

Encompass Health (EHC)

\$63.18 (As of 08/14/20)

Price Target (6-12 Months): **\$66.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 01/08/19)

Prior Recommendation: Outperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

3-Hold

Zacks Style Scores:

VGM:B

Value: B

Growth: B

Momentum: B

Summary

Encompass Health's second-quarter earnings missed estimates on lower revenues. Nevertheless, its top line has been consistently increasing since 2010, driven by a rise in revenues from its inpatient rehabilitation plus home health and hospice segment. Aging population should spur long-term demand for the services provided by the company. It actively pursues mergers and acquisitions to increase market density and build scale in hospice. Its solvency position is also encouraging by virtue of strong cash flow from operations and borrowings under its revolving credit facility. The company's shares have underperformed its industry in a year. However, elevated costs owing to labor supply shortage can put pressure on margins. Suspension of share buybacks due to the COVID-19 induced business uncertainty can also affect its bottom line.

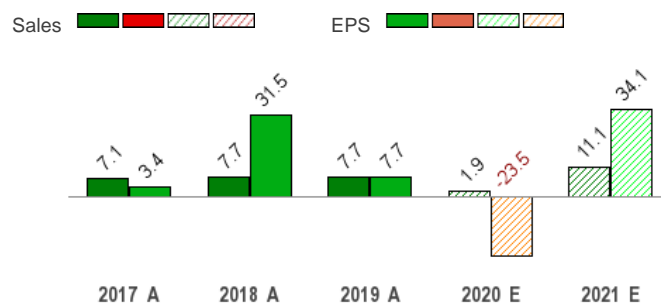
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$83.30 - \$48.01
20 Day Average Volume (sh)	624,651
Market Cap	\$6.3 B
YTD Price Change	-8.8%
Beta	0.91
Dividend / Div Yld	\$1.12 / 1.8%
Industry	Medical - Outpatient and Home Healthcare
Zacks Industry Rank	Top 29% (73 out of 252)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	-20.5%
Last Sales Surprise	1.1%
EPS F1 Est- 4 week change	-1.3%
Expected Report Date	NA
Earnings ESP	0.0%
P/E TTM	21.3
P/E F1	21.1
PEG F1	2.4
P/S TTM	1.4

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	1,269 E	1,309 E	1,296 E	1,345 E	5,212 E
2020	1,182 A	1,074 A	1,177 E	1,260 E	4,693 E
2019	1,124 A	1,135 A	1,162 A	1,184 A	4,605 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$1.03 E	\$1.08 E	\$0.92 E	\$1.05 E	\$4.01 E
2020	\$0.87 A	\$0.31 A	\$0.80 E	\$1.01 E	\$2.99 E
2019	\$1.04 A	\$1.08 A	\$0.93 A	\$0.85 A	\$3.91 A

*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 08/14/2020. The reports text is as of 08/17/2020.

