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

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2011

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from_____to_____.

Commission file number: 001-14057

KINDRED HEALTHCARE, INC.

(Exact name of registrant as specified in its charter)

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

(502) 596-7300

(Registrant s telephone number, including area code)

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

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

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

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

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

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

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

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FORM 10-Q

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(Unaudited)

(In thousands, except per share amounts)

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

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

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEET

(Unaudited)

(In thousands, except per share amounts)

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

Commitments and contingencies

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

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(Unaudited)

(In thousands)

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

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

See accompanying notes.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 BASIS OF PRESENTATION

Business

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

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

Recently issued accounting requirements

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 BASIS OF PRESENTATION (Continued)

Recently issued accounting requirements (Continued)

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

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

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

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 BASIS OF PRESENTATION (Continued)

Recently issued accounting requirements (Continued)

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

Comprehensive income

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

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

Equity

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 BASIS OF PRESENTATION (Continued)

Equity (Continued)

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

Other information

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

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

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

Reclassifications

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

NOTE 2 REHABCARE ACQUISITION

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 REHABCARE ACQUISITION (Continued)

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

New credit facilities and notes

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

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

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

ABL Facility

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 REHABCARE ACQUISITION (Continued)

ABL Facility (Continued)

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

Term Loan Facility

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

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

Notes

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

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

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

Purchase price allocation

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 REHABCARE ACQUISITION (Continued)

Purchase price allocation (Continued)

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

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

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

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

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

The aggregate goodwill arising from the Merger is based upon the expected future cash flows of the RehabCare operations, which reflect both growth expectations and cost savings from combining the operations of the Company and RehabCare. Goodwill is not amortized and is not

deductible for income tax purposes. Goodwill was preliminarily assigned to the Company s hospital reporting unit ($587 million), skilled nursing rehabilitation services reporting unit ($121 million) and hospital rehabilitation services reporting unit ($138 million).

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 REHABCARE ACQUISITION (Continued)

Purchase price allocation (Continued)

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

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

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

NOTE 3 OTHER ACQUISITIONS

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 3 OTHER ACQUISITIONS (Continued)

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

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

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

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

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

NOTE 4 IMPAIRMENT CHARGES

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

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

NOTE 5 DISCONTINUED OPERATIONS

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 DISCONTINUED OPERATIONS (Continued)

A summary of discontinued operations follows (in thousands):

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

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 DISCONTINUED OPERATIONS (Continued)

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

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

NOTE 6 REVENUES

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

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

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

NOTE 7 EARNINGS PER SHARE

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

security in the basic and diluted earnings per common share calculation pursuant to the two-class method.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7 EARNINGS PER SHARE (Continued)

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA

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

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

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA (Continued)

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA (Continued)

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 BUSINESS SEGMENT DATA (Continued)

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

NOTE 9 INSURANCE RISKS

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

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

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 INSURANCE RISKS (Continued)

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

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

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

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

NOTE 10 INSURANCE SUBSIDIARY INVESTMENTS

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 10 INSURANCE SUBSIDIARY INVESTMENTS (Continued)

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

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

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

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 11 INCOME TAXES

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

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

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

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

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

NOTE 12 CONTINGENCIES

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

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

Principal contingencies are described below:

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 12 CONTINGENCIES (Continued)

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

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

NOTE 13 CAPITAL STOCK

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

NOTE 14 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

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

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

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 14 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

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

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 14 FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

Recurring measurements

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

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

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

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

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

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

Non-recurring measurements

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

factoring in depreciation, economic obsolesce and inflation trends.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION

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

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Operations

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Operations (Continued)

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Operations (Continued)

	Nine months ended September 30, 2011				
(In thousands)	**Parent company/ issuer**	**Guarantor subsidiaries**	**Non-guarantor subsidiaries**	**Consolidating and eliminating adjustments**	**Consolidated**
Revenues	$	$ 3,879,843	$ 184,025	$ (64,793)	$ 3,999,075
Salaries, wages and benefits	401	2,290,765	53,232		2,344,398
Supplies		282,713	11,541		294,254
Rent	3	282,524	10,114		292,641
Other operating expenses	70	850,080	93,161	(64,793)	878,518
Other income		(8,480)			(8,480)
Depreciation and amortization		112,897	4,470		117,367
Management fees		(4,627)	4,627		
Intercompany interest (income) expense from affiliates	(61,317)	56,017	5,300		
Interest expense	54,228	144	303		54,675
Investment (income) loss		(6,212)	5,423		(789)
Equity in net income of consolidating affiliates	(14,225)			14,225	
	(20,840)	3,855,821	188,171	(50,568)	3,972,584
Income (loss) from continuing operations before income taxes	20,840	24,022	(4,146)	(14,225)	26,491
Provision for income taxes	2,490	7,194	164		9,848
Income (loss) from continuing operations	18,350	16,828	(4,310)	(14,225)	16,643
Income from discontinued operations, net of income taxes		1,527			1,527
Net income (loss)	18,350	18,355	(4,310)	(14,225)	18,170
Loss attributable to noncontrolling interest			180		180
Income (loss) attributable to Kindred	$ 18,350	$ 18,355	$ (4,130)	$ (14,225)	$ 18,350

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Operations (Continued)

	Nine months ended September 30, 2010				
(In thousands)	**Parent company/ issuer**	**Guarantor subsidiaries**	**Non-guarantor subsidiaries**	**Consolidating and eliminating adjustments**	**Consolidated**
Revenues	$	$ 3,222,587	$ 57,992	$ (56,366)	$ 3,224,213
Salaries, wages and benefits	249	1,852,738			1,852,987
Supplies		255,094			255,094
Rent	3	266,592			266,595
Other operating expenses	641	705,163	58,421	(56,366)	707,859
Other income		(8,735)			(8,735)
Depreciation and amortization		90,140			90,140
Management fees	168	(168)			
Intercompany interest (income) expense from affiliates	(23,737)	23,737			
Interest expense	4,148	99			4,247
Investment income		(68)	(835)		(903)
Equity in net income of consolidating affiliates	(24,673)			24,673	
	(43,201)	3,184,592	57,586	(31,693)	3,167,284
Income from continuing operations before income taxes	43,201	37,995	406	(24,673)	56,929
Provision for income taxes	7,134	13,205	199		20,538
Income from continuing operations	36,067	24,790	207	(24,673)	36,391
Discontinued operations, net of income taxes:					
Loss from operations		(327)			(327)
Gain on divestiture of operations		3			3
Loss from discontinued operations		(324)			(324)
Net income	$ 36,067	$ 24,466	$ 207	$ (24,673)	$ 36,067

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Balance Sheet

	As of September 30, 2011				
(In thousands)	**Parent company/ issuer**	**Guarantor subsidiaries**	**Non-guarantor subsidiaries**	**Consolidating and eliminating adjustments**	**Consolidated**
ASSETS					
Current assets:					
Cash and cash equivalents	$	$ 8,967	$ 25,128	$	$ 34,095
Cash restricted		5,402			5,402
Insurance subsidiary investments			64,846		64,846
Accounts receivable, net		880,145	92,195		972,340
Inventories		27,975	2,846		30,821
Deferred tax assets		28,799			28,799
Income taxes		18,039			18,039
Other		26,786	4,010		30,796
		996,113	189,025		1,185,138
Property and equipment, net		998,118	52,723		1,050,841
Goodwill		827,091	296,608		1,123,699
Intangible assets, net		479,472	26,594		506,066
Assets held for sale		7,094			7,094
Insurance subsidiary investments			104,298		104,298
Investment in subsidiaries	339,247			(339,247)	
Other	54,522	91,517	52,402		198,441
	$ 393,769	$ 3,399,405	$ 721,650	$ (339,247)	$ 4,175,577
LIABILITIES AND EQUITY					
Current liabilities:					
Accounts payable	$ 102	$ 200,221	$ 18,200	$	$ 218,523
Salaries, wages and other compensation	77	347,627	44,593		392,297
Due to third party payors		41,436			41,436
Professional liability risks		(10,475)	52,203		41,728
Other accrued liabilities		130,665	10,175		140,840
Income taxes		227	(227)		
Long-term debt due within one year	7,000	327	3,212		10,539
	7,179	710,028	128,156		845,363

Long-term debt	1,483,083	486	5,790		1,489,359
Intercompany	(2,454,556)	2,099,244	355,312		
Professional liability risks		118,078	106,825		224,903
Deferred tax liabilities		33,569	(6,891)		26,678
Deferred credits and other liabilities		141,290	48,524		189,814
Noncontrolling interests-redeemable			9,626		9,626
Commitments and contingencies					
Equity:					
Stockholders equity	1,358,063	296,710	42,537	(339,247)	1,358,063
Noncontrolling interests-nonredeemable			31,771		31,771
	1,358,063	296,710	74,308	(339,247)	1,389,834
	$ 393,769	$ 3,399,405	$ 721,650	$ (339,247)	$ 4,175,577

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Balance Sheet (Continued)

	As of December 31, 2010				
(In thousands)	**Parent company/ issuer**	**Guarantor subsidiaries**	**Non-guarantor subsidiaries**	**Consolidating and eliminating adjustments**	**Consolidated**
ASSETS					
Current assets:					
Cash and cash equivalents	$	$ 17,168	$	$	$ 17,168
Cash restricted		5,494			5,494
Insurance subsidiary investments			76,753		76,753
Accounts receivable, net		631,612	265		631,877
Inventories		24,327			24,327
Deferred tax assets		13,439			13,439
Income taxes		42,118			42,118
Other		24,850	12		24,862
		759,008	77,030		836,038
Property and equipment, net		896,547			896,547
Goodwill		242,420			242,420
Intangible assets, net		92,883			92,883
Assets held for sale		7,167			7,167
Insurance subsidiary investments			101,210		101,210
Deferred tax assets		82,536	6,280		88,816
Investment in subsidiaries	329,657			(329,657)	
Other	4,948	14,166	53,220		72,334
	$ 334,605	$ 2,094,727	$ 237,740	$ (329,657)	$ 2,337,415
LIABILITIES AND STOCKHOLDERS EQUITY					
Current liabilities:					
Accounts payable	$ 81	$ 172,296	$ 2,118	$	$ 174,495
Salaries, wages and other compensation	44	268,481	22,591		291,116
Due to third party payors		27,115			27,115
Professional liability risks		2,385	39,170		41,555
Other accrued liabilities		87,012			87,012
Long-term debt due within one year		91			91
	125	557,380	63,879		621,384
Long-term debt	365,000	556			365,556

Intercompany	(1,062,279)	1,071,029	(8,750)		
Professional liability risks		106,769	100,900		207,669
Deferred credits and other liabilities		64,712	46,335		111,047
Commitments and contingencies					
Stockholders equity	1,031,759	294,281	35,376	(329,657)	1,031,759
	$ 334,605	$ 2,094,727	$ 237,740	$ (329,657)	$ 2,337,415

