VALUE X VAIL

June 18 – 20, 2014

HEALTHSOUTH

Laughing Water Capital

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Context

"The broad filters that I apply for health-care investing in general is, No. 1: Does the health-care company deliver better quality of care than someone could get somewhere else? No. 2: Does it deliver a net savings to the health-care system? In other words, is the total bill for U.S. health-care cheaper because of the efficiency the company provides? And lastly: do you get a higher return on capital, predictable growth and shareholder-friendly management?"

~Berkshire Hathaway's Ted Weschler in reference to DVA

Investment Basics

- ✓ Easy To Understand
- ✓ Strong Moat
- ✓ Strong Balance Sheet
- ✓ Competitive Advantages
- ✓ Strong FCF Generation
- ✓ Opportunity for Reinvestment
- ✓ Long Runway for Growth
- ✓ Incentivized Management
- ✓ Excellent Capital Allocation
- ✓ Misunderstood Risks

Stock Basics

Stock Symbol	HLS
Stock Price	$35.94*
Shares Out (mm)	88.1
Market Cap (mm)	$3,166.0
Cash (mm)	$53.1
Debt (mm)	$1,503.1
Convertible Pfd (mm)	$93.2
Enterprise Value (mm)	$4,709.2
Current Yield	2.0%
52 Week Range	$27.51-37.68

*As of 6/17/2014

Company Description

HealthSouth is the largest operator of Inpatient Rehab Facilities (IRFs) in the United States

The average patient is 72 years old, and is suffering from one or more of 13 government designated qualifying conditions

All patients are referred to IRFs by physicians (typically from acute care hospitals) based on the acuity of their condtion. The highest acuity patients go to IRFs, while less severe cases go to SNFs or HHC.

IRF patients receive intensive multi-disciplinary rehabilitation therapy at least 3 hours a day, 5 days a week

The conditions that IRFs treat are generally non-discretionary in nature.

Key Takeaway: HLS is the dominant player in a niche segment of the healthcare complex

*the company also operates 17 outpatient rehab facilities and 25 hospital based home health agencies that together account for ~6% of revenue.

Market Share

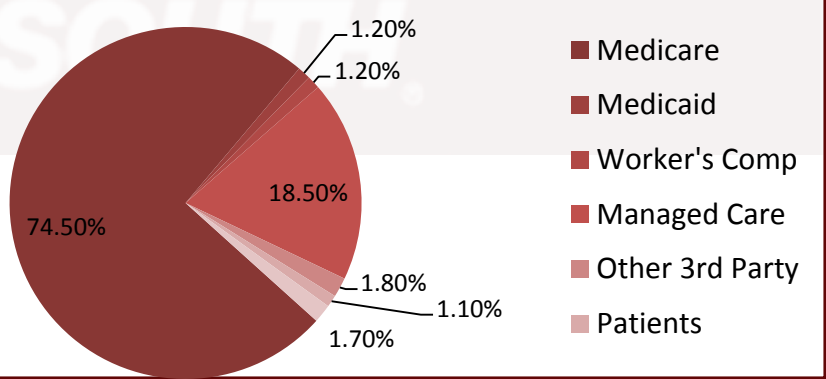
HLS Operates:

- 103 IRFs (31 as JVs with ACHs)
- ~9% of all US IRF facilities in the US
- ~19% of all IRF licensed beds in the US
- ~43% of all free standing IRF facilities in the US

Most Common Treatments Q1'14

Neurological	25.0%
Stroke	16.7%
Leg Fracture	9.2%
Other Orthopedic	9.0%
Brain Injury	8.3%

Payer Info



Competitive Advantages Unit Level

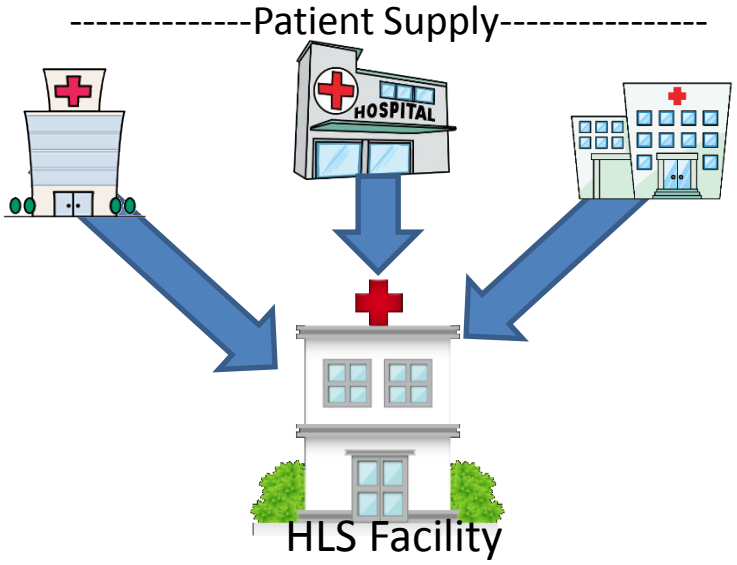
IRF facilities employ skilled staff such as physical, cognitive, and occupational therapists with the goal of returning patients to home and/or work.

HLS operates free standing IRF units, which are able to draw patients from multiple area acute care hospitals, resulting in higher utilization rates for their skilled staff.

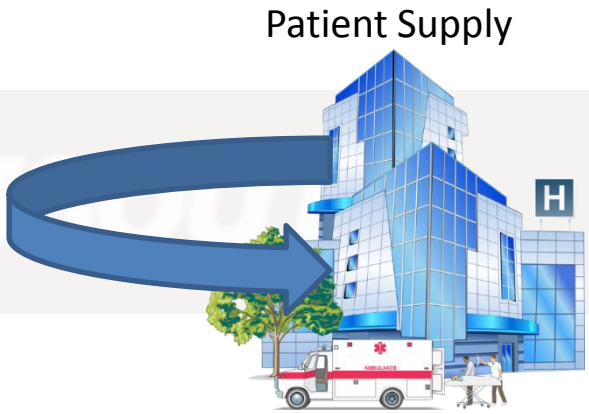
Non free standing IRF units receive patients from their parent hospital only, resulting in lower utilization levels for skilled staff.

