

ENSIGN GROUP, INC
Form 10-Q
May 02, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2018.

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: 001-33757

THE ENSIGN GROUP, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware 33-0861263
(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)

27101 Puerta Real, Suite 450
Mission Viejo, CA 92691
(Address of Principal Executive Offices and Zip Code)

(949) 487-9500
(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 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, non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>	Emerging growth company <input type="checkbox"/>
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If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the

Exchange Act.

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

As of April 30, 2018, 51,795,207 shares of the registrant's common stock were outstanding.

THE ENSIGN GROUP, INC.
QUARTERLY REPORT ON FORM 10-Q
FOR THE THREE MONTHS ENDED MARCH 31, 2018
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PART I.

Item 1. Financial Statements

THE ENSIGN GROUP, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (In thousands, except par values)
 (Unaudited)

	March 31, 2018	December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	\$35,057	\$ 42,337
Accounts receivable—less allowance for doubtful accounts of \$1,762 and \$43,961 at March 31, 2018 and December 31, 2017, respectively (Note 3)	258,509	265,068
Investments—current	13,631	13,092
Prepaid income taxes	12,794	19,447
Prepaid expenses and other current assets	24,735	28,132
Total current assets	344,726	368,076
Property and equipment, net	541,019	537,084
Insurance subsidiary deposits and investments	28,065	28,685
Escrow deposits	10,025	228
Deferred tax assets	12,731	12,745
Restricted and other assets	17,695	16,501
Intangible assets, net	32,236	32,803
Goodwill	80,963	81,062
Other indefinite-lived intangibles	25,249	25,249
Total assets	\$1,092,709	\$ 1,102,433
Liabilities and equity		
Current liabilities:		
Accounts payable	\$31,977	\$ 39,043
Accrued wages and related liabilities	84,018	90,508
Accrued self-insurance liabilities—current	22,163	22,516
Other accrued liabilities	63,088	63,815
Current maturities of long-term debt	10,035	9,939
Total current liabilities	211,281	225,821
Long-term debt—less current maturities	280,449	302,990
Accrued self-insurance liabilities—less current portion	51,518	50,220
Deferred rent and other long-term liabilities	11,608	11,268
Deferred gain related to sale-leaseback (Note 16)	11,910	12,075
Total liabilities	566,766	602,374
Commitments and contingencies (Notes 14, 16 and 17)		
Equity:		
Ensign Group, Inc. stockholders' equity:		
Common stock; \$0.001 par value; 75,000 shares authorized; 54,083 and 51,764 shares issued and outstanding at March 31, 2018, respectively, and 53,675 and 51,360 shares issued and outstanding at December 31, 2017, respectively (Note 18)	54	53
Additional paid-in capital	270,948	266,058

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Retained earnings	285,398	264,691
Common stock in treasury, at cost, 1,932 shares at March 31, 2018 and December 31, 2017, respectively	(38,405)	(38,405)
Total Ensign Group, Inc. stockholders' equity	517,995	492,397
Non-controlling interest	7,948	7,662
Total equity	525,943	500,059
Total liabilities and equity	\$1,092,709	\$ 1,102,433

See accompanying notes to condensed consolidated financial statements.

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THE ENSIGN GROUP, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF INCOME
 (In thousands, except per share data)
 (Unaudited)

	Three Months Ended March 31,	
	2018	2017
Revenue		
Service revenue	\$456,021	\$409,393
Assisted and independent living revenue	36,113	32,346
Total revenue	492,134	441,739
Expense		
Cost of services	390,243	355,486
(Return of unclaimed class action settlement)/charges related to class action lawsuit (Note 17)	(1,664)	11,000
Losses related to divestitures (Note 6 and 16)	—	4,017
Rent—cost of services (Note 16)	33,850	31,900
General and administrative expense	25,104	21,270
Depreciation and amortization	11,622	10,514
Total expenses	459,155	434,187
Income from operations	32,979	7,552
Other income (expense):		
Interest expense	(3,613)	(3,445)
Interest income	448	290
Other expense, net	(3,165)	(3,155)
Income before provision for income taxes	29,814	4,397
Provision for income taxes	6,521	1,441
Net income	23,293	2,956
Less: net income attributable to noncontrolling interests	161	116
Net income attributable to The Ensign Group, Inc.	\$23,132	\$2,840
Net income per share attributable to The Ensign Group, Inc.:		
Basic	\$0.45	\$0.06
Diluted	\$0.43	\$0.05
Weighted average common shares outstanding:		
Basic	51,585	50,767
Diluted	53,518	52,633
Dividends per share	\$0.0450	\$0.0425
See accompanying notes to condensed consolidated financial statements.		

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THE ENSIGN GROUP, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (In thousands)
 (Unaudited)