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Cash Flows

	Three months ended September 30, 2011				
(In thousands)	**Parent company/ issuer**	**Guarantor subsidiaries**	**Non-guarantor subsidiaries**	**Consolidating and eliminating adjustments**	**Consolidated**
Net cash provided by operating activities	$ 1,029	$ 58,112	$ 7,377	$	$ 66,518
Cash flows from investing activities:					
Routine capital expenditures		(35,140)	(1,455)		(36,595)
Development capital expenditures		(44,152)			(44,152)
Acquisitions, net of cash acquired		(50,928)			(50,928)
Purchase of insurance subsidiary investments			(8,867)		(8,867)
Sale of insurance subsidiary investments			10,398		10,398
Net change in insurance subsidiary cash and cash equivalents			(826)		(826)
Other		(663)			(663)
Net cash used in investing activities		(130,883)	(750)		(131,633)
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	533,200				533,200
Repayment of borrowings under revolving credit	(474,700)				(474,700)
Repayment of other long-term debt		(1,542)	(1,003)		(2,545)
Payment of deferred financing costs	(1,855)				(1,855)
Purchase of noncontrolling interests in subsidiaries			(7,292)		(7,292)
Change in intercompany accounts	(57,677)	48,084	9,593		
Insurance subsidiary distribution					
Other	3				3
Net cash provided by (used in) financing activities	(1,029)	46,542	1,298		46,811
Change in cash and cash equivalents		(26,229)	7,925		(18,304)
Cash and cash equivalents at beginning of period		35,196	17,203		52,399
Cash and cash equivalents at end of period	$	$ 8,967	$ 25,128	$	$ 34,095

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Cash Flows (Continued)

	Three months ended September 30, 2010				
(In thousands)	**Parent company/ issuer**	**Guarantor subsidiaries**	**Non-guarantor subsidiaries**	**Consolidating and eliminating adjustments**	**Consolidated**
Net cash provided by operating activities	$ 3,929	$ 61,562	$ 2,418	$	$ 67,909
Cash flows from investing activities:					
Routine capital expenditures		(28,623)			(28,623)
Development capital expenditures		(20,364)			(20,364)
Acquisitions		(38,379)			(38,379)
Purchase of insurance subsidiary investments			(10,566)		(10,566)
Sale of insurance subsidiary investments			11,138		11,138
Net change in insurance subsidiary cash and cash equivalents			(3,111)		(3,111)
Other		698			698
Net cash used in investing activities		(86,668)	(2,539)		(89,207)
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	457,900				457,900
Repayment of borrowings under revolving credit	(432,800)				(432,800)
Repayment of long-term debt		(22)			(22)
Payment of deferred financing costs	(1,361)				(1,361)
Change in intercompany accounts	(27,668)	27,547	121		
Other					
Net cash provided by (used in) financing activities	(3,929)	27,525	121		23,717
Change in cash and cash equivalents		2,419			2,419
Cash and cash equivalents at beginning of period		12,902			12,902
Cash and cash equivalents at end of period	$	$ 15,321	$	$	$ 15,321

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Cash Flows (Continued)

	Nine months ended September 30, 2011				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Net cash provided by (used in) operating activities	$ (38,301)	$ 143,202	$ 16,405	$ (3,500)	$ 117,806
Cash flows from investing activities:					
Routine capital expenditures		(93,734)	(1,529)		(95,263)
Development capital expenditures		(69,570)			(69,570)
Acquisitions, net of cash acquired		(741,079)	30,172		(710,907)
Sale of assets		1,714			1,714
Purchase of insurance subsidiary investments			(25,904)		(25,904)
Sale of insurance subsidiary investments			37,587		37,587
Net change in insurance subsidiary cash and cash equivalents			(4,870)		(4,870)
Change in other investments		1,000			1,000
Other		(692)			(692)
Net cash provided by (used in) investing activities		(902,361)	35,456		(866,905)
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	1,633,300				1,633,300
Repayment of borrowings under revolving credit	(1,749,800)				(1,749,800)
Proceeds from issuance of senior unsecured notes	550,000				550,000
Proceeds from issuance of term loan, net of discount	693,000				693,000
Repayment of other long-term debt		(346,959)	(1,274)		(348,233)
Payment of deferred financing costs	(8,715)				(8,715)
Issuance of common stock	3,019				3,019
Purchase of noncontrolling interests in subsidiaries			(7,292)		(7,292)
Change in intercompany accounts	(1,083,250)	1,097,917	(14,667)		
Insurance subsidiary distribution			(3,500)	3,500	
Other	747				747
Net cash provided by (used in) financing activities	38,301	750,958	(26,733)	3,500	766,026
Change in cash and cash equivalents		(8,201)	25,128		16,927
Cash and cash equivalents at beginning of period		17,168			17,168
Cash and cash equivalents at end of period	$	$ 8,967	$ 25,128	$	$ 34,095

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Cash Flows (Continued)

	Nine months ended September 30, 2010				
(In thousands)	**Parent company/ issuer**	**Guarantor subsidiaries**	**Non-guarantor subsidiaries**	**Consolidating and eliminating adjustments**	**Consolidated**
Net cash provided by operating activities	$ 32,147	$ 135,367	$ 5,141	$ (21,800)	$ 150,855
Cash flows from investing activities:					
Routine capital expenditures		(69,108)			(69,108)
Development capital expenditures		(40,219)			(40,219)
Acquisitions		(87,869)			(87,869)
Purchase of insurance subsidiary investments			(34,684)		(34,684)
Sale of insurance subsidiary investments			72,971		72,971
Net change in insurance subsidiary cash and cash equivalents			(10,612)		(10,612)
Change in other investments		2			2
Other		1,279			1,279
Net cash provided by (used in) investing activities		(195,915)	27,675		(168,240)
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	1,109,900				1,109,900
Repayment of borrowings under revolving credit	(1,092,400)				(1,092,400)
Repayment of long-term debt		(64)			(64)
Payment of deferred financing costs	(1,414)				(1,414)
Issuance of common stock	35				35
Change in intercompany accounts	(48,268)	59,284	(11,016)		
Insurance subsidiary distribution			(21,800)	21,800	
Other		346			346
Net cash provided by (used in) financing activities	(32,147)	59,566	(32,816)	21,800	16,403
Change in cash and cash equivalents		(982)			(982)
Cash and cash equivalents at beginning of period		16,303			16,303
Cash and cash equivalents at end of period	$	$ 15,321	$	$	$ 15,321

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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 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 words such as anticipate, approximate, believe, plan, estimate, expect, project, 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:

- the impact of a final rule issued by CMS on July 29, 2011 providing for a 11.1% reduction in Medicare reimbursement to nursing centers as well as changes in payments for the provision of group rehabilitation therapy services,

- other potential reimbursement changes resulting from the Budget Control Act of 2011,

- the Company s ability to integrate the operations of the acquired hospitals and rehabilitation services operations and realize the anticipated revenues, economies of scale, cost synergies and productivity gains in connection with the RehabCare acquisition and any other acquisitions undertaken during 2011, as and when planned, including the potential for unanticipated issues, expenses and liabilities associated with those acquisitions,

- the potential for diversion of management time and resources in seeking to integrate RehabCare s operations,

- the potential failure to retain key employees of RehabCare,

- the impact of the Company s significantly increased levels of indebtedness as a result of the RehabCare acquisition on the Company s funding costs, operating flexibility and ability to fund ongoing operations, development capital expenditures or other strategic acquisitions with additional borrowings, particularly in light of ongoing volatility in the credit and capital markets,

- the impact of healthcare reform, which will initiate significant reforms to the United States healthcare system, including potential material changes to the delivery of healthcare services and the reimbursement paid for such services by the government or other third party payors. Healthcare reform will impact each of the Company s businesses in some manner. Due to the substantial regulatory changes that will need to be implemented by CMS and others, and the numerous processes required to implement these reforms, the Company cannot predict which healthcare initiatives will be implemented at the federal or state level, the timing of any such reforms, or the effect such reforms or any other future legislation or regulation will have on the Company s business, financial position, results of operations and liquidity,

changes in the reimbursement rates or the methods or timing of payment from third party payors, including commercial payors and the Medicare and Medicaid programs, changes arising from and

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

Cautionary Statement (Continued)

related to the Medicare prospective payment system for LTAC hospitals, 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 nursing centers, and the expiration of the Medicare Part B therapy cap exception process,

the effects of additional legislative changes and government regulations, interpretation of regulations and changes in the nature and enforcement of regulations governing the healthcare industry,

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

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 moratorium on future hospital development,

the impact of the expiration of several moratoriums under the SCHIP Extension Act which could impact the short stay rules, the budget neutrality adjustment as well as implement the policy known as the 25 Percent Rule, which would limit certain patient admissions,

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

the further consolidation and cost containment efforts 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, Inc.,

the condition of the financial markets, including volatility and weakness 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,

the increase in the costs of defending and insuring against alleged professional liability and other claims and the 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 and other claims,

the Company s ability to successfully dispose of unprofitable facilities,

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

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

Cautionary Statement (Continued)

changes in generally accepted accounting principles or practices, and changes in tax accounting or tax laws (or authoritative interpretations relating to any of these matters), 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 LTAC hospitals, inpatient rehabilitation hospitals, nursing and rehabilitation centers, assisted living facilities and a contract rehabilitation services business across the United States. At September 30, 2011, the Company s hospital division operated 120 LTAC hospitals (8,597 licensed beds) and five inpatient rehabilitation hospitals (183 licensed beds) in 26 states. The Company s nursing center division operated 224 nursing and rehabilitation centers (27,172 licensed beds) and six assisted living facilities (413 licensed beds) in 27 states. The Company s rehabilitation division provided rehabilitative services primarily in hospital and long-term care settings in 46 states.

RehabCare acquisition

On June 1, 2011, the Company completed the Merger. Upon consummation of the Merger, each issued and outstanding share of RehabCare common stock was converted into the right to receive the Merger Consideration. Kindred issued approximately 12 million shares of its common stock in connection with the Merger. The purchase price totaled $963 million and was comprised of $662 million in cash and $301 million of Kindred common stock at fair value. The Company also assumed $356 million of long-term debt in the Merger, of which $345 million was refinanced on June 1, 2011. The operating results of RehabCare have been included in the accompanying unaudited condensed consolidated financial statements of the Company since June 1, 2011. RehabCare reported consolidated revenues of approximately $1.3 billion and net income from continuing operations of approximately $65 million in fiscal 2010.

Operating results for the third quarter of 2011 included transaction costs totaling $4 million and severance costs totaling $1 million related to the Merger. Operating results for the nine months ended September 30, 2011 included transaction costs totaling $27 million, financing costs totaling $14 million and severance costs totaling $16 million related to the Merger.

Vista acquisition

On November 1, 2010, the Company completed the acquisition of five LTAC hospitals from Vista Healthcare, LLC (Vista) for a purchase price of $179 million in cash (the Vista Acquisition). The Vista Acquisition was financed with proceeds from the Company s revolving credit facility.

The Vista Acquisition included four freestanding hospitals and one hospital-in-hospital with a total of 250 beds, all of which are located in southern California. The Company did not acquire the working capital of Vista or assume any of its liabilities. All of the Vista hospitals are leased.

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

General (Continued)

Discontinued operations

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 associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at September 30, 2011 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet.

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 various other assumptions that management believes to be reasonable under the circumstances to make judgments about the carrying values of assets and 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 $8 million and $6 million for the third quarter of 2011 and 2010, respectively, and $22 million and $18 million for the nine months ended September 30, 2011 and 2010, respectively.

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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

The Company insures a substantial portion of its professional liability risks and workers compensation risks through its 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 1% to 5% depending upon the policy year. The discount rate was 1% for the 2011 and 2010 policy years. The discount rates are based upon the risk free interest rate for the respective year. Amounts equal to the discounted loss provision are funded annually. The Company does not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. The allowance for professional liability risks aggregated $267 million at September 30, 2011 and $249 million at December 31, 2010. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated $270 million at September 30, 2011 and $253 million at December 31, 2010.