Key Takeaway: HLS has higher utilization rates for skilled staff than ACH based IRFs, resulting in higher margins.

HealthSouth Free Standing IRF Model



Acute Care Hospital IRF Model



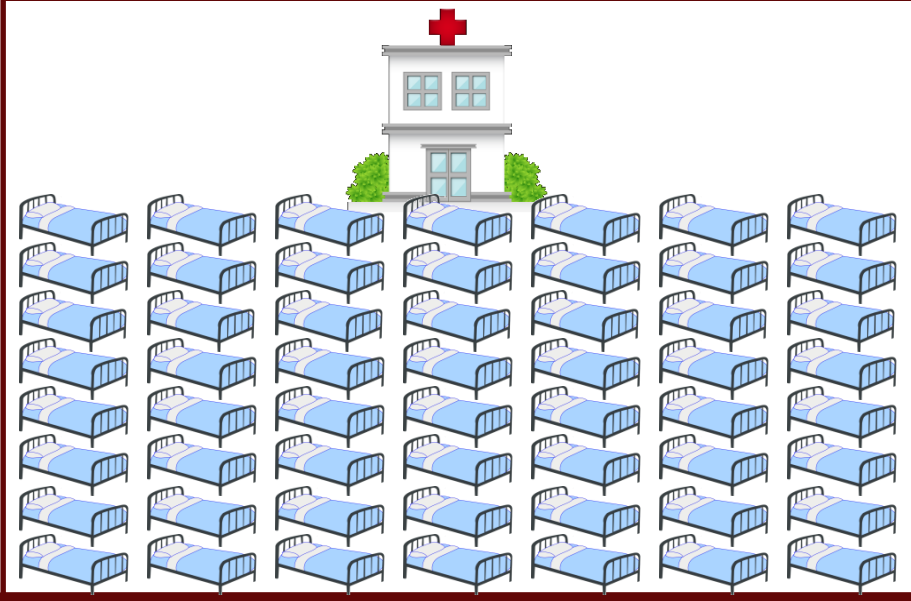
Competitive Advantages Unit Level

HLS facilities average 68 beds per unit, versus 52 beds per unit for non HLS freestanding IRFs.

A higher bed count results in higher utilization rates for skilled staff.

Key Takeaway: HLS has higher utilization rates for skilled staff than other free standing IRFs resulting in higher margins.

HealthSouth IRF Model

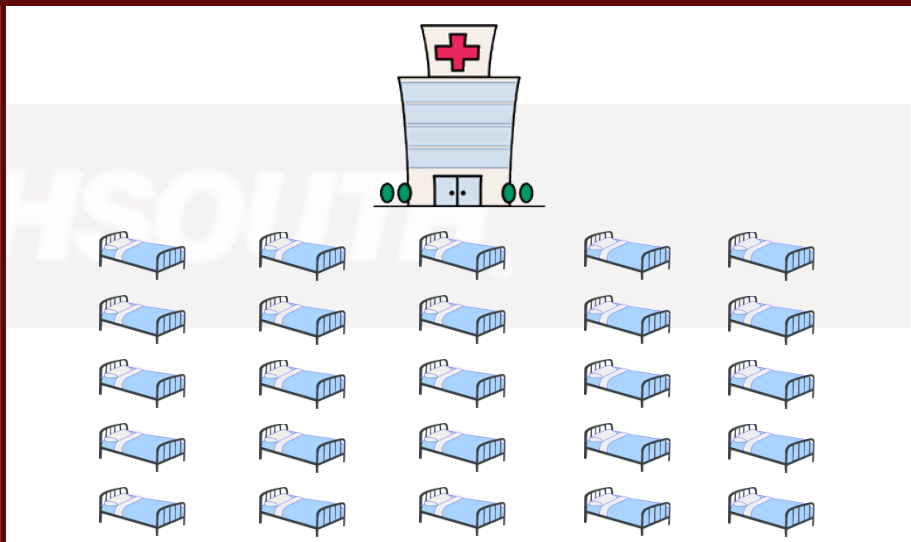


Direct Relationship Between Bed #s and Margin

# of beds	% of Medicare Discharges	EBIT Margins
1 to 10	2.5	-7.8
11 to 21	19	-1.9
22 to 59	42.3	9.3
60+	36.2	20.9

Source: MedPAC

Other Free Standing IRF Model



Competitive Advantages System Level

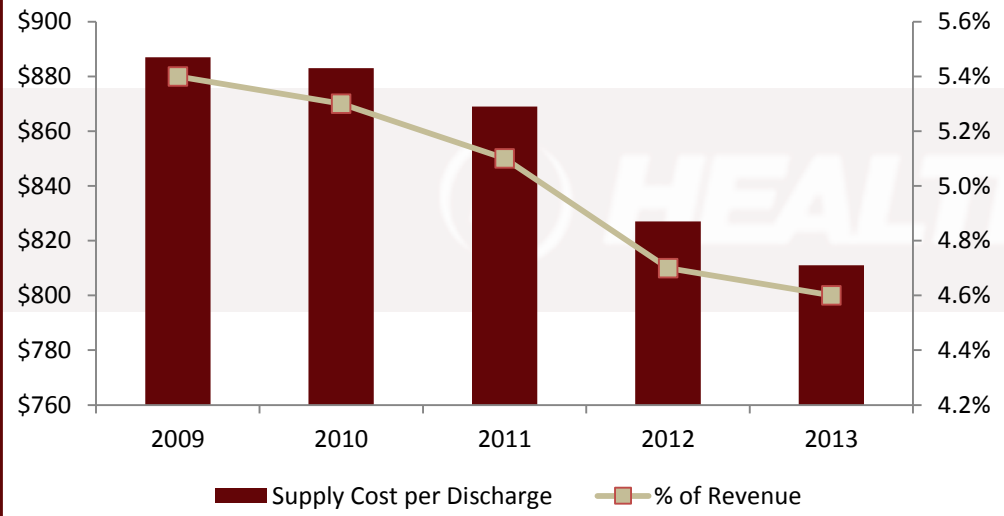
As the largest most profitable player in the space HLS enjoys the benefits of economies of scale

