

KINDRED HEALTHCARE, INC  
Form 10-Q  
May 09, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended March 31, 2007

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)

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

680 South Fourth Street  
Louisville, KY  
(Address of principal executive offices)

40202-2412  
(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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

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

| <b>Class of Common Stock</b>   | <b>Outstanding at April 30, 2007</b> |
|--------------------------------|--------------------------------------|
| Common stock, \$0.25 par value | 40,488,731 shares                    |

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

|   | <b>Three months ended<br/>March 31,</b> |              |
|---|---|--------------|
|   | <b>2007</b>                             | <b>2006</b>  |
| Revenues  | \$ 1,144,180                            | \$ 1,030,730 |
| Salaries, wages and benefits                          | 625,417                                 | 562,461      |
| Supplies  | 184,013                                 | 163,583      |
| Rent  | 87,297                                  | 69,293       |
| Other operating expenses                              | 190,885                                 | 170,910      |
| Depreciation and amortization                         | 29,421                                  | 27,846       |
| Interest expense                                      | 3,595                                   | 2,649        |
| Investment income                                     | (3,833)                                 | (3,691)      |
|   | 1,116,795                               | 993,051      |
| Income from continuing operations before income taxes | 27,385                                  | 37,679       |
| Provision for income taxes                            | 11,688                                  | 15,743       |
| Income from continuing operations                     | 15,697                                  | 21,936       |
| Discontinued operations, net of income taxes:         |   |              |
| Income (loss) from operations                         | (598)                                   | 1,866        |
| Gain (loss) on divestiture of operations              | (7,266)                                 | 157          |
| Net income  | \$ 7,833                                | \$ 23,959    |
| Earnings per common share:                            |   |              |
| Basic:  |   |              |
| Income from continuing operations                     | \$ 0.40                                 | \$ 0.60      |
| Discontinued operations:                              |   |              |
| Income (loss) from operations                         | (0.01)                                  | 0.05         |
| Gain (loss) on divestiture of operations              | (0.19)                                  |              |
| Net income  | \$ 0.20                                 | \$ 0.65      |
| Diluted:  |   |              |
| Income from continuing operations                     | \$ 0.39                                 | \$ 0.53      |
| Discontinued operations:                              |   |              |
| Income (loss) from operations                         | (0.01)                                  | 0.05         |
| Gain (loss) on divestiture of operations              | (0.18)                                  |              |
| Net income  | \$ 0.20                                 | \$ 0.58      |
| Shares used in computing earnings per common share:   |   |              |
| Basic   | 39,212                                  | 36,576       |
| Diluted   | 39,997                                  | 41,091       |

See accompanying notes.

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

|   | <b>March 31,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|---|---------------------------|------------------------------|
| <b>ASSETS</b>   |                           |                              |
| Current assets:   |                           |                              |
| Cash and cash equivalents   | \$ 19,763                 | \$ 20,857                    |
| Cash restricted   | 5,414                     | 5,757                        |
| Insurance subsidiary investments  | 214,114                   | 227,865                      |
| Accounts receivable less allowance for loss of \$53,645 March 31, 2007 and \$62,064 December 31, 2006   | 628,705                   | 588,166                      |
| Inventories   | 49,500                    | 49,533                       |
| Deferred tax assets   | 62,791                    | 62,512                       |
| Assets held for sale  | 3,205                     | 9,113                        |
| Income taxes  | 13,191                    | 10,652                       |
| Other   | 33,235                    | 28,106                       |
|   | 1,029,918                 | 1,002,561                    |
| Property and equipment  | 1,015,951                 | 1,027,112                    |
| Accumulated depreciation  | (495,136)                 | (475,882)                    |
|   | 520,815                   | 551,230                      |
| Goodwill  | 107,368                   | 107,852                      |
| Intangible assets less accumulated amortization of \$8,511 March 31, 2007 and \$6,925 December 31, 2006 | 115,759                   | 117,345                      |
| Insurance subsidiary investments  | 41,372                    | 52,977                       |
| Deferred tax assets   | 99,831                    | 96,252                       |
| Other   | 95,902                    | 87,910                       |
|   | \$ 2,010,965              | \$ 2,016,127                 |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                           |                              |
| Current liabilities:  |                           |                              |
| Accounts payable  | \$ 134,795                | \$ 158,085                   |
| Salaries, wages and other compensation  | 274,152                   | 280,039                      |
| Due to third party payors   | 25,602                    | 27,784                       |
| Professional liability risks  | 62,895                    | 65,497                       |
| Other accrued liabilities   | 75,475                    | 75,522                       |
| Long-term debt due within one year  | 73                        | 71                           |
|   | 572,992                   | 606,998                      |
| Long-term debt  | 113,471                   | 130,090                      |
| Professional liability risks  | 195,719                   | 184,749                      |
| Deferred credits and other liabilities  | 121,275                   | 98,712                       |
| Commitments and contingencies   |                           |                              |
| Stockholders equity:  | 10,008                    | 9,994                        |

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Common stock, \$0.25 par value; authorized 175,000 shares; issued 40,033 shares March 31, 2007 and  
39,978 shares December 31, 2006

|  |              |              |
|--|--------------|--------------|
| Capital in excess of par value         | 797,360      | 793,054      |
| Accumulated other comprehensive income | 1,335        | 1,246        |
| Retained earnings                      | 198,805      | 191,284      |
|  | 1,007,508    | 995,578      |
|  | \$ 2,010,965 | \$ 2,016,127 |

See accompanying notes.