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

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 September 30, 2011 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 $16 million and $13 million for the third quarter of 2011 and 2010, respectively, and $51 million and $46 million for the nine months ended September 30, 2011 and 2010, 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 $166 million at September 30, 2011 and $84 million December 31, 2010. The provision for workers compensation risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated $16 million and $10 million for the third quarter of 2011 and 2010, respectively, and $43 million and $32 million for the nine months ended September 30, 2011 and 2010, respectively.

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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

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 for the third quarter and nine months ended September 30, 2011 and 2010, respectively, were favorably impacted by approximately $3 million related to the resolution of certain prior year income tax contingencies.

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 $2 million at September 30, 2011 and $102 million at December 31, 2010. The change in net deferred taxes at September 30, 2011 was primarily attributable to the Merger and related fair value adjustments recorded in purchase accounting.

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

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 July 2011, the Company resolved federal income tax audits for the 2007 through 2009 tax years. The Company has been notified by the IRS that an examination will be conducted for the 2010 tax year. 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 finite lived 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 that 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

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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)

(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 in accordance with the authoritative guidance for goodwill and other intangible assets using the straight-line method over their estimated useful lives ranging from one to 20 years.

As a result of the Merger, the Company acquired finite lived intangible assets consisting of customer relationships ($189 million), a trade name ($17 million) and non-compete agreements ($3 million) with estimated useful lives ranging from two to 15 years.

In accordance with the authoritative guidance for goodwill and other intangible assets, 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.

On July 29, 2011, CMS issued the 2011 CMS Rules. Based upon the Company s review of the 2011 CMS Rules, the Company believes that its nursing center Medicare rates could decline by as much as 15% in 2012. As a result of these rules, the Company tested the recoverability of its nursing and rehabilitation centers reporting unit goodwill and intangible assets and property and equipment within asset groups impacted by the reduced payments. The Company determined that pretax impairment charges aggregating $27 million ($16 million net of income taxes or $0.31 per diluted share) were necessary. The charges included $6 million of goodwill (which represented the entire nursing and rehabilitation centers reporting unit goodwill) and $21 million of property and equipment. These charges reflected the amount by which the carrying value of certain assets exceeded their estimated fair value. The impairment charges did not impact the Company s cash flows or liquidity.

Although the Company has determined that there was no other goodwill or other indefinite lived intangible asset impairments as of September 30, 2011, 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 or declines in the value of the Company s common stock may result in future impairment charges for a portion or all of these assets. Specifically, if the rate of growth of government and commercial revenues earned by the Company s reporting units were to be less than projected or if healthcare reforms were to negatively impact the Company s business, an impairment charge of a portion or all of the assets may be required. 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.

When 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 and rehabilitation centers, skilled nursing

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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)

rehabilitation services, hospital rehabilitation services, home health and hospice. The carrying value of goodwill for each of the Company s reporting units at September 30, 2011 and December 31, 2010 follows (in thousands):

	September 30, 2011	December 31, 2010
Hospitals	$ 800,053	$ 213,200
Nursing and rehabilitation centers		6,080
Rehabilitation division:		
Skilled nursing rehabilitation services	124,507	3,363
Hospital rehabilitation services	137,978	
Home health	45,848	11,383
Hospice	15,313	8,394
	$ 1,123,699	$ 242,420

As a result of the Merger, goodwill was preliminarily assigned to the Company s hospital reporting unit ($587 million), skilled nursing rehabilitation services reporting unit ($121 million) and hospital rehabilitation services reporting unit ($138 million).

The 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, 2010. The Company did not believe that any of its reporting units were at risk of failing the step one impairment test at December 31, 2010.

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 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 management 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 for each reporting unit 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 Company s indefinite lived intangible assets as of December 31, 2010 consist primarily of certificates of need, which are estimated primarily using an excess earnings method, a form of discounted cash flows, which is based upon the concept that net after-tax cash flows provide a return supporting all of the assets of a business enterprise. The carrying value of the Company s certificates of need at December 31, 2010 was $66 million. The

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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)

fair values of the Company s indefinite lived intangible assets are derived from current market data and projections at a facility level 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. At December 31, 2010, the fair value of the Company s certificates of need intangible assets exceeded its carrying value.

As a result of the Merger, the Company acquired indefinite lived intangible assets consisting of trade names ($115 million), Medicare certifications ($76 million) and certificates of need ($8 million).

Recently Issued Accounting Requirements

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

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

In June 2011, the FASB issued authoritative guidance related to the presentation of other comprehensive income. The provisions of the guidance state that an entity has the option to present the total of comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The statement(s) should be presented with equal prominence to the other primary financial statements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. Early adoption is permitted, but full retrospective application is required. The adoption of the guidance will not have a material impact on the Company s business, financial position, results of operations or liquidity.

In May 2011, the FASB issued authoritative guidance related to fair value measurements. The provisions of the guidance result in applying common fair value measurement and disclosure requirements in both United States generally accepted accounting principles and International Financial Reporting Standards. The amendments primarily change the wording used to describe many of the requirements in generally accepted

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

Recently Issued Accounting Requirements (Continued)

accounting principles for measuring and disclosing information about fair value measurements. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2011. The adoption of the guidance is not expected to have a material impact on the Company s business, financial position, results of operations or liquidity.

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

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

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

In January 2010, the FASB issued authoritative guidance related to fair value measurements and disclosures. The provisions of the guidance require new disclosures related to transfers in and out of Levels 1 and 2 classifications (as described in Note 14). The provisions also require a reconciliation of the activity in Level 3 recurring fair value measurements (as described in Note 14). Existing disclosures also were expanded to include Level 2 fair value measurement valuation techniques and inputs. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2009, except for the disclosures for Level 3 activity which is effective for fiscal years beginning after December 15, 2010. The adoption of the guidance did not, and is not expected to, have a material impact on the Company s business, financial position, results of operations or liquidity.

Recent Regulatory Changes

On July 29, 2011, CMS issued the 2011 CMS Rules. Based upon the Company s review of the 2011 CMS Rules, the Company believes that its nursing center Medicare rates could decline by as much as 15% in 2012. Management believes that these rules could reduce the Company s annual revenues by approximately

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

Recent Regulatory Changes (Continued)

$95 million to $105 million in its nursing center business and approximately $10 million to $15 million in its rehabilitation therapy business. In addition, management believes that other technical changes required under the 2011 CMS Rules may increase rehabilitation therapy costs by approximately $20 million to $25 million on an annual basis.

In addition, CMS also issued final rules that provided payment increases to inpatient rehabilitation facilities (IRFs) and LTAC hospitals. Among other things, CMS indicated that Medicare payment rates for IRFs are expected to increase at an annual rate of 2.2% and LTAC hospital payment rates are expected to rise 2.5%. Based upon its review of the final rules, management believes that the Medicare rate increase for the Company s LTAC hospitals will likely approximate 0.7% in 2012.

Results of Operations Continuing Operations

Hospital division

Revenues increased 47% in the third quarter of 2011 to $685 million compared to $465 million in the same period in 2010 and increased 25% to $1.8 billion for the nine months ended September 30, 2011 from $1.5 billion in the same period in 2010. Revenue growth in both periods was primarily attributable to the Merger, the Vista Acquisition, the development of new hospitals and higher reimbursement rates. Same-facility revenues were up 5% for the third quarter and 3% for the nine months ended September 30, 2011 compared to the same periods in 2010, while aggregate same-facility admissions increased 4% in the third quarter and 2% for the nine months ended September 30, 2011 compared to the respective prior year periods. Aggregate revenues associated with the Merger and the Vista Acquisition were $196 million and $324 million for the third quarter and nine months ended September 30, 2011, respectively.

Operating income for the third quarter and nine months ended September 30, 2011 included $3 million related to an impairment charge. Excluding the impairment charge, hospital operating margins improved to 18.4% in the third quarter of 2011 and 18.6% for the nine months ended September 30, 2011 compared to 16.3% and 17.9% for the respective periods in 2010. The increase in operating margins for both periods was primarily attributable to higher reimbursement rates and cost efficiencies associated with volume growth. Aggregate operating income associated with the Merger and the Vista Acquisition was $45 million and $74 million for the third quarter and nine months ended September 30, 2011, respectively.

Average hourly wage rates increased 1% in the third quarter and 2% for the nine months ended September 30, 2011 compared to the respective prior year periods. Employee benefit costs increased 51% in the third quarter of 2011 and 30% for the nine months ended September 30, 2011 compared to the respective prior year periods, primarily attributable to the Merger and the Vista Acquisition.

Professional liability costs were $8 million and $6 million in the third quarter of 2011 and 2010, respectively, and $25 million and $22 million for the nine months ended September 30, 2011 and 2010, respectively.

Nursing center division

Revenues increased 6% in the third quarter of 2011 to $571 million compared to $540 million in the same period of 2010 and increased 5% to $1.7 billion for the nine months ended September 30, 2011 from $1.6 billion in the same period in 2010. Revenue growth in both periods was primarily attributable to growth in admissions and reimbursement rate increases that reflected inflationary adjustments and higher average patient acuity.

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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)

Nursing center division (Continued)

Aggregate same-facility admissions increased 5% in the third quarter and 6% for the nine months ended September 30, 2011 compared to the respective prior year periods. Aggregate same-facility patient days declined 2% in both the third quarter and nine months ended September 30, 2011 compared to the respective prior year periods, primarily as a result of declines in average length of stay.

Operating income for the third quarter and nine months ended September 30, 2011 included $24 million related to impairment charges. Excluding the impairment charges, nursing center operating margins improved to 15.7% in the third quarter of 2011 and 15.8% for the nine months ended September 30, 2011 compared to 12.8% and 13.4% for the respective periods in 2010. The increase in operating margins in both periods was primarily attributable to higher reimbursement rates, increases in Medicare and managed care payor mix, and operating efficiencies associated with the growth in admissions. Management expects that operating margins will be significantly reduced beginning in the fourth quarter of 2011 as a result of the 2011 CMS Rules.

Average hourly wage rates increased 2% in both the third quarter and nine months ended September 30, 2011 compared to the same periods in 2010, while employee benefit costs increased 3% and 4% in the respective periods compared to the same periods in 2010.

Professional liability costs were $8 million and $7 million in the third quarter of 2011 and 2010, respectively, and $25 million and $23 million for the nine months ended September 30, 2011 and 2010, respectively.

Rehabilitation division

Skilled nursing rehabilitation services

Revenues increased 158% in the third quarter of 2011 to $268 million compared to $104 million in the same period of 2010 and increased 85% to $563 million for the nine months ended September 30, 2011 from $304 million in the same period in 2010. Revenue growth in both periods was primarily attributable to the Merger, and to a lesser extent, growth in new customers and the volume of services provided to existing customers. Revenues associated with the Merger were $137 million and $183 million for the third quarter and nine months ended September 30, 2011, respectively. Revenues derived from unaffiliated customers aggregated $209 million and $47 million in the third quarter of 2011 and 2010, respectively, and $387 million and $134 million for the nine months ended September 30, 2011 and 2010, respectively.

Operating margins improved to 10.7% in the third quarter of 2011 and 9.5% for the nine months ended September 30, 2011 compared to 9.1% and 9.3% for the respective periods of 2010, primarily attributable to the Merger and increased operating efficiencies. Management expects that operating margins will be significantly reduced beginning in the fourth quarter of 2011 as a result of the 2011 CMS Rules. Operating income associated with the Merger was $16 million and $21 million for the third quarter and nine months ended September 30, 2011, respectively.