	Three Months Ended March 31,	
	2018	2017
Cash flows from operating activities:		
Net income	\$23,293	\$2,956
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	11,622	10,514
Amortization of deferred financing fees	299	254
Amortization of deferred gain on sale-leaseback	(164))
Impairment of long-lived assets	155	111
Deferred income taxes	14	61
Provision for doubtful accounts (Note 3)	570	7,350
Share-based compensation	2,309	2,224
Insurance proceeds received for damage to property	167	—
Gain on insurance claims for damaged property and other assets	(667))
Change in operating assets and liabilities		
Accounts receivable	6,453	(6,900)
Prepaid income taxes	6,654	252
Prepaid expenses and other assets	2,162	(2,790)
Insurance subsidiary deposits and investments	80	179
Charge related to class action lawsuit (Note 17)	—	11,000
Liabilities related to operational closures (Note 6 and 16)	—	3,906
Accounts payable	(6,815)	(4,044)
Accrued wages and related liabilities	(6,490)	(9,410)
Income taxes payable	—	1,175
Other accrued liabilities	(647)) 938
Accrued self-insurance liabilities	1,061	1,568
Deferred rent liability	339	242
Net cash provided by operating activities	40,395	19,586
Cash flows from investing activities:		
Purchase of property and equipment	(11,082)	(11,997)
Cash payments for business acquisitions (Note 7)	—	(8,693)
Cash payments for asset acquisitions (Note 7)	(4,447)	(310)
Escrow deposits	(10,025)	(2,394)
Escrow deposits used to fund acquisitions	228	1,582
Cash proceeds from the sale of assets and insurance proceeds	64	608
Restricted and other assets	(201)	(193)
Net cash used in investing activities	(25,463)	(21,397)
Cash flows from financing activities:		
Proceeds from revolving credit facility and other debt (Note 14)	195,000	345,000
Payments on revolving credit facility and other debt (Note 14)	(217,421)	(362,015)
Issuance of common stock upon exercise of options	2,920	957
Repurchase of shares of common stock (Note 18)	—	(6,068)
Dividends paid	(2,328)	(2,179)
Non-controlling interest distribution	(292))

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Purchase of non-controlling interest	—	(83)
Payments of deferred financing costs	(91)	—
Net cash used in financing activities	(22,212)	(24,388)
Net decrease in cash and cash equivalents	(7,280)	(26,199)
Cash and cash equivalents beginning of period	42,337	57,706
Cash and cash equivalents end of period	\$35,057	\$31,507

See accompanying notes to condensed consolidated financial statements.

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THE ENSIGN GROUP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS - (Continued)

(In thousands)

(Unaudited)

	Three Months Ended March 31,	
	2018	2017
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	\$3,809	\$4,076
Income taxes	\$—	\$8
Non-cash financing and investing activity:		
Accrued capital expenditures	\$3,300	\$5,708
Note receivable from sale of ancillary business	\$139	\$—
See accompanying notes to condensed consolidated financial statements.		

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THE ENSIGN GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars, shares and options in thousands, except per share data)

(Unaudited)

1. DESCRIPTION OF BUSINESS

The Company - The Ensign Group, Inc. (collectively, Ensign or the Company), is a holding company with no direct operating assets, employees or revenue. The Company, through its operating subsidiaries, is a provider of health care services across the post-acute care continuum, as well as other ancillary businesses. As of March 31, 2018, the Company operated 232 facilities, 46 home health, hospice and home care agencies and other ancillary operations located in Arizona, California, Colorado, Idaho, Iowa, Kansas, Nebraska, Nevada, Oklahoma, Oregon, South Carolina, Texas, Utah, Washington and Wisconsin. The Company's operating subsidiaries, each of which strives to be the operation of choice in the community it serves, provide a broad spectrum of skilled nursing, assisted living, home health, home care, hospice and other ancillary services. The Company's operating subsidiaries have a collective capacity of approximately 18,900 operational skilled nursing beds and 5,100 assisted living and independent living units. As of March 31, 2018, the Company owned 65 of its 232 affiliated facilities and leased an additional 167 facilities through long-term lease arrangements and had options to purchase eleven of those 167 facilities. As of December 31, 2017, the Company owned 63 of its 230 affiliated facilities and leased an additional 167 facilities through long-term lease arrangements and had options to purchase eleven of those 167 facilities.

Certain of the Company's wholly-owned independent subsidiaries, collectively referred to as the Service Center, provide certain accounting, payroll, human resources, information technology, legal, risk management and other centralized services to the other operating subsidiaries through contractual relationships with such subsidiaries. The Company also has a wholly-owned captive insurance subsidiary (the Captive) that provides some claims-made coverage to the Company's operating subsidiaries for general and professional liability, as well as coverage for certain workers' compensation insurance liabilities.

Each of the Company's affiliated operations are operated by separate, wholly-owned, independent subsidiaries that have their own management, employees and assets. References herein to the consolidated "Company" and "its" assets and activities in this quarterly report is not meant to imply, nor should it be construed as meaning, that The Ensign Group, Inc. has direct operating assets, employees or revenue, or that any of the subsidiaries, are operated by The Ensign Group, Inc.

Other Information — The accompanying condensed consolidated financial statements as of March 31, 2018 and for the three months ended March 31, 2018 and 2017 (collectively, the Interim Financial Statements) are unaudited. Certain information and note disclosures normally included in annual consolidated financial statements have been condensed or omitted, as permitted under applicable rules and regulations. Readers of the Interim Financial Statements should refer to the Company's audited consolidated financial statements and notes thereto for the year ended December 31, 2017 which are included in the Company's annual report on Form 10-K, File No. 001-33757 (the Annual Report) filed with the Securities and Exchange Commission (SEC). Management believes that the Interim Financial Statements reflect all adjustments which are of a normal and recurring nature necessary to present fairly the Company's financial position and results of operations in all material respects. The results of operations presented in the Interim Financial Statements are not necessarily representative of operations for the entire year.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation — The accompanying Interim Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP). The Company is the sole member or shareholder of various consolidated limited liability companies and corporations established to operate various acquired skilled nursing and assisted living operations, home health, hospice and home care operations, and related ancillary services. All intercompany transactions and balances have been eliminated in consolidation. The condensed consolidated financial statements include the accounts of all entities controlled by the Company through its ownership

of a majority voting interest. The Company presents noncontrolling interest within the equity section of its condensed consolidated balance sheets. The Company presents the amount of consolidated net income that is attributable to The Ensign Group, Inc. and the noncontrolling interest in its condensed consolidated statements of income.