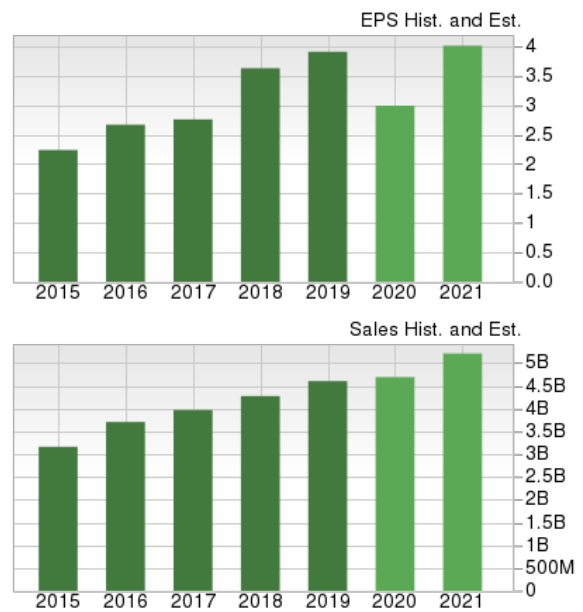
Overview

Encompass Health Corporation is a provider of integrated healthcare services. It offers both facility-based and home-based patient care through its network of inpatient rehabilitation hospitals, home health agencies and hospice agencies. With a national footprint that includes 130 hospitals and 278 home health plus hospice locations across 36 states and Puerto Rico, the company delivers high-quality, cost-effective, integrated care in the healthcare space. It provides a continuum of facility-based and home-based post-acute services for its patients and their families, which will gain more prevalence as coordinated care and integrated delivery payment models, such as accountable care organizations and bundled payment arrangements.

The company operates through two segments: Inpatient Rehabilitation as well as Home Health and Hospice business

The company's **Inpatient Rehabilitation** hospitals (78% of 2019 revenues) offer specialized rehabilitative care over a wide array of diagnoses and deliver comprehensive, high-quality, cost-effective patient care services. The company provides specialized rehabilitative treatment on both inpatient and outpatient basis. It operates hospitals in 32 states and Puerto Rico with concentrations on the eastern half of the United States and Texas. As of Dec 31, 2018, the company runs 130 inpatient rehabilitation hospitals including one operating as a joint venture. In addition to its hospitals, the company regulates five inpatient rehabilitation units via management contracts.

The company's **Home Health and Hospice** (22%) business is the nation's fourth largest provider of Medicare-certified skilled home health services in terms of revenues. It operates home health and hospice agencies in 30 states focusing on the Southeast and Texas. The company acquired a significant portion of its home health and hospice business when it purchased EHHI Holdings, Inc. ("EHHI") on Dec 31, 2014. This segment provides a range of Medicare-certified home care services, which comprise skilled nursing, physical, occupational and speech therapy, medical social work plus home health aide services.



Reasons To Buy:

▲ **Growing Revenues:** The company's top line has been consistently increasing, since 2010 at a 10-year CAGR of 9.5%. Revenues have been gaining on strong contributions from its inpatient rehabilitation, and home health and hospice segments. However, the momentum did not continue in the first half of 2020, where net operating revenues declined marginally year over year primarily owing to reduced volumes across both the segments. Nevertheless, the healthcare provider has been witnessing revival in patient volumes at both of its segments from low volumes in April. This uptick in volumes continued in July as well. We believe that an ageing population should continue to boost demand for the company's services.

Increasing revenues, inorganic growth via mergers and acquisitions and consistent cash flow generation should aid the company.

▲ **Acquisitions:** The company's mergers and acquisition (M&A) strategy is aimed to increase market density, increase overlap with the company's in-patient rehabilitation facilities (IRFs) and build scale in hospice. The buyout of Alacare Home Health & Hospice last year is in sync with the strategy. This deal has expanded Encompass Health's services into new markets and complements three markets in which it has existing IRFs in Alabama.

The company aims to address demand for facility-based and home-based post-acute care services in markets where it is not currently present by constructing or acquiring new hospitals and purchasing or opening home health and hospice agencies in those extremely fragmented industries. Despite the company's M&A activities remaining minimal due to the COVID-19 pandemic, Encompass Health has opened three new hospitals year to date, which include two new hospitals in the second quarter at Iowa and South Dakota. It has also inaugurated two new home health locations and one new hospice location till date in 2020. The company expects to open a new hospital containing 40 beds in Toledo, OH in the fourth quarter. The company has also laid plans for building eight and five new hospitals plan for 2021 and 2022, respectively. We thus believe, the company's acquisition strategy will continue to fuel inorganic growth.

▲ **Sound Debt Position:** The company's primary sources of liquidity are cash in hand, cash flow from operations and borrowings under its revolving credit facility. As of Jun 30, 2020, the company had approximately \$964 million in cash and nearly \$613 million available to it under its \$1 billion revolving credit facility. It has modified its revolving credit facility in a bid to tide over the adverse pandemic effects by the end of 2021. The company does not face any near-term refinancing risk as the amounts outstanding under its credit agreement do not mature until 2024 and its bonds all mature in 2023 and beyond. The company's leverage ratio at the end of the second quarter of 2020 was 4.2x.