Hospital rehabilitation services

Revenues increased 242% in the third quarter of 2011 to $69 million compared to $20 million in the same period of 2010 and increased 109% to $130 million for the nine months ended September 30, 2011 from $62 million in the same period in 2010. Revenue growth in both periods was primarily attributable to the Merger, and to a lesser extent, growth in new customers and the volume of services provided to existing customers.

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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)

Hospital rehabilitation services (Continued)

Revenues associated with the Merger were $47 million for the third quarter of 2011 and $63 million for the nine months ended September 30, 2011. Revenues derived from unaffiliated customers aggregated $49 million and $1 million in the third quarter of 2011 and 2010, respectively, and $68 million and $3 million for the nine months ended September 30, 2011 and 2010, respectively.

Operating margins declined to 22.4% in the third quarter of 2011 and 22.2% for the nine months ended September 30, 2011 compared to 23.1% and 23.5% for the respective periods of 2010, primarily attributable to start-up costs associated with new contracts. Operating income associated with the Merger was $11 million for the third quarter of 2011 and $15 million for the nine months ended September 30, 2011.

Corporate overhead

Operating income for the Company s operating divisions excludes allocations of corporate overhead. These costs aggregated $49 million and $34 million in the third quarter of 2011 and 2010, respectively, and $131 million and $101 million for the nine months ended September 30, 2011 and 2010, respectively. The increase in both periods was primarily attributable to the Merger. As a percentage of consolidated revenues, corporate overhead totaled 3.2% and 3.3% in the third quarter of 2011 and 2010, respectively, and totaled 3.3% and 3.1% for the nine months ended September 30, 2011 and 2010, respectively. Operating results for the nine months ended September 30, 2010 included approximately $1 million related to retirement costs.

Transaction costs

Operating results for the third quarter and nine months ended September 30, 2011 included transaction costs totaling $5 million and $29 million, respectively, primarily related to the Merger. Operating results for the third quarter and nine months ended September 30, 2011 also included severance costs totaling $1 million and $16 million, respectively, related to the Merger. Operating results for the third quarter and nine months ended September 30, 2010 included transaction costs totaling $1 million and $3 million, respectively.

Capital costs

Rent expense increased 18% to $106 million in the third quarter of 2011 compared to $89 million in the same period of 2010 and increased 10% to $293 million for the nine months ended September 30, 2011 from $267 million in the same period in 2010. The increase in both periods resulted primarily from the Merger, the Vista Acquisition, contractual inflation and contingent rent increases.

Depreciation and amortization expense increased 61% to $46 million in the third quarter of 2011 compared to $29 million in the same period of 2010 and increased 30% to $117 million for the nine months ended September 30, 2011 from $90 million in the same period in 2010. The increase in both periods resulted from the Merger, the Company s ongoing capital expenditure program and its hospital development projects.

Interest expense increased to $26 million in the third quarter of 2011 compared to $1 million in the same period of 2010 and increased to $55 million for the nine months ended September 30, 2011 from $4 million in the same period in 2010. The increase in the third quarter and nine months ended September 30, 2011 was attributable to increased borrowings necessary to finance the Merger and higher interest rates compared to the same periods in 2010. Interest expense for the nine months ended September 30, 2011 included $14 million of Merger related financing costs.

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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)

Consolidated results

Losses from continuing operations before income taxes aggregated $2 million in the third quarter of 2011 compared to income from continuing operations before income taxes of $4 million in the same period in 2010. Income from continuing operations before income taxes aggregated $26 million for the nine months ended September 30, 2011 compared to $57 million in the same period in 2010. Income from continuing operations aggregated $1 million in the third quarter of 2011 compared to $5 million in the same period in 2010. Income from continuing operations aggregated $17 million for the nine months ended September 30, 2011 compared to $36 million in the same period in 2010. Impairment charges totaling $27 million ($16 million net of income taxes) negatively impacted the consolidated pretax operating results for the third quarter and nine months ended September 30, 2011. Transaction, severance and financing costs primarily related to the Merger also negatively impacted the consolidated pretax operating results by $6 million ($4 million net of income taxes) for the third quarter of 2011 and $59 million ($38 million net of income taxes) for the nine months ended September 30, 2011. Transaction, severance and retirement costs (unrelated to the Merger) negatively impacted the consolidated pretax operating results by $1 million for the third quarter of 2010 and $6 million ($4 million net of income taxes) for the nine months ended September 30, 2010.

Results of Operations Discontinued Operations

Income from discontinued operations totaled $1.1 million in the third quarter of 2011 compared to a loss from discontinued operations of $0.2 million in the third quarter of 2010. Income from discontinued operations totaled $1.5 million for the nine months ended September 30, 2011 compared to a loss from discontinued operations of $0.3 million for the nine months ended September 30, 2010.

Liquidity

Operating cash flows

Cash flows provided by operations (including discontinued operations) aggregated $118 million for the nine months ended September 30, 2011 compared to $151 million for the same period in 2010. Operating cash flows for the nine months ended September 30, 2011 were negatively impacted by $99 million ($77 million net of income taxes) of transaction, severance and financing payments, primarily related to the Merger. Transaction, severance and retirement payments (unrelated to the Merger) for the nine months ended September 30, 2010 were $4 million ($2 million net of income taxes). Operating cash flows also were negatively impacted by lower accounts receivable collections for the nine months ended September 30, 2011 compared to the same period in 2010, primarily as a result of temporary billing delays caused by information systems conversions related to the Merger. Operating cash flows in both periods were favorably impacted by federal income tax refunds of $25 million and $10 million for the nine months ended September 30, 2011 and 2010, respectively. During the nine months ended September 30, 2011, the Company maintained sufficient liquidity to finance its routine capital expenditures, ongoing development programs, and acquisition (excluding the Merger) and strategic development activities.

The Company utilizes its ABL Facility to meet working capital needs and finance its acquisition and development activities. As a result, the Company typically carries minimal amounts of cash on its consolidated balance sheet. Based upon the Company s expected operating cash flows and the availability of borrowings under the Company s ABL Facility ($367 million at September 30, 2011), management believes that the Company has the necessary financial resources to satisfy its expected short-term and long-term liquidity needs.

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

Liquidity (Continued)

New credit facilities and notes

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

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

The agreements governing the ABL Facility, the Term Loan Facility and the Notes include a number of restrictive covenants that, among other things and subject to certain exceptions and baskets, impose operating and financial restrictions on the Company and certain of its subsidiaries. In addition, the Company is required to comply with a minimum fixed charge coverage ratio and a maximum total leverage ratio. These financing agreements also contain customary affirmative covenants and events of default. The Company was in compliance with the terms of the ABL Facility, the Term Loan Facility and the Notes at September 30, 2011.

ABL Facility

The ABL Facility has a five-year tenor and is secured by the First Priority ABL Collateral. The ABL Facility has a second priority lien on substantially all of the other assets and properties of the Company. As of September 30, 2011, the Company had $249 million outstanding under the ABL Facility. In addition, approximately $13 million of letters of credit were issued under the ABL Facility to backstop outstanding letters of credit previously issued by RehabCare under its terminated credit facility.

Borrowings under the ABL Facility bear interest at a rate per annum equal to the applicable margin plus, at the Company s option, either (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR as described in subclause (1) plus 1.00%. The initial applicable margin for borrowings under the ABL Facility was 2.75% with respect to LIBOR borrowings and 1.75% with respect to base rate borrowings. The applicable margin is subject to adjustment each fiscal quarter, based upon average historical excess availability during the preceding quarter.

Term Loan Facility

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

Borrowings under the Term Loan Facility bear interest at a rate per annum equal to an applicable margin plus, at the Company s option, either (1) LIBOR determined by reference to the costs of funds for eurodollar

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

Liquidity (Continued)

Term Loan Facility (Continued)

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

Notes

In connection with the Merger, the Company completed a private placement of the Notes. The Notes bear interest at an annual rate equal to 8.25% and are senior unsecured obligations of the Company and the subsidiary guarantors, ranking *pari passu* with all of their respective existing and future senior unsubordinated indebtedness. Pursuant to a registration rights agreement, the Company filed with the SEC a registration statement related to an offer to exchange the Notes for an issue of SEC-registered notes with substantially identical terms. The exchange offer commenced on October 13, 2011 and is currently scheduled to expire on November 10, 2011.

Other financing activities

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

Capital Resources

Excluding the Merger and acquisitions, routine capital expenditures (expenditures necessary to maintain existing facilities that generally do not increase capacity or add services) totaled $95 million for the nine months ended September 30, 2011 compared to $69 million for the same period in 2010. Hospital development capital expenditures (primarily new facility construction) totaled $54 million for the nine months ended September 30, 2011 compared to $29 million for the same period in 2010. Nursing and rehabilitation center development capital expenditures (primarily the addition of transitional care services for higher acuity patients and new facility construction) totaled $15 million for the nine months ended September 30, 2011 compared to $11 million for the same period in 2010. The Company anticipates that routine capital spending for 2011 should approximate $135 million to $140 million, hospital development capital spending should approximate $65 million to $70 million and nursing and rehabilitation center development capital spending should approximate $20 million to $25 million. Management expects that substantially all of these expenditures will be financed through internal sources.

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 September 30, 2011, the estimated cost to complete and equip construction in progress approximated $42 million.

The Merger purchase price totaled $963 million and was comprised of $662 million in cash and $301 million of Kindred common stock.

Excluding the Merger, the Company financed certain other acquisitions with either operating cash flows or revolving credit facility borrowings. These expenditures totaled $69 million for the nine months ended September 30, 2011 compared to $88 million for the same period in 2010.

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

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 and rehabilitation 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.

Various healthcare reform provisions became law when the Patient Protection and Affordable Care Act was enacted on March 23, 2010 and the Healthcare Education and Reconciliation Act was enacted on March 30, 2010 (collectively, the Affordable Care Act (the ACA)). The reforms contained in the ACA will impact each of the Company s businesses in some manner. Several of the reforms are very significant and could ultimately change the nature of the Company s services, the methods of payment for the Company s services and the underlying regulatory environment. The reforms include possible modifications to the conditions of qualification for payment, bundling payments to cover both acute and post-acute care and the imposition of enrollment limitations on new providers. In addition, a primary goal of healthcare reform is to reduce costs, which includes reductions in the reimbursement paid to the Company and other healthcare providers. Moreover, healthcare reform could negatively impact insurance companies, other third party payors, the Company s customers, as well as other healthcare providers, which may in turn negatively impact the Company s business. As such, these healthcare reforms or other similar healthcare reforms could have a material adverse effect on the Company s business, financial position, results of operations and liquidity.

The ACA enacted a series of reductions to the annual market basket payment updates for LTAC hospitals. In addition to specific market basket reductions, Congress has mandated that the annual market basket payment update for a variety of providers, including both LTAC hospitals and nursing centers, be reduced for a productivity adjustment determined by CMS. These productivity adjustments may vary and will be determined annually by CMS. The productivity adjustments for LTAC hospitals and nursing centers were implemented on October 1, 2011.

