions	18,987	18,288	17,583	17,821	72,679	18,845

Occupancy %	89.2	89.0	89.1	88.9	89.0	89.3
Medicare average length of stay	35.1	35.8	36.5	34.7	35.5	34.8
Annualized employee turnover %	48.2	50.2	51.0	48.9		37.9
Rehabilitation data:						
Revenue mix %:						
Company-operated	65	64	62	61	63	61
Non-affiliated	35	36	38	39	37	39
Sites of service (at end of period)	650	658	659	655		661
Revenue per site	$ 160,767	$ 161,578	$ 162,058	$ 167,492		$ 177,984
Therapist productivity %	81.9	81.3	80.1	82.3	81.4	84.8
Annualized employee turnover %	13.1	13.5	13.2	13.3		10.9

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The following discussion of the Company s exposure to market risk contains forward-looking statements that involve risks and uncertainties. Given the unpredictability of interest rates as well as other factors, actual results could differ materially from those projected in such forward-looking information.

The Company s exposure to market risk relates to changes in the prime rate, federal funds rate and LIBOR which affect the interest paid on certain borrowings.

The following table provides information about the Company s financial instruments that are sensitive to changes in interest rates. The table presents principal cash flows and related weighted average interest rates by expected maturity date.

Interest Rate Sensitivity

Principal (Notional) Amount by Expected Maturity

Average Interest Rate

(Dollars in thousands)

	Expected maturities							Fair value
	2009	2010	2011	2012	2013	Thereafter	Total	3/31/09
Liabilities:								
Long-term debt, including amounts due within one year:								
Fixed rate	$ 61	$ 86	$ 91	$ 96	$ 102	$ 358	$ 794	$ 773(a)
Average interest rate	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%		
Variable rate (b)	$	$	$	$ 367,900	$	$	$ 367,900	$ 367,900

(a) Calculated based upon the net present value of future principal and interest payments using a discount rate of 6%.

(b) Interest on borrowings under the Company s revolving credit facility is payable, at the Company s option, at (1) LIBOR plus an applicable margin ranging from 1.25% to 2.00% or (2) the applicable margin ranging from 0.25% to 1.00% plus the higher of the prime rate or 0.5% over the federal funds rate. The applicable margin is based upon the Company s average daily excess availability as defined in the Company s revolving credit facility.

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures and Changes in Internal Control Over Financial Reporting

The Company has carried out an evaluation under the supervision and with the participation of management, including the Company s Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of March 31, 2009, the Company s disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed in the reports that the Company files and submits under the Exchange Act is recorded, processed, summarized and reported as and when required.

There has been no change in the Company s internal control over financial reporting during the Company s quarter ended March 31, 2009, that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is a party to various legal actions (some of which are not insured), and regulatory and other government investigations and sanctions in the ordinary course of business. The Company is unable to predict the ultimate outcome of pending litigation and regulatory and other government investigations. 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.

Item 6. Exhibits

3.1	Amended and Restated Bylaws of the Company. Exhibit 3.1 to the Company s Current Report on Form 8-K dated March 20, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.1	Amendment to Master Lease and Memorandum of Lease dated as of January 16, 2009 and by and between Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc., as Tenant.
10.2	Amendment to Memorandum of Lease and Specific Property Lease Amendment dated as of January 9, 2009 and by between Ventas Realty, Limited Partnership, as Lessor and Kindred Healthcare, Inc. and Kindred Healthcare Operating, Inc., as Tenant.
10.3	Agreement dated as of March 20, 2009 by and between Kindred Healthcare, Inc. and Edward L. Kuntz. Exhibit 10.1 to the Company s Current Report on Form 8-K dated March 20, 2009 (Comm. File No. 001-14057) is hereby incorporated by reference.
10.4	Form of Kindred Healthcare, Inc. Stock Bonus Award Agreement under the 2001 Stock Incentive Plan, Amended and Restated.
10.5	Amended and Restated Kindred Healthcare, Inc. Long-Term Incentive Plan.
31	Rule 13a-14(a)/15d-14(a) Certifications.
32	Section 1350 Certifications.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

KINDRED HEALTHCARE, INC.

Date: May 8, 2009	/s/ PAUL J. DIAZ **Paul J. Diaz** **President and** **Chief Executive Officer**
Date: May 8, 2009	/s/ RICHARD A. LECHLEITER **Richard A. Lechleiter** **Executive Vice President and** **Chief Financial Officer**