- Better technology
- Better training
- Internal feedback loop nationalizes local best practices
- Able to buy supplies on a national rather than local level

CIS System

- HLS is installing a clinical information system across its network with all units expected to be online by 2017.
- Capable of interfacing with all major acute care medical electronic medical record systems
- Allows for seamless transfer from ACH to IRF, resulting in improved care
- HLS well positioned for evolution of coordinated care model

Supply Costs per Patient



Better Training

- HLS consistently produces best in class patient outcomes
- All patients are evaluated for Medicare reimbursement eligibility before treatment begins, which lowers audit costs

Competitive Advantage Patient Outcomes

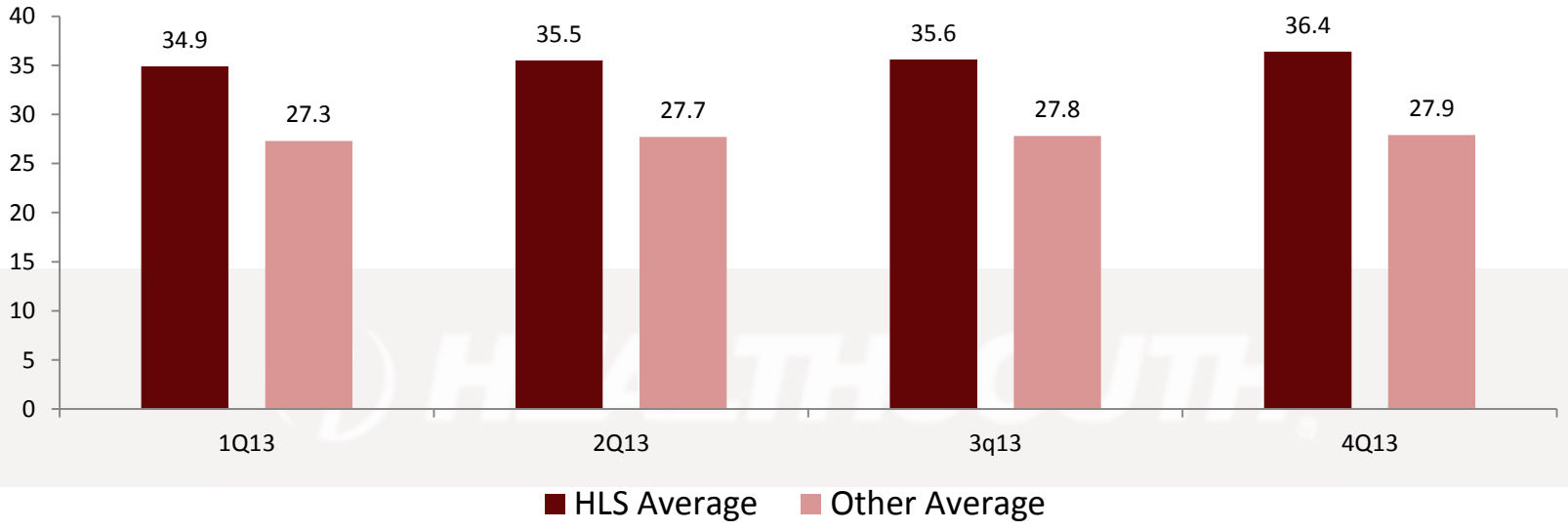
The industry standard for efficacy is the FIM score, or Functional Independence Measurment.

Patients are tested for ability on 18 skills upon admission and again upon on dismissal.

The greater the FIM score gain, the greater the patient's level of independence, and the lower the chances of re-admission.

The greater the FIM score gain, the more likely referring physicians are to choose a HLS facility

FIM Scores



Key Takeaway: HLS has best in class patient outcomes

Source: Company Presentation

The Result: Government Level

- HealthSouth on average treats the highest acuity patients
- HealthSouth on average bills Medicare less than the competition

	Case Mix Index (Acuity Level)	Average Estimated Total Cost per Discharge FY 2014	Average Estimated Total Payment per Discharge FY 2014	Average Estimated Margin Dollars per Discharge FY 2014
HLS	1.23	$12,194	$17,979	$5,785
Other Freestanding	1.20	$16,102	$18,971	$2,869
ACH Based	1.14	$18,925	$18,847	($78)
Total	1.18	$16,704	$18,668	$1,964