The Budget Control Act of 2011, enacted on August 2, 2011, increased the United States debt ceiling in connection with deficit reductions over the next ten years. The Budget Control Act of 2011 also establishes a 12 member joint committee of Congress known as the Joint Select Committee on Deficit Reduction. The goal of the Joint Select Committee on Deficit Reduction is to propose legislation to reduce the United States federal deficit by $1.5 trillion for fiscal years 2012 to 2021. Reductions in Medicare and Medicaid spending could be included as part of these deficit reduction measures. Moreover, if such legislation is not enacted by December 23, 2011, approximately $1.2 trillion in domestic and defense spending reductions will automatically begin January 1, 2013, split evenly between domestic and defense spending. Payments to Medicare providers would be subject to these automatic spending reductions, subject to a 2% cap. At this time it is unclear how this automatic reduction may be applied to various Medicare healthcare programs. Reductions to Medicare and Medicaid reimbursement from the Budget Control Act of 2011 could have a material adverse effect on the Company s business, financial position, results of operations or liquidity.

The Long-Term Acute Care Prospective Payment System (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, the average length of stay of fee for service Medicare patients must be at least 25 days.

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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)

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;

(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 policy known as the 25 Percent Rule (described below) 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 co-located hospital 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.

The ACA revised certain provisions of the SCHIP Extension Act. The moratoriums on the establishment of new LTAC hospitals or satellites and bed increases at LTAC hospitals or satellites, the application of a one-time budget neutrality adjustment to rates, the payment reductions due to the very short-stay outlier provisions and application of the 25 Percent Rule to freestanding hospitals have been extended from three years to five years. In addition, the periods during which LTAC hospitals may admit up to 50% of their patients from co-located hospitals and during which LTAC hospitals may admit up to 75% of their patients from a MSA Dominant hospital have been extended from three years to five years as well.

CMS has regulations governing payments to LTAC hospitals that are co-located with another hospital (a HIH). The rules generally limit Medicare payments to the HIH if the Medicare admissions to the HIH from its co-located hospital exceed 25% of the total Medicare discharges for the HIH s cost reporting period, the 25 Percent Rule. There are limited exceptions for admissions from rural, urban single and MSA Dominant

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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)

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 co-located hospital, are eligible for the full payment under LTAC PPS. If the HIH s admissions from the co-located 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 September 30, 2011, the Company operated 29 HIHs with 1,148 licensed beds.

On May 1, 2007, CMS issued regulatory changes regarding Medicare reimbursement for LTAC hospitals (the 2007 Final Rule). In the 2007 Final Rule, the 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 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 IPPS. However, as set forth above, the SCHIP Extension Act initially placed a three-year moratorium on the expansion of the 25 Percent Rule to freestanding hospitals. That moratorium was extended to five years by the ACA. In addition, the SCHIP Extension Act initially provided for a three-year period during which (1) LTAC hospitals may admit up to 50% of their patients from their co-located 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. Those periods also were extended to five years under the ACA. The five-year moratorium of the 25 Percent Rule threshold payment adjustment for freestanding hospitals and grandfathered HIHs will expire for cost reporting periods beginning on or after July 1, 2012. The expansion of the admission limit to 50% for non-grandfathered LTAC hospitals from their co-located hospital will expire for cost reports beginning on or after October 1, 2012, the same time at which the 75% limit for MSA Dominant hospitals will expire.

On July 31, 2009, CMS issued final regulations regarding Medicare reimbursement for LTAC hospitals for the fiscal year beginning October 1, 2009. Included in those final regulations is (1) a market basket increase to the standard federal payment rate of 2.5%; (2) an offset of 0.5% applied to the standard federal payment rate to account for the effect of documentation and coding changes; (3) adjustments to area wage indexes; and (4) a decrease in the high cost outlier threshold per discharge to $18,425. These final regulations also include a recalibration of the diagnostic categories called Medicare Severity Diagnosis Related Groups or more specifically, for LTAC hospitals, MS-LTC-DRGs, payment weights. CMS indicated that all of these changes will result in a 3.3% increase to average Medicare payments to LTAC hospitals. The 2.7% annualized reduction that resulted from a recalibration of MS-LTC-DRG payment weights on June 3, 2009 is incorporated into the final October 1, 2009 payment weights. On April 1, 2010, CMS reduced the October 1, 2009 standard federal payment rate by 0.25% as mandated by the ACA. In addition to specific market basket reductions, Congress has mandated that the annual market basket payment update for a variety of providers, including LTAC hospitals, be reduced for a productivity adjustment determined by CMS. These productivity adjustments may vary and will be determined annually by CMS. The productivity adjustments for LTAC hospitals were implemented on October 1, 2011.

On July 30, 2010, CMS issued final regulations regarding Medicare reimbursement for LTAC hospitals for the fiscal year beginning October 1, 2010. Included in those final regulations is (1) a market basket increase to the standard federal payment rate of 2.5%; (2) an offset of 2.5% applied to the standard federal payment rate to

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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)

account for the effect of documentation and coding changes; (3) an offset of 0.5% applied to the standard federal payment rate as mandated by the ACA; (4) adjustments to area wage indexes; and (5) an increase in the high cost outlier threshold per discharge to $18,785. CMS indicated that all of these changes will result in a 0.5% increase to average Medicare payments to LTAC hospitals.

On August 1, 2011, CMS issued final regulations regarding Medicare reimbursement for LTAC hospitals for the fiscal year beginning October 1, 2011. Included in the final regulations is (1) a market basket increase to the standard federal payment rate of 2.9%; (2) offsets to the standard federal payment rate mandated by the ACA of: (a) 1.0% to account for the effect of a productivity adjustment, and (b) 0.1% as required by statute; (3) a wage level budget neutrality factor of 0.99775 applied to the adjusted standard federal payment rate; (4) adjustments to area wage indexes; and (5) a decrease in the high cost outlier threshold per discharge to $17,931. CMS has projected the impact of these proposed changes will result in a 2.5% increase to average Medicare payments to LTAC hospitals. Management believes that the impact of these proposed changes to LTAC PPS would result in an approximate 0.7% increase in payments to the Company s LTAC hospitals.

On August 2, 2011, the Long-Term Care Hospital Improvement Act of 2011 was introduced into the United States Senate (the LTAC Legislation). If enacted, the LTAC Legislation would implement new patient and facility criteria for LTAC hospitals and alleviate the negative impact of various scheduled Medicare reimbursement adjustments. The LTAC Legislation provides for patient criteria to ensure that LTAC hospital patients are physician screened prior to admission and throughout their stay for the appropriateness of their stay in a LTAC hospital. In addition, facility criteria would establish common requirements for the programmatic, personnel and clinical operations of a LTAC hospital. The LTAC Legislation further provides that at least 70% of patients must be medically complex in order for a hospital to maintain its Medicare certification as a LTAC hospital. The LTAC Legislation also would repeal the 25 Percent Rule for all LTAC hospitals, the scheduled very short-stay outlier payment reductions and the one-time budget neutrality adjustment requirement. There can be no assurances that the LTAC Legislation will be enacted in its current form or at all.

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 commercial third party payors. Various factors, including a reduction in average length of stay, have negatively impacted revenues from commercial third party payors in recent years.

On July 29, 2011, CMS issued final regulations regarding Medicare reimbursement for IRFs for the fiscal year beginning October 1, 2011. Included in those proposed regulations is (1) a market basket increase to the standard payment conversion factor of 2.9%; (2) offsets to the standard payment conversion factor mandated by the ACA of: (a) 1.0% to account for the effect of a productivity adjustment, and (b) 0.1% as required by statute; (3) a wage level budget neutrality factor of 0.9988 applied to the standard payment conversion factor; (4) a case mix group budget neutrality factor of 0.9988 applied to the standard payment conversion factor; (5) adjustments to area wage indexes; and (6) a decrease in the high cost outlier threshold per discharge to $10,660. CMS has projected the impact of these proposed changes will result in a 2.2% increase to average Medicare payments to IRFs.

On July 31, 2009, CMS issued final regulations regarding Medicare reimbursement for nursing centers for the fiscal year beginning October 1, 2009. Included in these regulations are (1) a market basket increase to the

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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)

federal payment rates of 2.2%; (2) updates to the wage indexes which adjust the federal payment; and (3) a reduction in the resource utilization groups (RUG) indexes attributed to a CMS forecast error in a prior year, resulting in a 3.3% reduction in payments. CMS estimated that these changes will result in a net decrease in Medicare payments to nursing and rehabilitation centers of 1.1%. In addition to specific market basket reductions, Congress has mandated that the annual market basket payment update for a variety of providers, including nursing centers, be reduced for a productivity adjustment determined by CMS. These productivity adjustments may vary and will be determined annually by CMS. The productivity adjustments for nursing centers were implemented on October 1, 2011.

On July 16, 2010, CMS issued a notice that updates the payment rates for nursing centers for the fiscal year beginning October 1, 2010. That notice provided for an increase in rates of 1.7%, which is comprised of a market basket increase of 2.3% less a forecast error adjustment of 0.6%.

In addition, for the fiscal year beginning October 1, 2010, CMS finalized provisions that increase the number of RUG categories for nursing centers from 53 to 66 (i.e., RUGs IV) and amend the criteria, including the provision of therapy services, used to classify patients into these categories. CMS has indicated that these changes will be enacted in a budget neutral manner.

The therapy requirements to qualify for rehabilitation RUG categories are unchanged under RUGs IV, however, the regulatory changes altered how minutes were allocated to calculate the RUGs scores using the most recent clinical assessment tool of the minimum data set (MDS 3.0). Rather than count all therapy time that a nursing center patient receives, rehabilitation providers must now allocate therapy minutes between the patients being served during concurrent therapy sessions. In addition, the number of patients that a therapist/assistant may treat concurrently is limited to two patients. Additional tracking provisions also require therapists to track and report different delivery modes of therapy (individual, concurrent and group therapy) on MDS 3.0. The Company s rehabilitation division has hired additional therapists to facilitate the provision of additional individual minutes as clinically appropriate. Effective October 1, 2010, CMS began paying claims using the RUGs IV system.

CMS issued the 2011 CMS Rules on July 29, 2011 updating Medicare payment rates for skilled nursing centers effective October 1, 2011. The 2011 CMS Rules impose (1) a negative adjustment to RUGs IV therapy rates, and (2) a net market basket increase of 1.7% consisting of (a) a 2.7% market basket inflation increase, less (b) a 1.0% adjustment to account for the effect of a productivity adjustment, beginning on October 1, 2011. CMS has projected the impact of these changes will result in an 11.1% decrease in payments to skilled nursing centers. Based upon the Company s review of the 2011 CMS Rules, the Company believes that its nursing center Medicare rates could decline by as much as 15% in 2012. In addition to these rate changes, the 2011 CMS Rules introduced additional changes to RUG calculations along with adding additional assessments. Under the 2011 CMS Rules, group therapy is defined as therapy sessions with four patients who are performing similar therapy activities. In addition, for purposes of assigning patients to RUGs IV payment categories, the minutes of group therapy are divided by four with 25% of the minutes being allocated to each patient, consistent with the rules for concurrent therapy that have been in place since October 1, 2010. The 2011 CMS Rules also clarify the circumstances for reporting breaks in care of three or more days of therapy and also implement a new change of therapy assessment that is designed to allocate the patient to the RUG level that represents the treatment provided in the last seven days. Both changes are likely to produce alterations in the RUG scores billed for the patient along with generating additional assessments. Management believes that the 2011 CMS Rules could reduce the Company s annual revenues by approximately $95 million to $105 million in its nursing center

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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)

business and approximately $10 million to $15 million in its rehabilitation therapy business. In addition, management believes that other technical changes required under the 2011 CMS Rules may increase rehabilitation therapy costs by approximately $20 million to $25 million on an annual basis.