Estimates and Assumptions — The preparation of Interim Financial Statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the Interim Financial Statements and the reported amounts of revenue and expenses during the reporting periods. The most significant estimates in the Company's Interim Financial Statements relate to revenue, intangible assets and goodwill, impairment of long-lived assets, general and professional liability, workers' compensation and healthcare claims included in accrued self-insurance liabilities, and income taxes. Actual results could differ from those estimates.

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THE ENSIGN GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Fair Value of Financial Instruments — The Company's financial instruments consist principally of cash and cash equivalents, debt security investments, accounts receivable, insurance subsidiary deposits, accounts payable and borrowings. The Company believes all of the financial instruments' recorded values approximate fair values because of their nature or respective short durations.

Revenue Recognition — On January 1, 2018, the Company adopted Accounting Standards Codification Topic 606, Revenue from Contracts with Customers (ASC 606) applying the modified retrospective method. Results for reporting periods beginning January 1, 2018 are presented under ASC 606, while prior period amounts are not adjusted and continue to be reported under the accounting standards in effect for the prior period. The adoption of ASC 606 did not have a material impact on the measurement nor on the recognition of revenue of contracts, for which all revenue had not been recognized, as of January 1, 2018, therefore no cumulative adjustment has been made to the opening balance of retained earnings at the beginning of 2018. See Note 3, Revenue and Accounts Receivable.

Accounts Receivable and Allowance for Doubtful Accounts — Accounts receivable consist primarily of amounts due from Medicare and Medicaid programs, other government programs, managed care health plans and private payor sources, net of estimates for variable consideration. The allowance for doubtful accounts reflects the Company's best estimate of probable losses inherent in the accounts receivable balance. The Company determines the allowance based on known troubled accounts and other currently available evidence. See Note 3, Revenue and Accounts Receivable.

Property and Equipment — Property and equipment are initially recorded at their historical cost. Repairs and maintenance are expensed as incurred. Depreciation is computed using the straight-line method over the estimated useful lives of the depreciable assets (ranging from three to 59 years). Leasehold improvements are amortized on a straight-line basis over the shorter of their estimated useful lives or the remaining lease term.

Impairment of Long-Lived Assets — The Company reviews the carrying value of long-lived assets that are held and used in the Company's operating subsidiaries for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of these assets is determined based upon expected undiscounted future net cash flows from the operating subsidiaries to which the assets relate, utilizing management's best estimate, appropriate assumptions, and projections at the time. If the carrying value is determined to be unrecoverable from future operating cash flows, the asset is deemed impaired and an impairment loss would be recognized to the extent the carrying value exceeded the estimated fair value of the asset. The Company estimates the fair value of assets based on the estimated future discounted cash flows of the asset. Management has evaluated its long-lived assets and recorded an impairment charge of \$155 and \$111 during the three months ended March 31, 2018 and 2017, respectively.

Leases and Leasehold Improvements - At the inception of each lease, the Company performs an evaluation to determine whether the lease should be classified as an operating or capital lease. The Company records rent expense for operating leases that contain scheduled rent increases on a straight-line basis over the term of the lease. The lease term used for straight-line rent expense is calculated from the date the Company is given control of the leased premises through the end of the lease term. The lease term used for this evaluation also provides the basis for establishing depreciable lives for buildings subject to lease and leasehold improvements, as well as the period over which the Company records straight-line rent expense.

Intangible Assets and Goodwill — Definite-lived intangible assets consist primarily of favorable leases, lease acquisition costs, patient base, facility trade names and customer relationships. Favorable leases and lease acquisition costs are amortized over the life of the lease of the facility. Patient base is amortized over a period of four to eight months, depending on the classification of the patients and the level of occupancy in a new acquisition on the acquisition date. Trade names at affiliated facilities are amortized over 30 years and customer relationships are amortized over a period of up to 20 years.

The Company's indefinite-lived intangible assets consist of trade names and Medicare and Medicaid licenses. The Company tests indefinite-lived intangible assets for impairment on an annual basis or more frequently if events or changes in circumstances indicate that the carrying amount of the intangible asset may not be recoverable. The Company did not identify any intangible asset or goodwill impairment during the three months ended March 31, 2018 and 2017.

Goodwill represents the excess of the purchase price over the fair value of identifiable net assets acquired in business combinations. Goodwill is subject to annual testing for impairment. In addition, goodwill is tested for impairment if events occur or circumstances change that would reduce the fair value of a reporting unit below its carrying amount. The Company performs its annual test for impairment during the fourth quarter of each year. See further discussion at Note 10, Goodwill and Other Indefinite-Lived Intangible Assets.

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THE ENSIGN GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Self-Insurance — The Company is partially self-insured for general and professional liability up to a base amount per claim (the self-insured retention) with an aggregate, one-time deductible above this limit. Losses beyond these amounts are insured through third-party policies with coverage limits per claim, per location and on an aggregate basis for the Company. The combined self-insured retention is \$500 per claim, subject to an additional one-time deductible of \$750 for California affiliated operations and a separate, one-time, deductible of \$1,000 for non-California operations. For all affiliated operations, except those located in Colorado, the third-party coverage above these limits is \$1,000 per claim, \$3,000 per operation, with a \$5,000 blanket aggregate limit and an additional state-specific aggregate where required by state law. In Colorado, the third-party coverage above these limits is \$1,000 per claim and \$3,000 per operation, which is independent of the aforementioned blanket aggregate limits that apply outside of Colorado.