▲ **Share Price Performance:** The stock has underperformed its industry in a year's time. Nevertheless, the company's strong fundamentals are likely to drive shares going forward.

Reasons To Sell:

- ▼ **Reduced Availability of Personal Protective Equipment (PPE):** The increased utilization of PPE resulting from COVID-19 pandemic created supply-chain challenges for the company. PPE utilization has increased around 12 times for mask and four times for gowns in the company's inpatient rehabilitation segment. The company also experienced reduced allocations of PPE from primary suppliers and this prompted the company to find alternative suppliers, paying premium prices that are as much as 15X of its normal pricing and managing through limited visibility into production schedules and shipment status. The company believes that production capacity, both domestically and internationally, is increasing but increased PPE utilization and higher unit cost is likely to pose threat to the company in the near term.
- ▼ **Business Growth Uncertainty due to COVID-19:** Beginning March, the company experienced lower volumes and higher operating expenses related to the COVID-19 pandemic. These lower volumes are expected to continue in the near term, which will weigh on overall earnings. Also, given the rapidly-changing operating conditions on account of the COVID-19 pandemic, the company cannot accurately estimate the impact the plaguing health peril may have on its full-year financial results. As a result, it withdrew its 2020 guidance and five-year growth targets.
- ▼ **High Labor Cost:** Salaries and benefits forming nearly 60-65% of the company's total cost are on a rise for the past many years. The trend was similar in the first half of 2020 with salaries and benefits accounting for 67.3% of total operating costs. The company is witnessing an escalation in labor costs, which is outpacing general inflation rate growth. To address this challenge, the company will continue focusing on maintaining the competitiveness of its compensation and benefit programs and improving its recruitment, retention and productivity. Shortages of nurses and other medical personnel including therapists may from time to time require the company to ramp up usage of more expensive temporary personnel, generally called contract labor. Labor supply scarcity is an acute problem hounding the healthcare companies and an elevation in this cost will exert pressure on the margins.
- ▼ **Suspension of Share Buyback:** In an effort to enhance its operational and financial flexibility, in the face of the COVID-19-induced business uncertainty, the company deferred its share buyback plans. The suspension of share repurchases will affect the bottom line.

Reduced availability of personal protective equipment (PPE), uncertainty relating to reimbursement and increasing labor cost are some of the headwinds facing the company.

Last Earnings Report

Encompass Health Q2 Earnings Miss Estimates, Revenues Beat

Encompass Health's earnings of 31 cents per share missed the Zacks Consensus Estimate by 20.5% and declined 71.3% year over year. This year-over-year downside was due to lower revenues and rise in expenses.

Revenues of \$1.1 billion beat the Zacks Consensus Estimate by 1.1% but plunged 5.4% year over year. Decline in the top line was due to lower volumes in the inpatient rehabilitation segment and home health and hospice segment.

Adjusted EBITDA of \$162.2 million was down 35.7% year over year.

Quarter Ending 06/2020

Report Date	Jul 27, 2020
Sales Surprise	1.13%
EPS Surprise	-20.51%
Quarterly EPS	0.31
Annual EPS (TTM)	2.96

Segment Results

Inpatient rehabilitation segment's revenues of \$824.5 million were down 5.7% year over year, due to 5.1% lower revenues from Inpatient business and 25.3% decline in revenues from Outpatient and other business.

Adjusted EBITDA of \$180.3 million decreased 22.9% year over year due to adverse impacts on patient volumes, staff productivity and medical supplies due to the pandemic.

Home Health and Hospice segment's revenues of \$249.6 million were down 4.4% year over year, due to 9.4% lower revenues from Home Health sub-segment partly mitigated by 24.5% growth in Hospice sub-segment.

