

KINDRED HEALTHCARE, INC  
Form 10-Q  
May 04, 2005  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

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

**For the quarterly period ended March 31, 2005**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission file number: 001-14057**

**KINDRED HEALTHCARE, INC.**

**(Exact name of registrant as specified in its charter)**

**Delaware**  
**(State or other jurisdiction of**  
  
**incorporation or organization)**  
  
**680 South Fourth Street**

**61-1323993**  
**(I.R.S. Employer**  
  
**Identification No.)**  
  
**40202-2412**

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**Louisville, KY**  
(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  No

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

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes  No

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

<u>Class of Common Stock</u>	<u>Outstanding at April 30, 2005</u>
Common stock, \$0.25 par value	38,426,884 shares

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## KINDRED HEALTHCARE, INC.

## CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(Unaudited)

(In thousands, except per share amounts)

	Three months ended March 31,	
	2005	2004
Revenues	\$ 939,989	\$ 858,015
Salaries, wages and benefits	515,020	484,049
Supplies	128,283	115,496
Rent	67,996	63,619
Other operating expenses	152,167	142,321
Depreciation and amortization	24,114	21,561
Interest expense	2,000	3,654
Investment income	(2,348)	(1,214)
	<u>887,232</u>	<u>829,486</u>
Income from continuing operations before reorganization items and income taxes	52,757	28,529
Reorganization items	(1,371)	
Income from continuing operations before income taxes	54,128	28,529
Provision for income taxes	21,868	11,996
Income from continuing operations	32,260	16,533
Income (loss) from discontinued operations, net of income taxes	4,630	(2,693)
Net income	<u>\$ 36,890</u>	<u>\$ 13,840</u>
Earnings per common share:		
Basic:		
Income from continuing operations	\$ 0.89	\$ 0.47
Income (loss) from discontinued operations	0.13	(0.08)
Net income	<u>\$ 1.02</u>	<u>\$ 0.39</u>
Diluted:		
Income from continuing operations	\$ 0.73	\$ 0.38
Income (loss) from discontinued operations	0.10	(0.06)
Net income	<u>\$ 0.83</u>	<u>\$ 0.32</u>
Shares used in computing earnings per common share:		
Basic	36,312	35,414

Diluted

44,410

42,721

See accompanying notes.

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**Table of Contents****KINDRED HEALTHCARE, INC.****CONDENSED CONSOLIDATED BALANCE SHEET****(Unaudited)****(In thousands, except per share amounts)**

	<b>March 31,</b>	<b>December 31,</b>
	<b>2005</b>	<b>2004</b>
	<b>_____</b>	<b>_____</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 15,571	\$ 69,128
Cash restricted	5,874	6,054
Insurance subsidiary investments	251,850	238,856
Accounts receivable less allowance for loss of \$65,237 March 31, 2005 and \$60,320 December 31, 2004	463,278	400,517
Inventories	36,497	35,025
Deferred tax assets	70,137	70,137
Assets held for sale	16,343	22,672
Other	44,286	31,954
	<b>_____</b>	<b>_____</b>
	903,836	874,343
Property and equipment	786,340	765,586
Accumulated depreciation	(297,629)	(273,880)
	<b>_____</b>	<b>_____</b>
	488,711	491,706
Goodwill	41,960	31,582
Insurance subsidiary investments	44,442	41,651
Deferred tax assets	91,437	91,180
Other	105,884	62,831
	<b>_____</b>	<b>_____</b>
	<b>\$ 1,676,270</b>	<b>\$ 1,593,293</b>
	<b>_____</b>	<b>_____</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 111,876	\$ 122,176
Salaries, wages and other compensation	233,999	230,056
Due to third party payors	23,331	33,910
Professional liability risks	79,115	82,609
Other accrued liabilities	75,340	76,985
Income taxes	52,068	26,748
Long-term debt due within one year	5,506	5,282
	<b>_____</b>	<b>_____</b>
	581,235	577,766
Long-term debt	56,304	32,544
Professional liability risks	203,006	204,713
Deferred credits and other liabilities	60,901	58,485
Commitments and contingencies		

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Stockholders' equity:

Common stock, \$0.25 par value; authorized 175,000 shares; issued 38,273 shares	March 31, 2005 and		
37,189 shares	December 31, 2004	9,568	9,297
Capital in excess of par value		654,120	636,015
Deferred compensation		(7,118)	(7,353)
Accumulated other comprehensive income		6	468
Retained earnings		118,248	81,358
		<u>774,824</u>	<u>719,785</u>
		<u>\$ 1,676,270</u>	<u>\$ 1,593,293</u>

See accompanying notes.