Key Takeaway: HealthSouth costs the Government less money vs. IRF peers

Source: Company Presentation

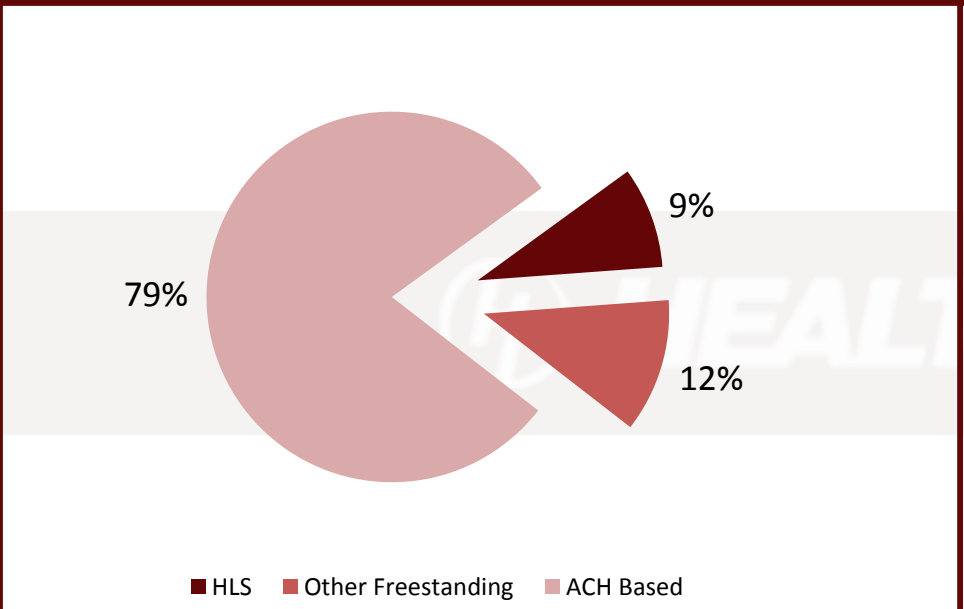
The Result: Shareholder Level

HLS is a small player in the total IRF space, but it is by far the most profitable player

High profitability creates opportunities to successfully re-deploy capital and increase market share

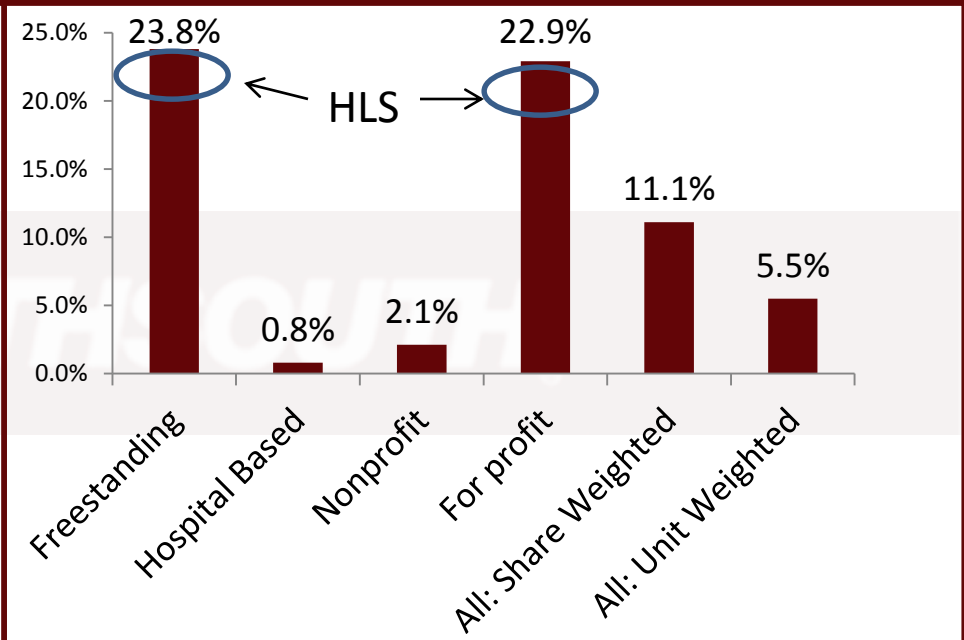
Eventual regulatory change in the form of reimbursement rate cuts will likely be based on unit weighted margins. If it isn't, a large number of IRF's will be forced out of business, leading to 1) public outcry due to lack of service and 2) opportunity for HLS to grow

Market Share # of Units



Source: MedPac

IRF EBIT Margins



Competitive Advantage Real Estate

In recent years the company has sought to strategically purchase the buildings and land that house its facilities

Purchases are viewed as deleveraging events

Over the next 10 years approximately 1 facility per year will be available for purchase

Typical cost per facility is $12-18 million.

In the event of regulatory change, HLS will have limited exposure to a dual threat from lower reimbursements combined with higher lease payments

Key Takeaway: HLS has taken steps to maximize control of their fixed costs

Strategically Located Facilities

Real Estate Portfolio

Own Building and Land	50
Own Building Only	26
Lease Building and Land w/ Purchase Option	10
Lease Building and Land w/o Purchase Option	17
Total Facilities	103

Barriers to Entry

Legal

- 49% of HLS beds are located in states that require a Certificate of Need (CON) be issued by the local government before construction on new facilities is allowed. This process can take years.
- Incumbents are often allowed to object to issuance of new CONs, creating a significant first mover advantage

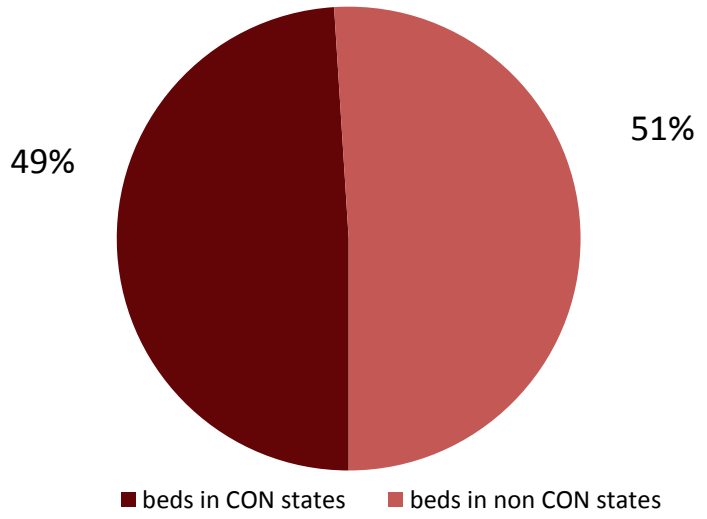
Quality of Care

- HLS has an established reputation for providing best in class patient care. New entrants to a geography would have to convince referring physicians to abandon the proven solution and try something new
- Joint Commission Disease Specific Care Certification Program

Regulatory risk

- Uncertainty regarding the regulatory environment virtually insures that new entrants will not make a large scale push into the space
  - Existing ACH networks are trying to expand into the freestanding IRF space, but profitable opportunities are limited by their existing footprint

% of Beds in CON States



Management on Competition:

"there's definitely competition. Most of the acute care providers who are getting into rehabilitative services that are moving in then, and HCA is a great example, are doing it where they have enough market concentration that they can support rehab services. There aren't a lot of systems out there that have that ability."