Adjusted EBITDA of \$15 million was down 69.5% year over year due to lower reimbursement rates under PDGM and higher administrative costs.

Financial Update

During the first half of 2020, adjusted free cash flow of \$242.8 million declined 10% year over year.

As of Jun 30, 2020, the company had almost \$419 million in cash and roughly \$964 million available to it under its \$1 billion revolving credit facility. The company's leverage ratio at the end of the second quarter of 2020 was 4.2x.

Recent News

Encompass Health's Expansion Plans Continue in Florida – Aug 11, 2020

Encompass Health unveiled plans to construct an inpatient rehabilitation hospital in Jacksonville, FL. The hospital, which will be known as Encompass Health Rehabilitation Hospital of Jacksonville, will have 50 beds in it. The healthcare provider has been making continuous efforts to strengthen presence in the state. To this effect, since July, the company has unveiled plans to construct six inpatient rehabilitation hospitals in different parts of Florida including the most recent one at Jacksonville.

Encompass Health Declares Quarterly Dividend – Jul 21, 2020

The company's board of directors has announced a quarterly dividend of 28 cents per share, which will be paid on Oct 15, 2020 to shareholders of record as of Oct 1. This indicates the company's commitment of returning value to shareholders.

Encompass & Covenant Health to Efficiently Serve Knoxville – Jul 1, 2020

Encompass Health has entered into a joint venture with Covenant Health through which the companies will be responsible for operating the Patricia Neal Rehabilitation Center. Notably, this rehab centre comes under the vast hospital network of Covenant Health. The joint venture will include filing of two certificate of need applications by the healthcare providers, the first application being construction of 51 beds and the second being renovating the rehab centre into hospital-in-hospital structure containing 22 beds. The venture is primarily intended for resolving health issues of Knoxville residents. The construction of the new structure and renovation of the existing one are likely to conclude in 2022.

Valuation

Encompass Health shares are down 8.8% and up 1.5% in the year-to-date period and the trailing 12-month period, respectively. Stocks in the Zacks sub-industry and the Zacks Medical sector are up 5.1% and 0.4% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and the sector are up 3.1% and 7.6%, respectively.

The S&P 500 index is up 4.5% in the year-to-date period and 15.4% in the past year.

The stock is currently trading at 17.39x forward 12-month earnings, which compares to 19.97x for the Zacks sub-industry, 22.17x for the Zacks sector and 22.87x for the S&P 500 index.

Over the past five years, the stock has traded as high as 22.44x and as low as 12.26x, with a 5-year median of 16.4x. Our Neutral recommendation indicates that the stock will perform in-line with the market. Our \$66 price target reflects 18.18x forward earnings.

The table below shows summary valuation data for EHC

Valuation Multiples - EHC					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	17.39	19.97	22.17	22.87
	5-Year High	22.44	22.66	23.17	22.87
	5-Year Low	12.26	14.49	15.89	15.25
	5-Year Median	16.4	17.72	18.97	17.58
P/S F12M	Current	1.25	2.61	2.81	3.7
	5-Year High	1.84	2.62	3.41	3.7
	5-Year Low	0.78	0.71	2.22	2.53
	5-Year Median	1.22	1.08	2.89	3.05
P/B TTM	Current	3.43	3.18	3.76	4.52
	5-Year High	5.45	4.04	5.07	4.56
	5-Year Low	2.88	1.91	2.94	2.83
	5-Year Median	4.04	2.49	4.28	3.74

As of 08/14/2020

Industry Analysis Zacks Industry Rank: Top 29% (73 out of 252)



Top Peers

Company (Ticker)	Rec	Rank
The Ensign Group, Inc. (ENSG)	Outperform	1
Amedisys, Inc. (AMED)	Neutral	3
American Renal Associates Holdings, Inc (ARA)	Neutral	3
Chemed Corporation (CHE)	Neutral	3
Quest Diagnostics Incorporated (DGX)	Neutral	3
Elanco Animal Health Incorporated (ELAN)	Neutral	3
Hanger Inc. (HNGR)	Neutral	3
RadNet, Inc. (RDNT)	Neutral	2