**Table of Contents****KINDRED HEALTHCARE, INC.****CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS****(Unaudited)****(In thousands)**

	<b>Three months ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 36,890	\$ 13,840
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	24,114	22,046
Amortization of deferred compensation costs	1,912	1,743
Provision for doubtful accounts	4,987	8,116
Reorganization items	(1,371)	
Other	(186)	(102)
Change in operating assets and liabilities:		
Accounts receivable	(59,132)	(54,304)
Inventories and other assets	(10,359)	(9,468)
Accounts payable	(2,445)	(3,184)
Income taxes	25,332	9,912
Due to third party payors	(10,579)	(3,737)
Other accrued liabilities	8,791	(9,062)
<b>Net cash provided by (used in) operating activities</b>	<b>17,954</b>	<b>(24,200)</b>
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment	(17,963)	(17,881)
Acquisition of institutional pharmacy	(27,600)	
Acquisition deposit	(31,500)	
Sale of assets	1,055	370
Purchase of insurance subsidiary investments	(113,884)	(9,776)
Sale of insurance subsidiary investments	84,591	5,672
Net change in insurance subsidiary cash and cash equivalents	13,111	(16,820)
Net change in other investments		1,777
Other	(99)	138
<b>Net cash used in investing activities</b>	<b>(92,289)</b>	<b>(36,520)</b>
<b>Cash flows from financing activities:</b>		
Net change in revolving credit borrowings	25,200	16,900
Repayment of long-term debt	(1,216)	(1,032)
Issuance of common stock	16,699	467
Other	(19,905)	(4,312)
<b>Net cash provided by financing activities</b>	<b>20,778</b>	<b>12,023</b>



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Change in cash and cash equivalents	(53,557)	(48,697)
Cash and cash equivalents at beginning of period	69,128	66,524
	<u>          </u>	<u>          </u>
Cash and cash equivalents at end of period	\$ 15,571	\$ 17,827
	<u>          </u>	<u>          </u>
Supplemental information:		
Interest payments	\$ 1,034	\$ 3,272
Income tax payments (refunds)	(566)	398

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. ( Kindred or the Company ) is a healthcare services company that through its subsidiaries operates hospitals, nursing centers, institutional pharmacies and a contract rehabilitation services business across the United States. At March 31, 2005, the Company's hospital division operated 73 hospitals in 24 states. The Company's health services division operated 249 nursing centers in 29 states. The Company's pharmacy division operated an institutional pharmacy business with 36 pharmacies in 23 states and a pharmacy management business servicing substantially all of the Company's hospitals. The Company also operated a contract rehabilitation services business which began operating as a separate division on January 1, 2004.

During 2004 and 2003, the Company completed several transactions related to the divestiture of unprofitable hospitals, nursing centers and other healthcare businesses. For accounting purposes, the operating results of these businesses and the losses associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at March 31, 2005 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet. See Note 2.

In April 2001, the Company and its subsidiaries emerged from proceedings under Chapter 11 of Title 11 of the United States Code (the Bankruptcy Code ) pursuant to the terms of the Company's Fourth Amended Joint Plan of Reorganization (the Plan of Reorganization ), as modified at the confirmation hearing by the United States Bankruptcy Court for the District of Delaware. In connection with its emergence, the Company changed its name to Kindred Healthcare, Inc.

*Impact of Recent Accounting Pronouncement*

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004) ( SFAS 123R ), Share-Based Payment, which requires companies to expense the fair value of employee stock options and other forms of stock-based compensation for interim periods that begin after June 15, 2005. This requirement represents a significant change because stock option awards have not been recognized as compensation expense in the Company's historical consolidated financial statements under Accounting Principles Board Opinion No. 25 ( APB 25 ), Accounting for Stock Issued to Employees. SFAS 123R requires the cost of an award, based upon fair value on the date of grant, to be recognized over the period during which an employee is required to provide service in exchange for the award (usually the vesting period). The fair value of the award on the date of grant will be estimated using option pricing models. In April 2005, the Securities and Exchange Commission (the SEC ) approved a new rule that delays the effective date of SFAS 123R for public companies until the first annual period, rather than the first interim period, that begins after June 15, 2005. The Company expects to adopt SFAS 123R on January 1, 2006 and recognize compensation expense prospectively for non-vested stock options outstanding at December 31, 2005 and for all future stock option grants.

*Stock Option Accounting*

As discussed above, the Company currently follows APB 25 and related interpretations in accounting for its employee stock options.