The self-insured retention and deductible limits for general and professional liability and workers' compensation for all states (except Texas and Washington for workers' compensation) are self-insured through the Captive, the related assets and liabilities of which are included in the accompanying condensed consolidated balance sheets. The Captive is subject to certain statutory requirements as an insurance provider. These requirements include, but are not limited to, maintaining statutory capital.

The Company's policy is to accrue amounts equal to the actuarially estimated costs to settle open claims of insureds, as well as an estimate of the cost of insured claims that have been incurred but not reported. The Company develops information about the size of the ultimate claims based on historical experience, current industry information and actuarial analysis, and evaluates the estimates for claim loss exposure on a quarterly basis. Accrued general liability and professional malpractice liabilities on an undiscounted basis, net of anticipated insurance recoveries, were \$39,982 and \$38,998 as of March 31, 2018 and December 31, 2017, respectively.

The Company's operating subsidiaries are self-insured for workers' compensation in California. To protect itself against loss exposure in California with this policy, the Company has purchased individual specific excess insurance coverage that insures individual claims that exceed \$500 per occurrence. In Texas, the operating subsidiaries have elected non-subscriber status for workers' compensation claims and the Company has purchased individual stop-loss coverage that insures individual claims that exceed \$750 per occurrence. The Company's operating subsidiaries in all other states, with the exception of Washington, are under a loss sensitive plan that insures individual claims that exceed \$350 per occurrence. In Washington, the operating subsidiaries' coverage is financed through premiums paid by the employers and employees. The claims and pay benefits are managed through a state insurance pool. Outside of California, Texas and Washington, the Company has purchased insurance coverage that insures individual claims that exceed \$350 per accident. In all states except Washington, the Company accrues amounts equal to the estimated costs to settle open claims, as well as an estimate of the cost of claims that have been incurred but not reported. The Company uses actuarial valuations to estimate the liability based on historical experience and industry information. Accrued workers' compensation liabilities are recorded on an undiscounted basis in the accompanying condensed consolidated balance sheets and were \$24,094 and \$23,621 as of March 31, 2018 and December 31, 2017, respectively.

In addition, the Company has recorded an asset and equal liability of \$5,278 and \$5,394 at March 31, 2018 and December 31, 2017, respectively, in order to present the ultimate costs of malpractice and workers' compensation claims and the anticipated insurance recoveries on a gross basis. See Note 11 Restricted and Other Assets.

The Company self-funds medical (including prescription drugs) and dental healthcare benefits to the majority of its employees. The Company is fully liable for all financial and legal aspects of these benefit plans. To protect itself against loss exposure with this policy, the Company has purchased individual stop-loss insurance coverage that insures individual claims that exceed \$300 for each covered person with an additional one-time aggregate individual stop loss deductible of \$75. Beginning 2016, the Company's policy does not include the additional one-time aggregate individual stop loss deductible of \$75. The Company's accrued liability under these plans recorded on an undiscounted basis in the accompanying condensed consolidated balance sheets was \$4,327 and \$4,723 as of March 31, 2018 and

December 31, 2017, respectively.

The Company believes that adequate provision has been made in the Interim Financial Statements for liabilities that may arise out of patient care, workers' compensation, healthcare benefits and related services provided to date. The amount of the Company's reserves was determined based on an estimation process that uses information obtained from both company-specific and industry data. This estimation process requires the Company to continuously monitor and evaluate the life cycle of the claims. Using data obtained from this monitoring and the Company's assumptions about emerging trends, the Company, with the assistance of an independent actuary, develops information about the size of ultimate claims based on the Company's historical experience and other available industry information. The most significant assumptions used in the estimation process include determining the trend in costs, the expected cost of claims incurred but not reported and the expected costs to settle or pay damage awards with respect to unpaid claims. The self-insured liabilities are based upon estimates, and while management believes that the estimates of loss are reasonable, the ultimate liability may be in excess of or less than the recorded amounts. Due to the inherent volatility of actuarially determined loss estimates, it is reasonably possible that the Company could experience changes in estimated losses

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THE ENSIGN GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

that could be material to net income. If the Company's actual liability exceeds its estimates of loss, its future earnings, cash flows and financial condition would be adversely affected.

Income Taxes — Deferred tax assets and liabilities are established for temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities at tax rates in effect when such temporary differences are expected to reverse. The Company generally expects to fully utilize its deferred tax assets; however, when necessary, the Company records a valuation allowance to reduce its net deferred tax assets to the amount that is more likely than not to be realized.

In determining the need for a valuation allowance or the need for and magnitude of liabilities for uncertain tax positions, the Company makes certain estimates and assumptions. These estimates and assumptions are based on, among other things, knowledge of operations, markets, historical trends and likely future changes and, when appropriate, the opinions of advisors with knowledge and expertise in certain fields. Due to certain risks associated with the Company's estimates and assumptions, actual results could differ.

The Tax Cuts and Jobs Act (the Tax Act), which was enacted in December 2017, decreased the corporate income tax rate from 35.0% to 21.0% beginning on January 1, 2018. The Company's actual effective tax rate for fiscal 2018 may differ from management's estimate due to changes in interpretations and assumptions, and the excess tax benefits impact of share-based payment awards. See Note 13, Income Taxes for further detail.

Noncontrolling Interest — The noncontrolling interest in a subsidiary is initially recognized at estimated fair value on the acquisition date and is presented within total equity in the Company's consolidated balance sheets. The Company presents the noncontrolling interest and the amount of consolidated net income attributable to The Ensign Group, Inc. in its condensed consolidated statements of income and net income per share is calculated based on net income attributable to The Ensign Group, Inc.'s stockholders. The carrying amount of the noncontrolling interest is adjusted based on an allocation of subsidiary earnings based on ownership interest.