On November 2, 2010, CMS issued a final rule related to rate changes to Medicare Part B therapy services included in the Medicare Physician Fee Schedule (MPFS) rule. The rule became effective January 1, 2011. The rule provides for a rate reduction for reimbursement of therapy expenses for secondary procedures when multiple therapy services are provided on the same day. CMS projects that the rule will result in an approximate 7% rate reduction for Medicare Part B therapy services in calendar year 2011. Based upon the Company s historical Medicare Part B therapy services data, the Company estimates that this rule will reduce its Medicare revenues related to Part B therapy services by approximately $7 million per year beginning in 2011.

Medicare Part B provides reimbursement for certain physician services, limited drug coverage and other outpatient services, such as therapy and other services, outside of a Medicare Part A covered patient stay. Payment for these services is determined according to MPFS. Annually since 1997, the MPFS has been subject to a sustainable growth rate adjustment (SGR) intended to keep spending growth in line with allowable spending. Each year since the SGR was enacted, this adjustment produced a scheduled negative update to payment for physicians, therapists and other healthcare providers paid under the MPFS. Annually, since 2002, Congress has stepped in with so-called doc fix legislation to stop payment cuts to physicians. In December 2010, Congress passed the Medicare and Medicaid Extenders Act of 2010 (MMEA) which again suspended the payment cut for 2011.

Since 2006, federal legislation has provided for an annual Medicare Part B outpatient therapy cap. In succeeding years, CMS subsequently increased the amount of the therapy cap. Legislation also was passed that required CMS to implement a broad process for reviewing medically necessary therapy claims, creating an exception to the cap. Legislation has annually extended the Medicare Part B outpatient therapy cap exception process. 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 ACA provided that the exception process remain in effect from January 1, 2010 through December 31, 2010. MMEA extended the therapy cap exception process through December 31, 2011.

The Company believes that its operating margins will continue to be under pressure as the growth in operating expenses, particularly professional liability, labor and employee benefits costs, exceeds payment increases from 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)

	2010 Quarters				2011 Quarters		
	First	Second	Third	Fourth	First	Second	Third
Revenues	$ 1,089,837	$ 1,081,364	$ 1,053,012	$ 1,135,484	$ 1,192,421	$ 1,292,592	$ 1,514,062
Salaries, wages and benefits	627,175	612,205	613,607	652,703	678,695	765,133	900,570
Supplies	85,886	85,455	83,753	87,103	90,022	96,718	107,514
Rent	88,319	88,981	89,295	90,777	91,453	95,677	105,511
Other operating expenses	234,204	238,687	234,968	240,750	259,369	287,132	332,017
Other income	(3,084)	(2,857)	(2,794)	(2,687)	(2,785)	(2,880)	(2,815)
Depreciation and amortization	31,121	29,852	29,167	31,412	32,549	37,871	46,947
Interest expense	1,307	1,298	1,642	2,843	5,728	23,157	25,790
Investment (income) loss	(877)	377	(403)	(342)	(495)	(257)	(37)
	1,064,051	1,053,998	1,049,235	1,102,559	1,154,536	1,302,551	1,515,497
Income (loss) from continuing operations before income taxes	25,786	27,366	3,777	32,925	37,885	(9,959)	(1,435)
Provision (benefit) for income taxes	10,631	11,230	(1,323)	13,170	15,609	(3,419)	(2,342)
Income (loss) from continuing operations	15,155	16,136	5,100	19,755	22,276	(6,540)	907
Discontinued operations, net of income taxes:							
Income (loss) from operations	(154)	87	(260)	1,125	(179)	587	1,119
Gain (loss) on divestiture of operations	(137)	54	86	(456)			
Income (loss) from discontinued operations	(291)	141	(174)	669	(179)	587	1,119
Net income (loss)	14,864	16,277	4,926	20,424	22,097	(5,953)	2,026
(Earnings) loss attributable to noncontrolling interest						421	(241)
Income (loss) attributable to Kindred	$ 14,864	$ 16,277	$ 4,926	$ 20,424	$ 22,097	$ (5,532)	$ 1,785
Amounts attributable to Kindred stockholders:							
Income (loss) from continuing operations	$ 15,155	$ 16,136	$ 5,100	$ 19,755	$ 22,276	$ (6,119)	$ 666
Income (loss) from discontinued operations	(291)	141	(174)	669	(179)	587	1,119
Income (loss) attributable to Kindred	$ 14,864	$ 16,277	$ 4,926	$ 20,424	$ 22,097	$ (5,532)	$ 1,785
Earnings (loss) per common share:							
Basic:							
Income (loss) from continuing operations	$ 0.38	$ 0.41	$ 0.13	$ 0.50	$ 0.56	$ (0.14)	$ 0.01
Discontinued operations:							
Income (loss) from operations			(0.01)	0.03		0.01	0.02
Gain (loss) on divestiture of operations				(0.01)			

Net income (loss)	$	0.38	$	0.41	$	0.12	$	0.52	$	0.56	$	(0.13)	$	0.03
Diluted:														
Income (loss) from continuing operations	$	0.38	$	0.41	$	0.13	$	0.50	$	0.55	$	(0.14)	$	0.01
Discontinued operations:														
Income (loss) from operations						(0.01)		0.03				0.01		0.02
Gain (loss) on divestiture of operations								(0.01)						
Net income (loss)	$	0.38	$	0.41	$	0.12	$	0.52	$	0.55	$	(0.13)	$	0.03
Shares used in computing earnings (loss) per common share:														
Basic		38,626		38,756		38,778		38,790		39,035		43,231		51,329
Diluted		38,859		38,914		38,838		39,089		39,543		43,231		51,406

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

Operating Data

(Unaudited)

(In thousands)

	2010 Quarters				2011 Quarters		
	First	Second	Third	Fourth	First	Second	Third
Revenues:							
Hospital division	$ 507,062	$ 493,401	$ 465,198	$ 507,660	$ 558,974	$ 593,425	$ 684,781
Nursing center division	539,321	542,215	539,914	566,435	567,472	568,199	571,226
Rehabilitation division:							
Skilled nursing rehabilitation services	98,997	101,148	103,807	117,325	122,656	172,074	267,993
Hospital rehabilitation services	21,147	20,913	20,436	21,182	22,490	38,291	69,811
	120,144	122,061	124,243	138,507	145,146	210,365	337,804
	1,166,527	1,157,677	1,129,355	1,212,602	1,271,592	1,371,989	1,593,811
Eliminations:							
Skilled nursing rehabilitation services	(56,464)	(56,279)	(56,841)	(57,084)	(57,946)	(58,691)	(59,221)
Hospital rehabilitation services	(20,226)	(20,034)	(19,502)	(20,034)	(21,225)	(20,706)	(20,528)
	(76,690)	(76,313)	(76,343)	(77,118)	(79,171)	(79,397)	(79,749)
	$ 1,089,837	$ 1,081,364	$ 1,053,012	$ 1,135,484	$ 1,192,421	$ 1,292,592	$ 1,514,062
Income (loss) from continuing operations:							
Operating income (loss):							
Hospital division	$ 95,440	$ 91,790	$ 75,784	$ 97,343	$ 108,385	$ 108,465	$ 122,599(a)
Nursing center division	70,614	76,529	69,363	86,912	87,350	93,532	65,982(a)
Rehabilitation division:							
Skilled nursing rehabilitation services	9,537	9,307	9,486	5,307	9,149	15,531	28,682
Hospital rehabilitation services	5,146	4,793	4,728	4,302	5,332	8,033	15,606
	14,683	14,100	14,214	9,609	14,481	23,564	44,288
Corporate:							
Overhead	(33,831)	(32,799)	(34,329)	(33,002)	(38,315)	(43,801)	(48,806)
Insurance subsidiary	(480)	(791)	(783)	(1,099)	(602)	(420)	(750)
	(34,311)	(33,590)	(35,112)	(34,101)	(38,917)	(44,221)	(49,556)
Transaction costs (b)	(770)	(955)	(771)	(2,148)	(4,179)	(34,851)	(6,537)
Operating income	145,656	147,874	123,478	157,615	167,120	146,489	176,776
Rent	(88,319)	(88,981)	(89,295)	(90,777)	(91,453)	(95,677)	(105,511)
Depreciation and amortization	(31,121)	(29,852)	(29,167)	(31,412)	(32,549)	(37,871)	(46,947)
Interest, net	(430)	(1,675)	(1,239)	(2,501)	(5,233)	(22,900)	(25,753)
Income (loss) from continuing operations before income taxes	25,786	27,366	3,777	32,925	37,885	(9,959)	(1,435)
Provision (benefit) for income taxes	10,631	11,230	(1,323)	13,170	15,609	(3,419)	(2,342)

$ 15,155	$ 16,136	$ 5,100	$ 19,755	$ 22,276	$ (6,540)	$ 907

(a) Includes impairment charges of $3.1 million for the hospital division and $23.6 million for the nursing center division.
(b) Transaction-related charges for the 2010 periods have been reclassified to conform with the current period presentation.

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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)

	2010 Quarters				2011 Quarters		
	First	Second	Third	Fourth	First	Second	Third
Rent:							
Hospital division	$ 37,415	$ 38,043	$ 38,122	$ 39,406	$ 40,299	$ 43,997	$ 52,737
Nursing center division	49,392	49,439	49,627	49,647	49,384	49,562	49,862
Rehabilitation division:							
Skilled nursing rehabilitation services	1,449	1,445	1,474	1,662	1,698	1,791	2,169
Hospital rehabilitation services	26	25	28	27	28	33	95
	1,475	1,470	1,502	1,689	1,726	1,824	2,264
Corporate	37	29	44	35	44	294	648
	$ 88,319	$ 88,981	$ 89,295	$ 90,777	$ 91,453	$ 95,677	$ 105,511
Depreciation and amortization:							
Hospital division	$ 13,014	$ 12,549	$ 12,655	$ 13,421	$ 14,278	$ 16,572	$ 21,612
Nursing center division	12,113	11,185	10,527	11,646	11,793	13,038	12,655
Rehabilitation division:							
Skilled nursing rehabilitation services	523	558	591	731	759	1,339	3,023
Hospital rehabilitation services	62	68	77	99	97	819	2,372
	585	626	668	830	856	2,158	5,395
Corporate	5,409	5,492	5,317	5,515	5,622	6,103	7,285
	$ 31,121	$ 29,852	$ 29,167	$ 31,412	$ 32,549	$ 37,871	$ 46,947
Capital expenditures, excluding acquisitions (including discontinued operations):							
Hospital division:							
Routine	$ 6,065	$ 7,954	$ 9,113	$ 13,835	$ 12,144	$ 11,809	$ 12,919
Development	5,774	10,209	12,900	12,257	7,777	6,423	39,964
	11,839	18,163	22,013	26,092	19,921	18,232	52,883
Nursing center division:							
Routine	4,049	9,135	11,548	12,292	8,155	8,000	10,572
Development	1,793	2,079	7,464	15,365	3,322	7,705	4,113
	5,842	11,214	19,012	27,657	11,477	15,705	14,685
Rehabilitation division:							
Skilled nursing rehabilitation services:							
Routine	228	258	328	1,608	255	217	296

Development					10	181	75
	228	258	328	1,608	265	398	371
Hospital rehabilitation services:							
Routine	39	23	23	208	25	72	81
Development							
	39	23	23	208	25	72	81
Corporate:							
Information systems	4,146	7,853	6,625	11,162	3,932	13,641	11,516
Other	288	447	986	683	207	211	1,211
	$ 22,382	$ 37,958	$ 48,987	$ 67,410	$ 35,827	$ 48,259	$ 80,747