~CEO Jay Grinney, Q2'13

Growth

Demographics

- "Graying of America" = Medicare eligible population growing ~3% per year

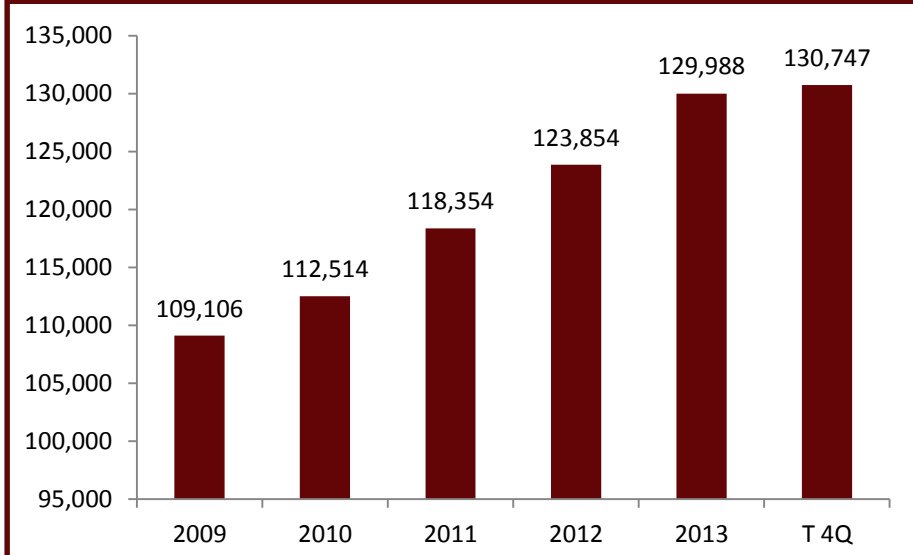
Organic Opportunity

- Stated 15% IRR hurdle for new projects
- Bed expansion (highest return – target 80/year)
- De novo expansion ($17-22M per – target ~4/year)
  - 160 potential opportunities have been identified
- Acquisitions
  - ACHs are seeking to JV with HLS and/or possibly exit the space
    - ~700 non profit IRF are operating with average 2.1% margins = rich opportunity set
  - Increased Obamacare compliance costs = others leaving the space

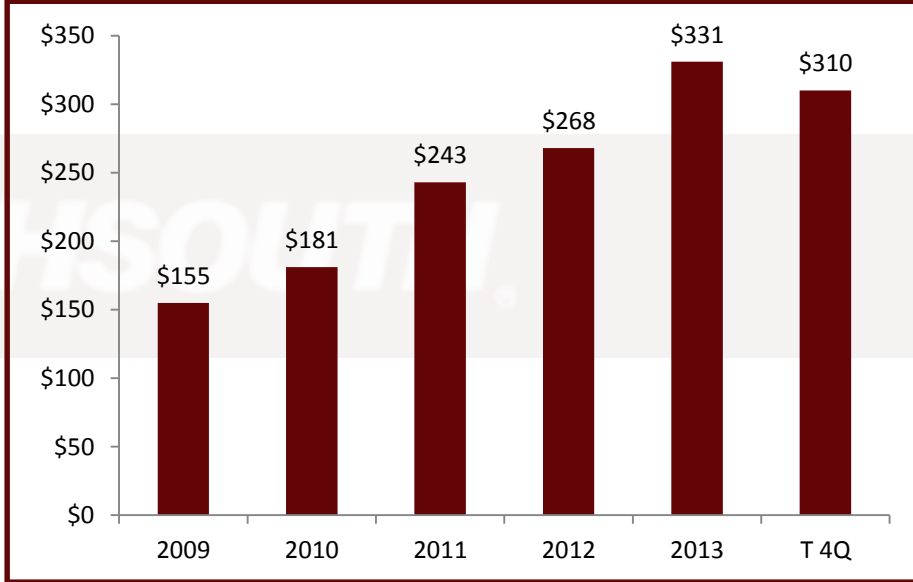
"Our development pipeline is very attractively populated with opportunities that we think will allow us to continue to add hospitals, [and] enter new markets." *~CEO Jay Grinney Q3'13*

Source: Company Presentation

Discharge Volume



Adjusted FCF (millions)



Management & Capital Allocation

Management is excellent, and consistently under-promises while over delivering.