Share-Based Compensation — The Company measures and recognizes compensation expense for all share-based payment awards made to employees and directors including employee stock options based on estimated fair values, ratably over the requisite service period of the award. Net income has been reduced as a result of the recognition of the fair value of all stock options and restricted stock awards issued, the amount of which is contingent upon the number of future grants and other variables.

Recent Accounting Pronouncements — Except for rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws and a limited number of grandfathered standards, the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) is the sole source of authoritative GAAP literature recognized by the FASB and applicable to the Company. For any new pronouncements announced, the Company considers whether the new pronouncements could alter previous generally accepted accounting principles and determines whether any new or modified principles will have a material impact on the Company's reported financial position or operations in the near term. The applicability of any standard is subject to the formal review of the Company's financial management and certain standards are under consideration.

Recent Accounting Standards Adopted by the Company

In 2014, the FASB and International Accounting Standards Board issued their final standard on revenue from contracts with customers that outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. Under this new standard and subsequently issued amendments, revenue is recognized at the time a good or service is transferred to a customer for the amount of consideration received. Entities

may apply the new standard either retrospectively to each period presented (full retrospective method) or retrospectively with the cumulative effect recognized in beginning retained earnings as of the date of adoption (modified retrospective method). The Company adopted the new revenue standard as of January 1, 2018 using the modified retrospective transition method. The adoption of ASC 606 did not have a material impact on the measurement nor on the recognition of revenue of contracts for which all revenue had not been recognized as of January 1, 2018, therefore no cumulative adjustment has been made to the opening balance of retained earnings at the beginning of 2018. The comparative information has not been restated and continues to be reported under the accounting standards in effect for the period presented.

In May 2017, the FASB issued amended authoritative guidance to provide guidance on types of changes to the terms or conditions of share-based payments awards to which an entity would be required to apply modification accounting under ASC 718. The new guidance was effective for the Company in the first quarter of fiscal year 2018. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

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THE ENSIGN GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

In January 2017, the FASB issued amended authoritative guidance to clarify the definition of a business and reduce diversity in practice related to the evaluation of whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The new provisions provide the requirements needed for an integrated set of assets and activities (the set) to be a business and also establish a practical way to determine when a set is not a business. The accounting standards update (ASU) provides a screen to determine when an integrated set of assets and activities is not a business. The more robust framework helps entities to narrow the definition of outputs created by the set and align it with how outputs are described in the new revenue standard. The new guidance was effective for the Company in the first quarter of fiscal year 2018. The Company's acquisitions during the three months ended March 31, 2018 were classified as asset acquisitions as the fair value of assets acquired is concentrated in a single asset. These acquisitions would have been classified as business combination prior to the adoption of the ASU. The Company anticipates that future acquisitions will be classified as a mixture of business and asset acquisitions under the new guidance.

In March 2018, we adopted FASB ASU 2018-05, Income Taxes (topic 740): Amendments to the SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 118, which updates the income tax accounting in U.S. GAAP to reflect the securities and Exchange Commission ('SEC') interpretive guidance released in December 2017, when the Tax Cuts and Jobs Act (the 'Tax Act') was signed into law. Additional information regarding the adoption of this standard is contained in Note 13, Income Taxes.

In October 2016, the FASB issued amended authoritative guidance to require companies to recognize the income tax consequences of an intra-entity transfer of an asset, other than inventory, when the transfer occurs. The new guidance is required to be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The new guidance was effective for the Company in the first quarter of fiscal year 2018. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

In August 2016, the FASB issued amended authoritative guidance to reduce the diversity in practice related to the presentation and classification of certain cash receipts and cash payments in the statement of cash flows. The new provisions target cash flow issues related to (i) debt prepayment or debt extinguishment costs, (ii) settlement of debt instruments with coupon rates that are insignificant relative to effective interest rates, (iii) contingent consideration payments made after a business combination, (iv) proceeds from settlement of insurance claims, (v) proceeds from the settlement of corporate-owned life insurance and bank-owned life insurance policies, (vi) distributions received from equity method investees, (vii) beneficial interests in securitization transactions and (viii) separately identifiable cash flows and application of the predominance principle. The new guidance was effective for the Company in the first quarter of fiscal year 2018. The adoption of this standard did not have a material impact on the Company's consolidated financial statements.

Accounting Standards Recently Issued But Not Yet Adopted by the Company

In January 2017, the FASB issued amended authoritative guidance to simplify and reduce the cost and complexity of the goodwill impairment test. The new provisions eliminate step 2 from the goodwill impairment test and shifts the concept of impairment from a measure of loss when comparing the implied fair value of goodwill to its carrying amount to comparing the fair value of a reporting unit with its carrying amount. The FASB also eliminated the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment or step 2 of the goodwill impairment test. The new guidance does not amend the optional qualitative assessment of goodwill impairment. This guidance is effective for annual periods beginning after December 15, 2019, which will be

the Company's fiscal year 2020, with early adoption permitted. The adoption of this standard is not expected to have a material impact on the Company's consolidated financial statements.

In February 2016, the FASB issued amended authoritative guidance on accounting for leases. The new provisions require that a lessee of operating leases recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. The lease liability will be equal to the present value of lease payments, with the right-of-use asset based upon the lease liability. The classification criteria for distinguishing between finance (or capital) leases and operating leases are substantially similar to the previous lease guidance, but with no explicit bright lines. As such, operating leases will result in straight-line rent expense similar to current practice. For short term leases (term of 12 months or less), a lessee is permitted to make an accounting election not to recognize lease assets and lease liabilities, which would generally result in lease expense being recognized on a straight-line basis over the lease term. This guidance applies to all entities and is effective for annual periods beginning after December 15, 2018, which will be the Company's fiscal year 2019, with early adoption permitted. The Company is currently evaluating the impact this guidance will have on its consolidated financial statements but expects this adoption will result in a significant increase in the assets and liabilities on its consolidated balance sheets.