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

Condensed Consolidating Statement of Operations

(Unaudited)

(In thousands)

	Three months ended September 30, 2011								
	Rehabilitation division								
	Hospital division (a)	Nursing center division (a)	Skilled nursing services	Hospital services	Total	Corporate	Transaction costs	Eliminations	Consolidated
Revenues	$ 684,781	$ 571,226	$ 267,993	$ 69,811	$ 337,804	$	$	$ (79,749)	$ 1,514,062
Salaries, wages and benefits	316,507	272,505	227,577	49,262	276,839	33,482	1,256	(19)	900,570
Supplies	77,045	28,650	1,506	62	1,568	251			107,514
Rent	52,737	49,862	2,169	95	2,264	648			105,511
Other operating expenses	168,630	204,089	10,228	4,881	15,109	18,638	5,281	(79,730)	332,017
Other income						(2,815)			(2,815)
Depreciation and amortization	21,612	12,655	3,023	2,372	5,395	7,285			46,947
Interest expense	206	25				25,559			25,790
Investment income	(1)	(18)	(1)	(1)	(2)	(16)			(37)
	636,736	567,768	244,502	56,671	301,173	83,032	6,537	(79,749)	1,515,497
Income (loss) from continuing operations before income taxes	$ 48,045	$ 3,458	$ 23,491	$ 13,140	$ 36,631	$ (83,032)	$ (6,537)	$	(1,435)
Income tax benefit									(2,342)
Income from continuing operations									$ 907

	Three months ended September 30, 2010								
	Rehabilitation division								
	Hospital division	Nursing center division	Skilled nursing services	Hospital services	Total	Corporate	Transaction costs	Eliminations	Consolidated
Revenues	$ 465,198	$ 539,914	$ 103,807	$ 20,436	$ 124,243	$	$	$ (76,343)	$ 1,053,012
Salaries, wages and benefits	215,590	267,665	89,923	15,040	104,963	25,403		(14)	613,607
Supplies	55,189	27,559	836	24	860	145			83,753
Rent	38,122	49,627	1,474	28	1,502	44			89,295
Other operating expenses	118,635	175,327	3,562	644	4,206	12,358	771	(76,329)	234,968
Other income						(2,794)			(2,794)
Depreciation and amortization	12,655	10,527	591	77	668	5,317			29,167
Interest expense		36				1,606			1,642
Investment income		(21)				(382)			(403)
	440,191	530,720	96,386	15,813	112,199	41,697	771	(76,343)	1,049,235

Income from continuing operations before income taxes	$ 25,007	$ 9,194	$ 7,421	$ 4,623	$ 12,044	$ (41,697)	$ (771)	$ 3,777
Income tax benefit								(1,323)
Income from continuing operations								$ 5,100

(a) Includes $26.7 million in aggregate of impairment charges in other operating expenses (hospital division $3.1 million and nursing center division $23.6 million).

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

Condensed Consolidating Statement of Operations (Continued)

(Unaudited)

(In thousands)

	Nine months ended September 30, 2011								
	Rehabilitation division								
	Hospital division	Nursing center division	Skilled nursing services	Hospital services	Total	Corporate	Transaction costs	Eliminations	Consolidated
Revenues	$ 1,837,180	$ 1,706,897	$ 562,723	$ 130,592	$ 693,315	$	$	$ (238,317)	$ 3,999,075
Salaries, wages and benefits	842,829	816,022	483,996	93,996	577,992	91,502	16,122	(69)	2,344,398
Supplies	206,504	83,645	3,396	122	3,518	587			294,254
Rent	137,033	148,808	5,658	156	5,814	986			292,641
Other operating expenses	448,398	560,366	21,969	7,503	29,472	49,085	29,445	(238,248)	878,518
Other income						(8,480)			(8,480)
Depreciation and amortization	52,462	37,486	5,121	3,288	8,409	19,010			117,367
Interest expense	272	76				40,525	13,802		54,675
Investment income	(4)	(58)	(3)	(1)	(4)	(723)			(789)
	1,687,494	1,646,345	520,137	105,064	625,201	192,492	59,369	(238,317)	3,972,584
Income from continuing operations before income taxes	$ 149,686	$ 60,552	$ 42,586	$ 25,528	$ 68,114	$ (192,492)	$ (59,369)	$	26,491
Provision for income taxes									9,848
Income from continuing operations									$ 16,643

	Nine months ended September 30, 2010								
	Rehabilitation division								
	Hospital division(a)	Nursing center division(a)	Skilled nursing services	Hospital services	Total	Corporate(a)	Transaction costs	Eliminations	Consolidated
Revenues	$ 1,465,661	$ 1,621,450	$ 303,952	$ 62,496	$ 366,448	$	$	$ (229,346)	$ 3,224,213
Salaries, wages and benefits	664,317	805,560	261,497	45,960	307,457	75,667		(14)	1,852,987
Supplies	170,273	82,135	2,206	67	2,273	413			255,094
Rent	113,580	148,458	4,368	79	4,447	110			266,595
Other operating expenses	368,057	517,249	11,919	1,802	13,721	35,668	2,496	(229,332)	707,859
Other income						(8,735)			(8,735)
Depreciation and amortization	38,218	33,825	1,672	207	1,879	16,218			90,140
Interest expense	3	96				4,148			4,247
Investment income	(1)	(56)	(3)	(1)	(4)	(842)			(903)
	1,354,447	1,587,267	281,659	48,114	329,773	122,647	2,496	(229,346)	3,167,284

Income from continuing operations before income taxes	$ 111,214	$ 34,183	$ 22,293	$ 14,382	$ 36,675	$ (122,647)	$ (2,496)	$ 56,929
Provision for income taxes								20,538
Income from continuing operations								$ 36,391

(a) Includes $2.9 million in aggregate of severance and retirement costs in salaries, wages and benefits (hospital division $1.1 million, nursing center division $0.5 million and corporate $1.3 million).

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

Operating Data

(Unaudited)

	2010 Quarters				2011 Quarters		
	First	Second	Third	Fourth	First	Second	Third
Hospital data:							
End of period data:							
Number of hospitals:							
Long-term acute care	83	83	83	89	89	120	120
Inpatient rehabilitation						5	5
	83	83	83	89	89	125	125
Number of licensed beds:							
Long-term acute care	6,580	6,576	6,563	6,887	6,889	8,609	8,597
Inpatient rehabilitation						183	183
	6,580	6,576	6,563	6,887	6,889	8,792	8,780
Revenue mix %:							
Medicare	56	56	55	58	60	60	60
Medicaid	9	9	9	9	8	8	8
Medicare Advantage	10	10	10	9	10	10	10
Commercial insurance and other	25	25	26	24	22	22	22
Admissions:							
Medicare	7,432	7,125	6,769	7,640	8,504	8,913	11,002
Medicaid	997	990	1,022	1,034	1,085	1,163	1,236
Medicare Advantage	1,129	1,106	936	1,071	1,172	1,348	1,609
Commercial insurance and other	2,262	2,048	1,978	2,020	2,282	2,290	2,669
	11,820	11,269	10,705	11,765	13,043	13,714	16,516
Admissions mix %:							
Medicare	63	63	63	65	65	65	67
Medicaid	8	9	10	9	8	8	7
Medicare Advantage	10	10	9	9	9	10	10
Commercial insurance and other	19	18	18	17	18	17	16
Patient days:							
Medicare	202,882	195,964	179,324	198,129	219,213	237,257	275,561
Medicaid	47,813	45,952	48,514	46,596	45,650	45,746	48,911
Medicare Advantage	34,524	36,000	31,186	32,868	35,639	39,503	47,819
Commercial insurance and other	75,483	70,651	70,198	69,585	70,522	72,759	83,375
	360,702	348,567	329,222	347,178	371,024	395,265	455,666
Average length of stay:							
Medicare	27.3	27.5	26.5	25.9	25.8	26.6	25.0

Medicaid	48.0	46.4	47.5	45.1	42.1	39.3	39.6
Medicare Advantage	30.6	32.5	33.3	30.7	30.4	29.3	29.7
Commercial insurance and other	33.4	34.5	35.5	34.4	30.9	31.8	31.2
Weighted average	30.5	30.9	30.8	29.5	28.4	28.8	27.6
Revenues per admission:							
Medicare	$ 38,078	$ 38,938	$ 37,675	$ 38,368	$ 39,439	$ 40,089	$ 37,408
Medicaid	45,738	42,774	42,910	41,704	42,432	41,576	40,720
Medicare Advantage	45,187	46,169	48,122	44,744	46,217	42,708	43,616
Commercial insurance and other	56,344	59,842	61,314	61,131	54,065	56,850	57,216
Weighted average	42,899	43,784	43,456	43,150	42,856	43,271	41,462
Revenues per patient day:							
Medicare	$ 1,395	$ 1,416	$ 1,422	$ 1,479	$ 1,530	$ 1,506	$ 1,494
Medicaid	954	922	904	925	1,009	1,057	1,029
Medicare Advantage	1,478	1,418	1,444	1,458	1,520	1,457	1,468
Commercial insurance and other	1,688	1,735	1,728	1,775	1,749	1,789	1,832
Weighted average	1,406	1,416	1,413	1,462	1,507	1,501	1,503
Medicare case mix index (discharged patients only)	1.21	1.21	1.19	1.17	1.21	1.22	1.17
Average daily census	4,008	3,830	3,579	3,774	4,122	4,344	4,953
Occupancy %	68.2	66.1	62.0	64.0	68.7	65.5	62.6
Annualized employee turnover %	21.8	22.6	22.3	22.0	21.2	22.1	21.4

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

Operating Data (Continued)

(Unaudited)

	2010 Quarters				2011 Quarters		
	First	Second	Third	Fourth	First	Second	Third
Nursing and rehabilitation center data:							
End of period data:							
Number of facilities:							
Nursing and rehabilitation centers:							
Owned or leased	218	219	222	222	220	220	220
Managed	4	4	4	4	4	4	4
Assisted living facilities	6	7	7	7	6	6	6
	228	230	233	233	230	230	230
Number of licensed beds:							
Nursing and rehabilitation centers:							
Owned or leased	26,711	26,760	27,030	26,957	26,767	26,687	26,687
Managed	485	485	485	485	485	485	485
Assisted living facilities	327	463	463	463	413	413	413
	27,523	27,708	27,978	27,905	27,665	27,585	27,585
Revenue mix %:							
Medicare	35	34	33	36	38	37	36
Medicaid	41	41	41	39	37	38	38
Medicare Advantage	6	7	7	7	7	7	7
Private and other	18	18	19	18	18	18	19
Patient days (excludes managed facilities):							
Medicare	369,102	363,149	346,837	344,018	370,395	358,760	345,362
Medicaid	1,312,517	1,292,246	1,289,643	1,287,739	1,232,620	1,229,517	1,255,418
Medicare Advantage	87,692	92,051	91,643	94,336	97,460	94,483	95,751
Private and other	397,550	415,921	437,413	453,357	425,414	435,667	436,074
	2,166,861	2,163,367	2,165,536	2,179,450	2,125,889	2,118,427	2,132,605
Patient day mix %:							
Medicare	17	17	16	16	17	17	16
Medicaid	61	60	60	59	58	58	59
Medicare Advantage	4	4	4	4	5	4	5
Private and other	18	19	20	21	20	21	20
Revenues per patient day:							
Medicare Part A	$ 470	$ 469	$ 468	$ 534	$ 537	$ 544	$ 550
Total Medicare (including Part B)	513	515	519	587	579	589	599
Medicaid	168	171	171	171	172	173	174
Medicare Advantage	398	400	405	432	416	420	421
Private and other	238	234	232	228	235	240	243
Weighted average	249	250	249	260	267	268	268