- Over the last 6 years the company has out performed initial EBITDA guidance by an average of 6.5%
- Over the last 6 years the company has out performed initial EPS guidance by an average of 53.1%

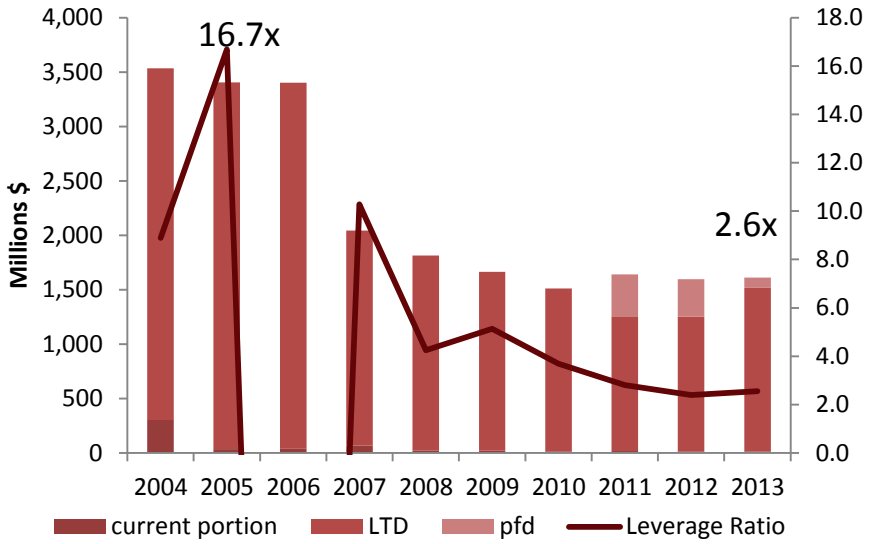
Management collectively owns 5% of the company, including CEO Jay Grinney who owns ~$85M worth of stock

Much of the last 10 years has been about cleaning up past mistakes and cleaning up the balance sheet

The company has recently turned a corner and is now focused on returning capital to shareholders

- $234M tender in March 2013 – 9.5% of company
- Initiated dividend in July of 2013 (2% yield)
- Repurchased $26.3M in Q1'14
- Current repurchase authorization of $223.7M (~7%of outstanding)

The Past: Managing Legacy Debt



The Future: Rewarding Shareholders

"[returning capital to shareholders] is an integral part of our business model and we will be evaluating all of those levers, and we'll continue to have that dialogue with our board. I think what you can certainly take away is that our board is very prepared to pull multiple levers"
~CEO Jay Grinney, Q2'13

Why Does the Opportunity Exist: The Past

Company History

- Founded in 1984 by high school dropout Richard M. Scrushy as an outpatient rehab facility focused on worker's comp injuries
- Evolved into a healthcare behemoth and Wall Street darling through rapid M&A – reported $4.3 billion in revenue in 2001
- March 2003 the FBI raids HLS offices and finds that earnings had been overstated by more than $4 billion since 1999
- Current CEO Jay Grinney takes over in May of 2004 and narrowly avoids bankruptcy
- Grinney divests essentially all business units except for inpatient rehab facilities, where he believed they had significant advantages
- In 2013 HLS shifts its focus from legacy litigation and paying down debt to returning capital to shareholders

Key Takeaway – its been 10 years, and HLS has just recently shaken off the effects of prior management's scandal

The Wrong Company to Keep:

HLS: Then vs. Now

Old HLS	New HLS
• Outpatient Rehab	• Inpatient Rehab (94% of revenue)
• Outpatient Surgery	• Outpatient & Other (6% of revenue)
• Diagnostic Services	
• Outpatient Services Management	
• Medical Centers	
• Inpatient Rehab	

Why Does the Opportunity Exist: The Future

The possibility of Healthcare reform / reimbursement cuts is a significant “known unknown”

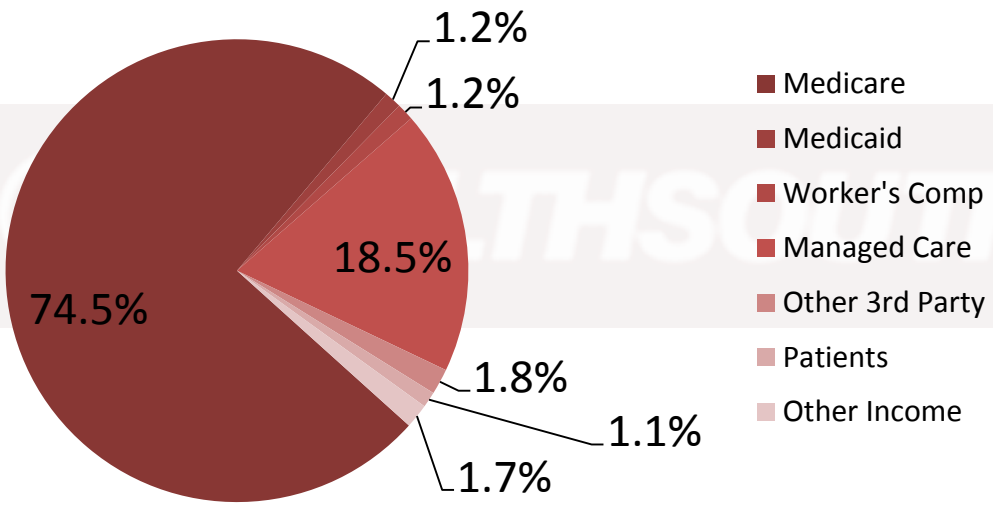
Key Risks:

- Reduction in Medicare reimbursement rates
- 60% rule → 75% rule
- Changes to 13 qualifying conditions
- Site neutral Payments

Management Take on Reform:

“we see [the buyback authorization] as sort of an opportunistic opportunity to take advantage of any change, dramatic change, in the stock price that may occur as a result of what's going on in Washington or what's not going on in Washington.”
~CEO Jay Grinney Q3 2013

HLS Revenue is HIGHLY Dependant on Medicare Reimbursement



Second Level Thinking

First-level thinking says, “It’s a good company; let’s buy the stock.” Second-level thinking says, “It’s a good company, but everyone thinks it’s a great company, and it’s not. So, the stock’s overrated and overpriced; let’s sell.”

First-level thinking says, “The outlook calls for low growth and rising inflation. Let’s dump our stocks.” Second-level thinking says, “The outlook stinks, but everyone else is selling in panic. Buy!”