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THE ENSIGN GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

3. REVENUE AND ACCOUNTS RECEIVABLE

The Company's revenue is derived primarily from providing healthcare services to its patients. Revenues are recognized when services are provided to the patients at the amount that reflects the consideration to which the Company expects to be entitled from patients and third-party payors, including Medicaid, Medicare and insurers (private and Medicare replacement plans), in exchange for providing patient care. The healthcare services in transitional and skilled, home health and hospice patient contracts include routine services in exchange for a contractual agreed-upon amount or rate. Routine services are treated as a single performance obligation satisfied over time as services are rendered. As such, patient care services represent a bundle of services that are not capable of being distinct. Additionally, there may be ancillary services which are not included in the daily rates for routine services, but instead are treated as separate performance obligations satisfied at a point in time, if and when, those services are rendered.

Revenue recognized from healthcare services are adjusted for estimates of variable consideration to arrive at the transaction price. The Company determines the transaction price based on contractually agreed-upon amounts or rate, adjusted for estimates of variable consideration. The Company uses the expected value method in determining the variable component that should be used to arrive at the transaction price, using contractual agreements and historical reimbursement experience within each payor type. The amount of variable consideration which is included in the transaction price may be constrained, and is included in the net revenue only to the extent that it is probable that a significant reversal in the amount of the cumulative revenue recognized will not occur in a future period. If actual amounts of consideration ultimately received differ from the Company's estimates, the Company adjusts these estimates, which would affect net service revenue in the period such variances become known.

Revenue from the Medicare and Medicaid programs accounted for 67.9% and 68.2% of the Company's revenue for the three months ended March 31, 2018 and 2017, respectively. Settlement with Medicare and Medicaid payors for retroactive adjustments due to audits and reviews are considered variable consideration and are included in the determination of the estimated transaction price. These settlements are estimated based on the terms of the payment agreement with the payor, correspondence from the payor and the Company's historical settlement activity. Consistent with healthcare industry practices, any changes to these revenue estimates are recorded in the period the change or adjustment becomes known based on final settlement. The Company recorded adjustments to revenue which were not material to the Company's consolidated revenue or Interim Financial Statements for the three months ended March 31, 2018 and 2017.

Disaggregation of Revenue

The Company disaggregates revenue from contracts with its patients by reportable operating segments and payors. The Company determines that disaggregating revenue into these categories achieves the disclosure objectives to depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. A reconciliation of disaggregated revenue to segment revenue as well as revenue by payor is provided in Note 6, Business Segments.

The Company's service specific revenue recognition policies are as follows:

Transitional and Skilled Nursing Revenue

The Company's revenue is derived primarily from providing long-term healthcare services to patients and is recognized on the date services are provided at amounts billable to individual patients, adjusted for estimates for variable consideration. For patients under reimbursement arrangements with third-party payors, including Medicaid, Medicare and private insurers, revenue is recorded based on contractually agreed-upon amounts or rate, adjusted for estimates for variable consideration, on a per patient, daily basis or as services are performed.

Assisted and Independent Living Revenue

The Company's assisted and independent living revenue consists of fees for basic housing and assisted living care. Accordingly, we record revenue when services are rendered on the date services are provided at amounts billable to individual residents. Residency agreements are generally for a term of 30 days, with resident fees billed monthly in advance. For patients under reimbursement arrangements with Medicaid, revenue is recorded based on contractually agreed-upon amounts or rates on a per resident, daily basis or as services are rendered.

Home Health Revenue

Medicare Revenue

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THE ENSIGN GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Net service revenue is recorded under the Medicare prospective payment system based on a 60-day episode payment rate that is subject to adjustment based on certain variables including, but not limited to: (a) an outlier payment if patient care was unusually costly; (b) a low utilization payment adjustment if the number of visits was fewer than five; (c) a partial payment if the patient transferred to another provider or the Company received a patient from another provider before completing the episode; (d) a payment adjustment based upon the level of therapy services required; (e) the number of episodes of care provided to a patient, regardless of whether the same home health provider provided care for the entire series of episodes; (f) changes in the base episode payments established by the Medicare program; (g) adjustments to the base episode payments for case mix and geographic wages; and (h) recoveries of overpayments.

The Company makes adjustments to Medicare revenue on completed episodes to reflect differences between estimated and actual payment amounts, an inability to obtain appropriate billing documentation or authorizations acceptable to the payor and other reasons unrelated to credit risk. Revenue is also adjusted for estimates for variable consideration. Therefore, the Company believes that its reported net service revenue and patient accounts receivable will be the net amounts to be realized from Medicare for services rendered.

In addition to revenue recognized on completed episodes, the Company also recognizes a portion of revenue associated with episodes in progress. Episodes in progress are 60-day episodes of care that begin during the reporting period, but were not completed as of the end of the period. As such, the Company estimates revenue and recognizes it on a daily basis. The primary factors underlying this estimate are the number of episodes in progress at the end of the reporting period, expected Medicare revenue per episode and its estimate of the average percentage complete based on visits performed.

Non-Medicare Revenue

Episodic Based Revenue - The Company recognizes revenue in a similar manner as it recognizes Medicare revenue for episodic-based rates that are paid by other insurance carriers, including Medicare Advantage programs; however, these rates can vary based upon the negotiated terms.

Non-episodic Based Revenue - Revenue is recorded on an accrual basis based upon the date of service at amounts equal to its established or estimated per-visit rates, and adjusted for estimates for variable consideration, as applicable.