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 1 BASIS OF PRESENTATION (Continued)***Stock Option Accounting (Continued)*

Pro forma information regarding net income and earnings per share determined as if the Company had accounted for its employee stock options under the fair value method of SFAS 123 follows (in thousands, except per share amounts):

	<b>Three months ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Net income, as reported	\$ 36,890	\$ 13,840
Adjustments:		
Stock-based employee compensation expense included in reported net income	1,191	1,106
Stock-based employee compensation expense determined under fair value based method	(2,927)	(2,780)
<b>Pro forma net income</b>	<b>\$ 35,154</b>	<b>\$ 12,166</b>
<b>Earnings per common share:</b>		
As reported:		
Basic	\$ 1.02	\$ 0.39
Diluted	\$ 0.83	\$ 0.32
Pro forma:		
Basic	\$ 0.97	\$ 0.34
Diluted	\$ 0.77	\$ 0.28

*Comprehensive income*

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

	<b>Three months ended March 31,</b>	
	<b>2005</b>	<b>2004</b>

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Net income	\$ 36,890	\$ 13,840
Net unrealized investment gains (losses), net of income taxes	(462)	148
Comprehensive income	\$ 36,428	\$ 13,988

### *Other information*

The accompanying unaudited condensed consolidated financial statements 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, 2004 filed with the SEC on Form 10-K.

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.

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 1 BASIS OF PRESENTATION (Continued)***Reclassifications*

Certain prior period amounts have been reclassified to conform with the current period presentation. These changes did not have any impact on the Company's financial position, results of operations or cash flows.

**NOTE 2 DISCONTINUED OPERATIONS**

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the divestitures 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 losses related to these divestitures have been classified as discontinued operations, net of income taxes, in the accompanying unaudited condensed consolidated statement of operations. At March 31, 2005, the Company held for sale three hospitals and one nursing center.

Discontinued operations for the first quarter of 2005 included a favorable pretax adjustment of \$9.6 million (\$5.9 million net of income taxes) resulting from a change in estimate for professional liability reserves related to the Company's former nursing centers in Florida and Texas.

A summary of discontinued operations follows (in thousands):

	<b>Three months ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Revenues	\$ 6,519	\$ 29,525
Salaries, wages and benefits	4,465	20,045
Supplies	936	2,047
Rent	230	1,123
Other operating expenses (income)	(6,475)	10,432
Depreciation		485
Interest expense		2

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Investment income	(165)	(230)
	<u>(1,009)</u>	<u>33,904</u>
Income (loss) from operations before income taxes	7,528	(4,379)
Income tax provision (benefit)	2,898	(1,686)
Income (loss) from operations	<u>\$ 4,630</u>	<u>\$ (2,693)</u>

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## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 2 DISCONTINUED OPERATIONS (Continued)

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

	Three months ended March 31,	
	2005	2004
<b>Revenues:</b>		
Hospital division:		
Hospitals	\$ 5,641	\$ 7,531
Ancillary services	6	(91)
	<u>5,647</u>	<u>7,440</u>
Health services division	872	22,117
Pharmacy division		(32)
	<u>\$ 6,519</u>	<u>\$ 29,525</u>
<b>Operating income (loss):</b>		
Hospital division:		
Hospitals	\$ 12	\$ (1,767)
Ancillary services	6	(186)
	<u>18</u>	<u>(1,953)</u>
Health services division	7,567	(1,119)
Pharmacy division	8	73
	<u>\$ 7,593</u>	<u>\$ (2,999)</u>
<b>Rent:</b>		
Hospital division:		
Hospitals	\$ 50	\$ 413
Ancillary services		(5)
	<u>50</u>	<u>408</u>
Health services division	180	671



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Pharmacy division		44
	<u>          </u>	<u>          </u>
	\$ 230	\$ 1,123
	<u>          </u>	<u>          </u>
<b>Depreciation:</b>		
Hospital division:		
Hospitals	\$	\$ 207
Ancillary services		
	<u>          </u>	<u>          </u>
		207
Health services division		278
Pharmacy division		
	<u>          </u>	<u>          </u>
	\$	\$ 485
	<u>          </u>	<u>          </u>

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

	<b>March 31, 2005</b>	<b>December 31, 2004</b>
	<u>          </u>	<u>          </u>
Current assets:		
Property and equipment, net	\$ 15,706	\$ 18,793
Other	637	3,879
	<u>16,343</u>	<u>22,672</u>
Current liabilities (included in other accrued liabilities)	(286)	(1,245)
	<u>\$ 16,057</u>	<u>\$ 21,427</u>

**NOTE 3 REORGANIZATION ITEMS**

Transactions related to the Plan of Reorganization have been classified separately in the accompanying unaudited condensed consolidated statement of operations. Operating results for the first quarter of 2005 included income of \$1.4 million resulting from changes in estimates for accrued professional and administrative costs in connection with the completion of legal proceedings related to the Plan of Reorganization in March 2005.