First-level thinking says, “I think the company’s earnings will fall; sell.” Second-level thinking says, “I think the company’s earnings will fall less than people expect, and the pleasant surprise will lift the stock; buy.”

~Howard Marks, The Most Important Thing

Second Level Thinking

First-level thinking says, "Healthcare reform is a major risk. This is un-investable." Second-level thinking says, "With ~20% margins HealthSouth is way better equipped to handle reform than their already barely profitable competition. If there is healthcare reform, the competition will be crushed and HealthSouth will benefit."

"Tough periods allow the strong and capable to strengthen. Over time the stock price will gain if you build business value. Carnegie Steel built its business during bad times. Opportunities happen with trouble."

~Charlie Munger, 2009 Berkshire Hathaway annual meeting

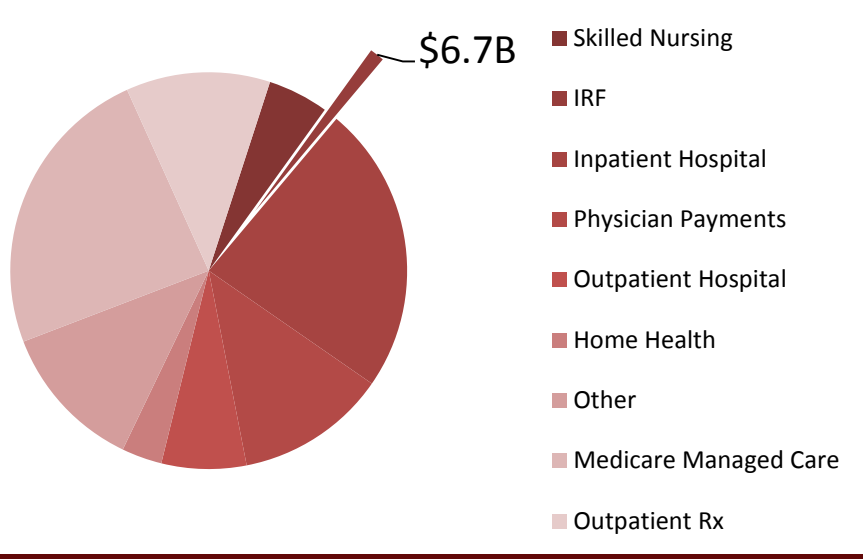
IRFs : Not a High Value Target

"if you look at the percent of Medicare spending on inpatient rehabilitative services, as a percent of total Medicare spending, since I think 2007 or '08, we have been less than 1.5% and almost consistently at that 1.2%. So I don't think we're an outsized target. Are we taking that for granted, assuming that nothing is going to come our way? No. We're on the Hill a lot."

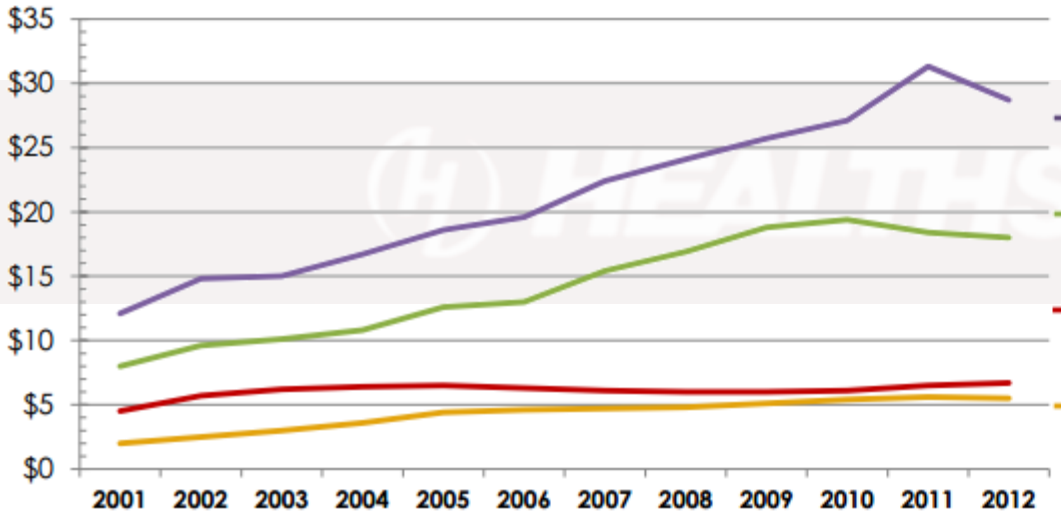
~ CEO Jay Grinney Q2'13

Key Takeaway: Reform risk is very real, but there are much higher impact targets available

IRF Spending was ~1% of the 2012 Medicare Pie



IRF Medicare Spending Has Remained Stable, and is Lower Margin Than Other Post Acute Alternatives



Post-Acute Settings	2012 Medicare Margin	Projected 2014 Medicare Margin
Skilled nursing facilities	13.8%	12.0%
Home health agencies	14.4%	12.6%
Inpatient rehabilitation hospitals	11.1%	11.8%
Long-term acute care hospitals	7.1%	6.5%

Source: Company Presentation, MedPac
Note: Above margins are pre sequestration

Scenario Analysis: Rate Cuts

Proposal: Reduce reimbursement rates for post acute care providers

Headline Risk: Very real

Mitigating Factors: IRFs are a very small piece of the Medicare pie

IRF margins are already lower than other healthcare segments

HLS is well positioned to transition to an ACO / bundled payment model

HLS margins are ~4x average unit weighted margins making the Company much more able to handle any cuts than the competition

Likely Event Path:

1) Headline hits, stock immediately sells off.
2) Management begins to aggressively buy back stock.
3) Lobbyists and lawyers have a bonanza seeking to slow implementation.
4) HLS has 2-3 years to adapt.
5) Competitors recognize that they can not function under the new normal, so they seek to exit or JV with HLS.
6) HLS gains market share, albeit it at a less profitable rate.