Hospice Revenue

Revenue is recorded on an accrual basis based upon the date of service at amounts equal to the estimated payment rates, net of estimates for variable consideration. The estimated payment rates are daily rates for each of the levels of care the Company delivers. The Company makes adjustments to revenue for an inability to obtain appropriate billing documentation or authorizations acceptable to the payor and other reasons, including credit risk. Additionally, as Medicare hospice revenue is subject to an inpatient cap limit and an overall payment cap, the Company monitors its provider numbers and estimates amounts due back to Medicare if a cap has been exceeded. The Company records these adjustments as a reduction to revenue and increases to other accrued liabilities.

Impact of New Revenue Guidance on Financial Statement Line Items

The following tables summarize the impacts of adopting ASC 606 on the Company's condensed consolidated statements of income for the three months ended March 31, 2018. There was no impact to the condensed consolidated balance sheet as of March 31, 2018 or condensed consolidated statements of cash flows for the three months ended March 31, 2018, as such, no pro forma information is provided.

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THE ENSIGN GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	Three Months Ended March 31,	
	2018	2017
Total revenue		
As Reported	\$492,134	\$441,739
Adjustments	8,804	—
Pro forma as if the previous accounting guidance was in effect	\$500,938	\$441,739
Cost of Services:		
As Reported	\$390,243	\$355,486
Adjustments	8,804	—
Pro forma as if the previous accounting guidance was in effect	\$399,047	\$355,486
Total Expense:		
As Reported	\$459,155	\$434,187
Adjustments	8,804	—
Pro forma as if the previous accounting guidance was in effect	\$467,959	\$434,187

The majority of what was previously presented as bad debt expense under operating expenses has been incorporated as an implicit price concession factored into the calculation of net revenues, as shown in the "Adjustments" line in the table above. Subsequent material events that alter the payor's ability to pay are recorded as bad debt expense. The Company's bad debt expense and bad debt as a percent of total revenue for the three months ended March 31, 2018 and 2017 was \$570 and 0.1%, and \$7,350 and 1.7%, respectively.

Prior period results reflect reclassifications, for comparative purposes, related to the adoption of ASC 606, for the presentation of the Company's assisted and independent living revenues. Historically, the Company only presented total revenue for all revenue services. This reclassification had no effect on the reported results of operations.

Revenue for the three months ended March 31, 2018 and 2017 is summarized in the following tables:

	Three Months Ended March 31,					
	2018		2018 Pro Forma (2)		2017	
	Revenue	% of Revenue	Revenue	% of Revenue	Revenue	% of Revenue
Medicaid	\$167,625	34.1 %	\$170,309	34.0 %	\$148,271	33.6 %
Medicare	139,314	28.3	140,381	28.0	129,920	29.4
Medicaid — skilled	27,042	5.5	27,538	5.5	23,017	5.2
Total Medicaid and Medicare	333,981	67.9	338,228	67.5	301,208	68.2
Managed care	83,716	17.0	85,845	17.1	75,562	17.1
Private and other payors ⁽¹⁾	74,437	15.1	76,865	15.4	64,969	14.7
Revenue	\$492,134	100.0 %	\$500,938	100.0 %	\$441,739	100.0 %

(1) Private and other payors also includes revenue from all payors generated in other ancillary services for the three months ended March 31, 2018 and 2017.

(2) The 2018 pro forma results reflect balances assuming previous accounting guidance was still in effect.

Balance Sheet Impact

Included in the Company's condensed consolidated balance sheet are contract assets, comprised of billed accounts receivable and unbilled receivables which are the result of the timing of revenue recognition, billings and cash collections, as well as, contract liabilities, which primarily represent payments the Company receives in advance of

services provided. The Company had no material contract liabilities or activity as of and for the three months ended March 31, 2018 related to its transitional and skilled services, and home health and hospice services segments.

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THE ENSIGN GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Accounts receivable as of March 31, 2018 and December 31, 2017 is summarized in the following table:

	March 31, 2018	2018 Pro Forma (1)	December 31, 2017
Medicaid	\$99,799	\$112,419	\$119,441
Managed care	59,358	71,955	68,930
Medicare	49,765	55,361	55,667
Private and other payors	51,349	64,983	64,991
	260,271	304,718	309,029
Less: allowance for doubtful accounts	(1,762)	(46,209)	(43,961)
Accounts receivable, net	\$258,509	\$258,509	\$265,068

(1) The 2018 pro forma results reflect balances assuming previous accounting guidance was still in effect.

Practical Expedients and Exemptions

As the Company's contracts with its patients have an original duration of one year or less, the Company uses the practical expedient applicable to its contracts and does not consider the time value of money. Further, because of the short duration of these contracts, the Company has not disclosed the transaction price for the remaining performance obligations as of the end of each reporting period or when the Company expects to recognize this revenue. In addition, the Company has applied the practical expedient provided by ASC 340, Other Assets and Deferred Costs, and all incremental customer contract acquisition costs are expensed as they are incurred because the amortization period would have been one year or less.

4. COMPUTATION OF NET INCOME PER COMMON SHARE

Basic net income per share is computed by dividing income from continuing operations attributable to The Ensign Group, Inc. stockholders by the weighted average number of outstanding common shares for the period. The computation of diluted net income per share is similar to the computation of basic net income per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the dilutive potential common shares had been issued.