Average daily census	24,076	23,773	23,538	23,690	23,621	23,279	23,180
Admissions (excludes managed facilities)	19,026	18,924	19,383	19,118	20,619	20,143	20,118
Occupancy %	89.0	87.3	86.8	86.4	86.9	85.9	85.5
Medicare average length of stay	33.7	35.2	34.3	33.0	32.9	33.4	33.0
Annualized employee turnover %	36.7	38.8	39.8	39.6	37.8	39.8	40.2

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

Operating Data (Continued)

(Unaudited)

	2010 Quarters				2011 Quarters		
	First	Second	Third	Fourth	First	Second	Third
Rehabilitation data:							
Skilled nursing rehabilitation services:							
Revenue mix %:							
Company-operated	57	56	55	49	47	34	22
Non-affiliated	43	44	45	51	53	66	78
Sites of service (at end of period)	554	568	595	635	641	1,848	1,835
Revenue per site	$ 172,498	$ 171,254	$ 167,832	$ 174,896	$ 178,812	$ 137,316	$ 137,643
Therapist productivity %	83.8	84.2	82.1	78.6	80.6	81.6	80.5
Home health and hospice revenues	$ 3,434	$ 3,875	$ 3,947	$ 6,266	$ 8,038	$ 10,828	$ 15,419
Hospital rehabilitation services:							
Revenue mix %:							
Company-operated	96	96	95	95	94	54	29
Non-affiliated	4	4	5	5	6	46	71
Sites of service (at end of period):							
Inpatient rehabilitation units				1	1	104	102
LTAC hospitals	85	85	85	91	93	97	99
Sub-acute units	7	7	7	7	8	22	23
Outpatient units	10	11	11	12	12	119	114
Other	2	2	4	4	5	8	7
	104	105	107	115	119	350	345
Revenue per site	$ 203,337	$ 199,174	$ 190,986	$ 184,193	$ 188,989	$ 199,661	$ 202,352
Annualized employee turnover %	12.6	14.2	15.4	14.4	14.5	17.1	16.5

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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 Amount by Expected Maturity

Average Interest Rate

(Dollars in thousands)

	Expected maturities							Fair value
	2011	2012	2013	2014	2015	Thereafter	Total	9/30/11
Liabilities:								
Long-term debt, including amounts due within one year:								
Fixed rate:								
Notes	$	$	$	$	$	$ 550,000	$ 550,000	$ 420,062
Other	24	96	102	109	116	133	580	550(a)
	$ 24	$ 96	$ 102	$ 109	$ 116	$ 550,133	$ 550,580	$ 420,612
Average interest rate	6.0%	6.0%	6.0%	6.0%	6.0%	8.2%		
Variable rate:								
ABL Facility (b)	$	$	$	$	$	$ 248,500	$ 248,500	$ 248,500
Term Loan Facility (c)	1,750	7,000	7,000	7,000	7,000	668,500	698,250	647,627
Other (d)	58	232	233	233	3,720		4,476	4,476
	$ 1,808	$ 7,232	$ 7,233	$ 7,233	$ 10,720	$ 917,000	$ 951,226	$ 900,603

(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 ABL Facility is payable, at the Company s option, at a rate per annum equal to the applicable margin plus, at the Company s option, either (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR as described in subclause (1) plus 1.00%. The initial applicable margin for borrowings under the ABL Facility was 2.75% with respect to LIBOR borrowings and 1.75% with respect to base rate borrowings. The applicable margin is subject to adjustment each fiscal quarter, based upon average historical excess availability during the preceding quarter.

(c) Interest on borrowings under the Company s Term Loan Facility is payable, at the Company s option, at a rate per annum equal to an applicable margin plus, at the Company s option, either (1) LIBOR determined by reference to the costs of funds for eurodollar deposits for

the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR described in subclause (1) plus 1.00%. LIBOR is subject to an interest rate floor of 1.50%. The initial applicable margin for borrowings under the Term Loan Facility was 3.75% with respect to LIBOR borrowings and 2.75% with respect to base rate borrowings. The expected maturities for the Term Loan Facility exclude the original issue discount of approximately $7 million.

(d) Interest based upon LIBOR plus 4%.

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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 September 30, 2011, 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.

Except as described below with respect to the status of the integration of RehabCare, there has been no change in the Company s internal control over financial reporting during the Company s quarter ended September 30, 2011, that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

On June 1, 2011, the Company completed the RehabCare acquisition. The Company is in the process of integrating RehabCare into the Company s existing internal control environment. The Company expects to exclude RehabCare from the assessment of internal control over financial reporting as of December 31, 2011.

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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 in the ordinary course of business. The Company is unable to predict the ultimate outcome of pending litigation and regulatory and other government investigations. These legal actions and investigations could potentially subject the Company to sanctions, damages, recoupments, fines and other penalties. 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.

On February 10, 2011, Arthur I. Murphy, Jr., a purported stockholder of RehabCare, filed a purported class action lawsuit in the Circuit Court of St. Louis County, Missouri (which we refer to as the Circuit Court) against RehabCare, RehabCare s directors and Kindred (which we refer to as the Murphy litigation); and on March 2, 2011, Alfred T. Kowalewski, a purported stockholder of RehabCare, filed a purported class action lawsuit in the Circuit Court, Missouri against RehabCare, RehabCare s directors and Kindred (which we refer to as the Kowalewski litigation and, together with the Murphy litigation, the Missouri litigation). On February 15, 2011, the Norfolk County Retirement System, a purported stockholder of RehabCare, filed a purported class action lawsuit in the Court of Chancery against RehabCare, RehabCare s directors and Kindred (which we refer to as the Norfolk County litigation); on February 28, 2011, City of Pontiac General Employees Retirement System, a purported stockholder of RehabCare, filed a purported class action lawsuit in the Court of Chancery against RehabCare, RehabCare s directors and Kindred (which we refer to as the City of Pontiac litigation); and on March 4, 2011, Plumbers & Pipefitters National Pension Fund, a purported stockholder of RehabCare, filed a purported class action lawsuit in the Court of Chancery against RehabCare, RehabCare s directors and Kindred (which we refer to as the Plumbers & Pipefitters litigation and, together with the Norfolk County litigation and the City of Pontiac litigation, the Delaware litigation).

The complaints in the Missouri litigation and Delaware litigation contain similar allegations, including among other things, that RehabCare s directors breached their fiduciary duties to the RehabCare stockholders, including their duties of loyalty, due care, independence, good faith and fair dealing, by entering into a merger agreement which provides for inadequate consideration to RehabCare stockholders, and that RehabCare and Kindred aided and abetted RehabCare s directors alleged breaches of their fiduciary duties. The plaintiffs seek injunctive relief preventing the defendants from consummating the transactions contemplated by the merger agreement, or in the event the defendants consummate the transactions contemplated by the merger agreement, rescission of such transactions and attorneys fees and expenses.

On March 8, 2011, the plaintiffs in the Kowalewski litigation filed a motion with the Circuit Court to consolidate the Missouri litigation and to appoint lead counsel. On March 31, 2011, the plaintiffs in the Kowalewski litigation filed an amended complaint and a motion for expedited discovery and on April 11, 2011, the plaintiffs in the Murphy litigation filed an amended complaint and a motion for expedited discovery. This April 11, 2011 amended complaint in the Murphy litigation also added Citigroup Global Markets Inc. as a named defendant in the litigation. On April 7, 2011, the defendants filed a motion to dismiss and/or stay the Missouri litigation. After holding hearings on April 8 and April 22, 2011, the Circuit Court stayed the Missouri litigation by Order dated April 25, 2011.

On March 9, 2011, the Court of Chancery consolidated the Delaware litigation under the caption *In Re RehabCare Group, Inc. Shareholders Litigation* and plaintiffs filed a verified consolidated class action complaint on April 5, 2011.

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PART II. OTHER INFORMATION (Continued)

Item 1. Legal Proceedings (Continued)

On May 12, 2011, the defendants entered into a memorandum of understanding with the plaintiffs in the Delaware litigation regarding the settlement of the Delaware litigation. In connection with the settlement contemplated by the memorandum of understanding, (i) Kindred and RehabCare agreed to make certain additional disclosures related to the proposed merger, which were contained in a Form 8-K filed with the SEC on May 12, 2011, (ii) RehabCare agreed to make the payment, at and subject to the closing of the merger between Kindred and RehabCare, of $2.5 million in cash into a settlement pool for the benefit of the plaintiff class in *In re RehabCare Group, Inc. Shareholders Litigation*, to be distributed after final approval of the settlement of the Delaware Litigation and (iii) Kindred, Kindred Healthcare Development, Inc. and RehabCare agreed to enter into an amendment, dated May 12, 2011, to the merger agreement, dated as of February 7, 2011, among Kindred, Kindred Healthcare Development, Inc. and RehabCare, the material terms of which are as follows:

- inclusion of an acknowledgement by Kindred and RehabCare of the waiver of any existing standstill undertakings for the benefit of RehabCare;
- change of the definition of Company Termination Fee to mean an amount equal to $13 million; and
- modification of the agreement to eliminate the requirement for a three-business day period during which Kindred has the right to match a superior proposal.

A copy of the Amendment to Agreement and Plan of Merger was filed as Exhibit 2.1 to the Form 8-K filed with the SEC on May 12, 2011. The foregoing description of such Amendment to Agreement and Plan of Merger is qualified by this exhibit which is incorporated herein by reference.

On June 29, 2011, the parties submitted to the Court of Chancery a proposed Stipulation of Settlement and Dismissal, which the Court granted on July 1, 2011. The Court of Chancery held a formal settlement hearing on September 8, 2011, at which the Court approved the agreed-upon Stipulation of Settlement and Dismissal as fair and reasonable, and awarded plaintiffs attorneys fees in the amount of $1.7 million plus expenses incurred. The Stipulation of Settlement and Dismissal became final on October 11, 2011 after the time to file an appeal of the Court s order approving the settlement expired.

Item 6. Exhibits

4.1	Second Supplemental Indenture, dated as of September 28, 2011, among Kindred Healthcare, Inc., the Subsidiary Guarantors party thereto and Wells Fargo Bank, National Association, as Trustee. Exhibit 4.1 to the Company s Current Report on Form 8-K dated September 28, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
4.2	Second Joinder Agreement to the Registration Rights Agreement, dated as of September 28, 2011, among the Subsidiary Guarantors party thereto. Exhibit 4.2 to the Company s Current Report on Form 8-K dated September 28, 2011 (Comm. File No. 001-14057) is hereby incorporated by reference.
31	Rule 13a-14(a)/15d-14(a) Certifications.
32	Section 1350 Certifications.
101.XML	XBRL Instance Document. *

101.XSD XBRL Taxonomy Extension Schema Document. *

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document. *

101.DEF XBRL Taxonomy Extension Definition Linkbase Document.*

101.LAB XBRL Taxonomy Extension Label Linkbase Document. *

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document. *

* In accordance with Regulation S-T, the XBRL-related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall be deemed to be furnished and not filed.

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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: November 9, 2011

/s/ PAUL J. DIAZ
Paul J. Diaz
President and

Chief Executive Officer

Date: November 9, 2011

/s/ RICHARD A. LECHLEITER
Richard A. Lechleiter
Executive Vice President and

Chief Financial Officer