Management Take:

"because of reimbursement pressures or cost pressures that [acute care hospitals with rehab units] are under, they're just making the decision to get out of that business. In other instances, they're looking to joint venture that oftentimes, with the idea that we might come in and take the unit that is currently inside the hospital and joint venture that and build a new freestanding hospital, that would give them additional capacity on the acute care side."
~CEO Jay Grinney Q4'12

Scenario Analysis: 75% rule

Proposal: Require that 75% of all IRF patients fit within 13 diagnostic categories in order to be eligible for Medicare reimbursement *vs* 60% as it is now.

Headline Risk: Very real

Mitigating Factors: HLS already qualifies on the system level

HLS has the margins and balance sheet to adapt on a unit level

Likely Event Path:

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Management Take:

[We are at 75% compliance as a] total company right now. I think we'd be able to move to that level [on a unit basis] if we had to. I think the problem is going to be more on the other rehab units, the non-HealthSouth rehab units. I think that's really where the biggest impact would be. But we think that we could accommodate a rule change if we absolutely had to."

~CEO Jay Grinney Q2'13

Scenario Analysis: Qualifying Conditions Change

Proposal: Change the 13 qualifying conditions currently necessary for IRF treatment, essentially sending patients to SNFs rather than IRFs.

Headline Risk: Very real

Mitigating Factors: SNFs are not equipped to handle the highest acuity patients

American Hospital Association opposes any change

Average length of stay (12.9 days for IRFs, 27.4 days for SNFs)

Readmission rates (9.4% for IRFs vs. 22% for SNFs)

Likely Event Path:

1) Headline hits, stock immediately sells off.
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5) Competitors recognize that they can not function under the new normal, so they seek to exit or JV with HLS.
6) HLS gains market share

Management Take:

"we believe that CMS increasingly is going to be looking at the entire episode of care and will, in fact, incorporate things like readmission rates, things like discharge back to home and quality outcomes, frankly, to determine whether or not it is better to pay for a shorter, higher quality stay in a rehabilitation hospital or a longer, less quality stay in a nursing home, where there is a significantly greater probability that the patient is going to end up being readmitted back to an acute care hospital."

~ CEO Jay Grinney Q1, 2013

Scenario Analysis: Site Neutral Payments

Proposal: Equalize post acute care reimbursement rates across provider type

Headline Risk: Very real

Mitigating Factors: American Hospital Association opposes any change

Average length of stay (12.9 days for IRFs, 27.4 days for SNFs)

Readmission rates (9.4% for IRFs vs. 22% for SNFs)

Likely Event Path:

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Management Take:

"[the site neutral debate] is very much in the – in its infancy, but it's certainly a concept that's out there and as we've said in the past, we don't necessarily believe that moving to site neutral would be negative for HealthSouth because presumably in that calculation of what that site neutral payment would be, especially if the comparison is between a rehabilitation payment and a nursing home payment, factors beyond just what is the per day payment would be included, and those factors would include items such as length of stay, return rates or readmission rates to acute care hospitals, and more importantly outcomes. So it is something that gets talked about, it's not something that is ready for prime time in our space. And as I've said, we're not looking at it necessarily as a big negative, it could be a real positive for us."

~ CEO Jay Grinney, Q1 2014

Regulatory Reform Risk is Not New…

… Yet the Company Has Done Just Fine

Source: Company Presentation

Valuation

Buffett: it is easier to know that something will be worth a lot more in ten years than to know what it is worth today.

A shifting cap structure, large NOLs that won't last forever, and regulatory risk make it difficult to put a current "value" on HLS shares.

Demographics, industry characteristics, and capital allocation make it easy to say that intrinsic value will continue to grow.

As a theoretical apples to oranges exercise, consider HLS's current free cash flow if they stopped investing for the future, and put a comp multiple on it.

Now consider that 1) HLS has better opportunities for reinvestment than healthcare comps 2) HLS likely deserves a premium multiple to SNFs due to lower regulatory risk and strong industry position. Conservative future assumptions seem to confirm steady state analysis.

The real opportunity here is not in multiple expansion, but in reinvesting in the business for years to come.

Comp Universe

Subsector	P/FCF	EV/EBITDA
Hospitals	15.6x	9.2x
LTAC Hospitals	13.5x	8.2x
Home Health	9.5x	14.5x
Skilled Nursing	12.9x	7.4x
Average	12.9x	9.8x

HLS Theoretical Steady State

E2014 FCF (OCF - maintenance CapEx)	$360
@ 12.9x	*$4,644*
Shares (million, not diluted)	88.0
Per Share	$52.77
Current Discount	~47%

HLS 2017 Estimates

E2017 Adj. EBITDA	$680
E2017 EV @ 8.5x	*$5,777*
E2017 Net Debt	-875
E2017 Equity Value	$4,902
E2017 Diluted Shares (million)	91.0
E2017 Value Per Share	$53.87
Current Discount	~50%

Key Takeaways

- ✓Attractive, defensive, niche industry
- ✓HLS is the dominant player
- ✓HLS will benefit from an aging population for years to come
- ✓Other industry participants are disadvantaged and seeking to exit or JV with HLS
- ✓Management is incentivized to maximize per share growth
- ✓Management has proven they are capable capital allocators
- ✓Regulatory risks are well documented and already reflected in the stock price
- ✓Intrinsic value is likely to grow at a mid teens rate for years to come
- ✓Closing of valuation gap is not needed for a successful investment

"ultimately, those of us who can ensure that the quality of care is superior and better than the competitors and we can offer that at a cost-effective basis, we're going to do fine."
~CEO Jay Grinney Q2'13

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HEALTHSOUTH

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