A reconciliation of the numerator and denominator used in the calculation of basic net income per common share follows:

	Three Months Ended March 31, 2018		2017
Numerator:			
Net income	\$23,293	\$2,956	
Less: net income attributable to noncontrolling interests	161	116	
Net income attributable to The Ensign Group, Inc.	\$23,132	\$2,840	
Denominator:			
Weighted average shares outstanding for basic net income per share	51,585	50,767	
Basic net income per common share attributable to The Ensign Group, Inc.	\$0.45	\$0.06	

A reconciliation of the numerator and denominator used in the calculation of diluted net income per common share follows:

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THE ENSIGN GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	Three Months Ended March 31,	
	2018	2017
Numerator:		
Net income	\$23,293	\$2,956
Less: net income attributable to noncontrolling interests	161	116
Net income attributable to The Ensign Group, Inc.	\$23,132	\$2,840
Denominator:		
Weighted average common shares outstanding	51,585	50,767
Plus: incremental shares from assumed conversion ⁽¹⁾	1,933	1,866
Adjusted weighted average common shares outstanding	53,518	52,633
Diluted net income per common share attributable to The Ensign Group, Inc.	\$0.43	\$0.05

(1) Options outstanding which are anti-dilutive and therefore not factored into the weighted average common shares amount above were 937 and 1,272 for the three months ended March 31, 2018 and 2017, respectively.

5. FAIR VALUE MEASUREMENTS

Fair value measurements are based on a three-tier hierarchy that prioritizes the inputs used to measure fair value. These tiers include: Level 1, defined as observable inputs such as quoted market prices in active markets; Level 2, defined as inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

The following table summarizes the financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2018 and December 31, 2017:

	March 31, 2018			December 31, 2017		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Cash and cash equivalents	\$35,057	\$ —	\$ —	-\$42,337	\$ —	\$ —

The Company's non-financial assets, which include long-lived assets, including goodwill, intangible assets and property and equipment, are not required to be measured at fair value on a recurring basis. However, on a periodic basis, or whenever events or changes in circumstances indicate that their carrying value may not be recoverable, the Company assesses its long-lived assets for impairment. When impairment has occurred, such long-lived assets are written down to fair value. See Note 2, Summary of Significant Accounting Policies for further discussion of the Company's significant accounting policies.

Debt Security Investments - Held to Maturity

At March 31, 2018 and December 31, 2017, the Company had approximately \$41,696 and \$41,777, respectively, in debt security investments which were classified as held to maturity and carried at amortized cost. The carrying value of the debt securities approximates fair value based on Level 1. The Company has the intent and ability to hold these debt securities to maturity. Further, as of March 31, 2018, the debt security investments were held in AA, A and BBB+ rated debt securities.

6. BUSINESS SEGMENTS

The Company has three reportable operating segments: (1) transitional and skilled services, which includes the operation of skilled nursing facilities; (2) assisted and independent living services, which includes the operation of assisted and independent living facilities; and (3) home health and hospice services, which includes the Company's home health, home care and hospice businesses. The Company's Chief Executive Officer, who is its chief operating decision maker, or CODM, reviews financial information at the operating segment level.

The Company also reports an “all other” category that includes results from its mobile diagnostics and other ancillary operations for the three months ended March 31, 2018 and 2017. These operations are neither significant individually nor in

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THE ENSIGN GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

aggregate and therefore do not constitute a reportable segment. The reporting segments are business units that offer different services and are managed separately to provide greater visibility into those operations.

As of March 31, 2018, transitional and skilled services included 160 wholly-owned affiliated skilled nursing facilities and 21 campuses that provide skilled nursing and rehabilitative care services and assisted and independent living services. The Company provided room and board and social services through 51 wholly-owned affiliated assisted and independent living facilities and 21 campuses as mentioned above. Home health, home care and hospice services were provided to patients through 46 affiliated agencies. As of March 31, 2018, the Company held majority membership interests in other ancillary operations, which operating results are included in the "all other" category.

The Company evaluates performance and allocates capital resources to each segment based on an operating model that is designed to maximize the quality of care provided and profitability. General and administrative expenses are not allocated to any segment for purposes of determining segment profit or loss, and are included in the "all other" category in the selected segment financial data that follows. The accounting policies of the reporting segments are the same as those described in Note 2, Summary of Significant Accounting Policies. The Company's CODM does not review assets by segment in his resource allocation and therefore assets by segment are not disclosed below.

Segment revenues by major payor source were as follows:

	Three Months Ended March 31, 2018					
	Transitional and Skilled Services	Assisted and Independent Living Services	Home Health and Hospice Services	All Other	Total Revenue	Revenue %
Medicaid	\$156,511	\$ 8,264	\$ 2,850	\$—	\$167,625	34.1 %
Medicare	111,953	—	27,361	—	139,314	28.3
Medicaid-skilled	27,042	—	—	—	27,042	5.5
Subtotal	295,506	8,264	30,211	—	333,981	67.9
Managed care	77,800	—	5,916	—	83,716	17.0
Private and other	33,710	27,849	3,631	9,247	(1)74,437	15.1
Total revenue	\$407,016	\$ 36,113	\$ 39,758	\$9,247	\$492,134	100.0 %

(1) Private and other payors also includes revenue from all payors generated in other ancillary services for the three months ended March 31, 2018.

	Three Months Ended March 31, 2017					
	Transitional and Skilled Services	Assisted and Independent Living Services	Home Health and Hospice Services	All Other	Total Revenue	Revenue %
Medicaid	\$138,825	\$ 7,036	\$ 2,410	\$ —	-\$148,271	33.6 %
Medicare	107,928	—	21,992	—	129,920	29.4
Medicaid-skilled	23,017	—	—	—	23,017	5.2
Subtotal	269,770	7,036	24,402	—	301,208	68.2
Managed care	70,357	—	5,205	—	75,562	17.1