**NOTE 4 PHARMACY ACQUISITIONS**

On March 2, 2005, the Company acquired the assets of Pharmacy Partners, Inc. ( PPI ), an operator of two institutional pharmacies in Pennsylvania (the PPI Acquisition ). The operating results of PPI have been included in the accompanying unaudited condensed consolidated financial statements of the Company since the date of acquisition. The transaction was financed through the use of existing cash. A preliminary summary of the PPI Acquisition follows (in thousands):

Fair value of assets acquired, including goodwill and other intangible assets	\$ 31,358
Fair value of liabilities assumed	(3,758)

Net cash paid

\$ 27,600

The purchase price of the assets acquired in the PPI Acquisition resulted from negotiations with PPI and its shareholders that were based upon both the historical and expected future cash flows of the enterprise. Goodwill recorded in connection with the PPI Acquisition aggregated \$10.2 million. The purchase price also included acquired identifiable intangible assets totaling \$11.3 million that will be amortized over approximately 12 years. Additional adjustments to the purchase price of up to \$1.4 million may occur through September 2006 as a result of contingent consideration in accordance with the acquisition agreement.

On April 1, 2005, the Company acquired the assets of Skilled Care Pharmacy (the SCP Acquisition), an operator of two institutional pharmacies in California. In connection with the acquisition, the Company funded an acquisition deposit of \$31.5 million for the SCP Acquisition on March 31, 2005. The deposit is included in other non-current assets in the accompanying unaudited condensed consolidated balance sheet at March 31, 2005.

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 5 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 and other third party payors.

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

	<b>Three months ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
Medicare	\$ 414,016	\$ 386,824
Medicaid	287,389	263,721
Private and other	318,586	261,247
	<u>1,019,991</u>	<u>911,792</u>
Eliminations:		
Rehabilitation	(49,545)	(36,023)
Pharmacy	(30,457)	(17,754)
	<u>(80,002)</u>	<u>(53,777)</u>
	<u>\$ 939,989</u>	<u>\$ 858,015</u>

The Company recorded income of approximately \$2.9 million in the first quarter of 2005 and \$2.2 million in the first quarter of 2004 related to settlements of prior year hospital Medicare cost reports.

**NOTE 6 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 for all periods includes the dilutive effect of warrants, employee stock options and non-vested restricted stock.



**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 6 EARNINGS PER SHARE (Continued)**

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

	<b>Three months ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>Earnings:</b>		
Income from continuing operations	\$ 32,260	\$ 16,533
Income (loss) from discontinued operations, net of income taxes	4,630	(2,693)
<b>Net income</b>	<b>\$ 36,890</b>	<b>\$ 13,840</b>
<b>Shares used in the computation:</b>		
Weighted average shares outstanding basic computation	36,312	35,414
<b>Dilutive effect of certain securities:</b>		
Warrants	6,550	5,672
Employee stock options	985	1,091
Non-vested restricted stock	563	544
<b>Adjusted weighted average shares outstanding diluted computation</b>	<b>44,410</b>	<b>42,721</b>
<b>Earnings per common share:</b>		
<b>Basic:</b>		
Income from continuing operations	\$ 0.89	\$ 0.47
Income (loss) from discontinued operations	0.13	(0.08)
<b>Net income</b>	<b>\$ 1.02</b>	<b>\$ 0.39</b>
<b>Diluted:</b>		
Income from continuing operations	\$ 0.73	\$ 0.38
Income (loss) from discontinued operations	0.10	(0.06)
<b>Net income</b>	<b>\$ 0.83</b>	<b>\$ 0.32</b>

**NOTE 7 BUSINESS SEGMENT DATA**

The Company operates four business segments: the hospital division, the health services division, the rehabilitation division and the pharmacy division. The hospital division operates long-term acute care hospitals. The health services division operates nursing centers. The rehabilitation division provides rehabilitation services primarily to nursing centers and long-term acute care hospitals. The pharmacy division provides pharmacy services to nursing centers and other healthcare providers. 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.

On July 1, 2004, the rehabilitation division and pharmacy division began providing services to the Company's hospital division. Internal personnel from the hospital division were transferred to the rehabilitation division and pharmacy division in conjunction with the realignment of these services (the Hospital Services Reorganization).

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 7 BUSINESS SEGMENT DATA (Continued)**

The Company identifies its segments in accordance with the aggregation provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. This information is consistent with information used by the Company in managing its businesses and aggregates businesses with similar economic characteristics. The information provided in Note 7 should be read in conjunction with the discussion and analysis contained in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

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

	<b>Three months ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>Revenues:</b>		
Hospital division	\$ 393,040	\$ 343,349
Health services division	454,047	435,998
Rehabilitation division	64,947	52,699
Pharmacy division	107,957	79,746
	<b>1,019,991</b>	<b>911,792</b>
Eliminations:		