Industry Comparison Industry: Medical - Outpatient And Home Healthcare				Industry Peers		
	EHC	X Industry	S&P 500	CHE	ELAN	ENSG
Zacks Recommendation (Long Term)	Neutral	-	-	Neutral	Neutral	Outperform
Zacks Rank (Short Term)	3	-	-	3	3	1
VGM Score	B	-	-	B	F	B
Market Cap	6.28 B	1.07 B	23.68 B	8.06 B	10.28 B	2.99 B
# of Analysts	8	3.5	14	2	5	3
Dividend Yield	1.77%	0.00%	1.68%	0.25%	0.00%	0.36%
Value Score	B	-	-	D	D	C
Cash/Price	0.07	0.09	0.07	0.00	0.14	0.07
EV/EBITDA	10.15	11.13	13.36	26.14	23.13	21.04
PEG Ratio	2.38	3.27	2.99	3.21	4.81	1.29
Price/Book (P/B)	3.43	3.16	3.22	10.74	1.55	4.16
Price/Cash Flow (P/CF)	10.16	13.38	12.82	29.38	13.57	17.56
P/E (F1)	21.06	38.66	22.06	30.94	44.28	19.31
Price/Sales (P/S)	1.37	1.17	2.51	3.99	3.67	1.28
Earnings Yield	4.73%	2.09%	4.30%	3.23%	2.25%	5.19%
Debt/Equity	2.06	0.63	0.77	0.14	0.31	1.54
Cash Flow (\$/share)	6.22	1.90	6.94	17.24	1.90	3.16
Growth Score	B	-	-	A	C	B
Hist. EPS Growth (3-5 yrs)	13.25%	7.92%	10.41%	22.39%	NA	17.68%
Proj. EPS Growth (F1/F0)	-23.47%	11.78%	-6.32%	17.35%	-45.09%	28.42%
Curr. Cash Flow Growth	8.30%	6.12%	5.20%	14.93%	-2.65%	18.22%
Hist. Cash Flow Growth (3-5 yrs)	13.00%	13.00%	8.55%	14.21%	NA	16.88%
Current Ratio	1.66	1.14	1.33	0.59	3.82	0.94
Debt/Capital	67.57%	43.98%	44.59%	12.21%	23.39%	60.56%
Net Margin	6.21%	3.79%	10.13%	12.99%	-3.63%	5.81%
Return on Equity	16.89%	13.78%	14.51%	36.71%	4.68%	20.42%
Sales/Assets	0.73	0.83	0.51	1.59	0.30	0.97
Proj. Sales Growth (F1/F0)	1.91%	0.96%	-1.43%	7.54%	-11.14%	5.22%
Momentum Score	B	-	-	D	F	C
Daily Price Chg	-1.47%	0.00%	0.12%	-0.32%	5.44%	-1.51%
1 Week Price Chg	-0.69%	1.21%	2.30%	4.01%	2.84%	23.96%
4 Week Price Chg	-3.34%	7.00%	4.41%	7.13%	7.37%	24.17%
12 Week Price Chg	-13.71%	6.18%	13.66%	6.14%	36.06%	30.99%
52 Week Price Chg	4.36%	13.21%	5.80%	18.76%	-11.72%	9.35%
20 Day Average Volume	624,651	147,517	1,984,154	66,414	5,486,156	262,920
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	6.82%
(F1) EPS Est 4 week change	-1.34%	0.83%	2.08%	-1.04%	-8.59%	14.31%
(F1) EPS Est 12 week change	-4.10%	0.88%	2.66%	-1.04%	-23.71%	13.83%
(Q1) EPS Est Mthly Chg	7.65%	1.30%	0.94%	-1.72%	-23.88%	28.30%

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	B
Growth Score	B
Momentum Score	B
VGM Score	B

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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