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

|   | <b>Three months ended<br/>March 31,</b> |                  |
|---|---|------------------|
|   | <b>2007</b>                             | <b>2006</b>      |
| <b>Cash flows from operating activities:</b>  |   |                  |
| Net income  | \$ 7,833                                | \$ 23,959        |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |   |                  |
| Depreciation and amortization   | 29,421                                  | 28,454           |
| Amortization of stock-based compensation costs  | 3,580                                   | 4,694            |
| Provision for doubtful accounts   | 7,195                                   | 8,717            |
| Deferred income taxes   | (5,431)                                 |                  |
| Loss (gain) on divestiture of discontinued operations                                       | 7,266                                   | (157)            |
| Other   | (652)                                   | (1,604)          |
| Change in operating assets and liabilities:   |   |                  |
| Accounts receivable   | (47,192)                                | (93,678)         |
| Inventories and other assets  | (5,718)                                 | (18,977)         |
| Accounts payable  | (11,091)                                | 3,649            |
| Income taxes  | 16,187                                  | 16,294           |
| Due to third party payors   | (2,182)                                 | (3,683)          |
| Other accrued liabilities   | 8,042                                   | 7,962            |
| <b>Net cash provided by (used in) operating activities</b>                                  | <b>7,258</b>                            | <b>(24,370)</b>  |
| <b>Cash flows from investing activities:</b>  |   |                  |
| Purchase of property and equipment  | (34,022)                                | (25,295)         |
| Acquisitions  | (39,642)                                | (123,073)        |
| Sale of assets  | 77,166                                  | 10,305           |
| Purchase of insurance subsidiary investments  | (50,678)                                | (40,731)         |
| Sale of insurance subsidiary investments  | 51,487                                  | 58,560           |
| Net change in insurance subsidiary cash and cash equivalents                                | 24,993                                  | (8,152)          |
| Other   | (7,114)                                 | 2,292            |
| <b>Net cash provided by (used in) investing activities</b>                                  | <b>22,190</b>                           | <b>(126,094)</b> |
| <b>Cash flows from financing activities:</b>  |   |                  |
| Proceeds from borrowings under revolving credit   | 436,800                                 | 246,500          |
| Repayment of borrowings under revolving credit  | (453,400)                               | (134,800)        |
| Repayment of long-term debt   | (17)                                    | (1,440)          |
| Payment of deferred financing costs   | (71)                                    | (486)            |
| Issuance of common stock  | 870                                     | 290              |
| Other   | (14,724)                                | (19,008)         |
| <b>Net cash provided by (used in) financing activities</b>                                  | <b>(30,542)</b>                         | <b>91,056</b>    |
| <b>Change in cash and cash equivalents</b>  | <b>(1,094)</b>                          | <b>(59,408)</b>  |
| Cash and cash equivalents at beginning of period  | 20,857                                  | 83,420           |



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|  |           |           |
|--|-----------|-----------|
| Cash and cash equivalents at end of period | \$ 19,763 | \$ 24,012 |
|--|-----------|-----------|

Supplemental information:

|                     |          |          |
|---------------------|----------|----------|
| Interest payments   | \$ 3,940 | \$ 2,077 |
| Income tax payments | 258      | 617      |

See accompanying notes.

**Table of Contents****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 hospitals, nursing centers, a contract rehabilitation services business and institutional pharmacies across the United States (collectively, the Company). At March 31, 2007, the Company's hospital division operated 82 long-term acute care (LTAC) hospitals in 24 states. The Company's health services division operated 249 nursing centers in 28 states. The Company operated a contract rehabilitation services business which provides rehabilitative services primarily in long-term care settings. The Company's pharmacy division operated an institutional pharmacy business with 44 pharmacies in 25 states and a pharmacy management business servicing substantially all of the Company's hospitals.

In recent years, the Company has completed several transactions related to the divestiture of unprofitable hospitals, nursing centers and other healthcare businesses to improve its future operating results. For accounting purposes, the operating results of these businesses and the gains or 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, 2007 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 3 for a summary of discontinued operations.

*Impact of recent accounting pronouncement*

In September 2006, the Financial Accounting Standards Board (the FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157 (SFAS 157), 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. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The adoption of SFAS 157 is not expected to have a material impact on the Company's financial position, results of operations or liquidity.

*Comprehensive income*

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

|   | <b>Three months ended</b> |                  |
|---|---------------------------|------------------|
|   | <b>March 31,</b>          |                  |
|   | <b>2007</b>               | <b>2006</b>      |
| Net income  | \$ 7,833                  | \$ 23,959        |
| Net unrealized investment gains (losses), net of income taxes | 89                        | (5)              |
| <b>Comprehensive income</b>                                   | <b>\$ 7,922</b>           | <b>\$ 23,954</b> |

*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, 2006 filed with the Securities and Exchange Commission (the SEC) on Form 10-K. The accompanying condensed consolidated balance sheet



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**KINDRED HEALTHCARE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**NOTE 1 BASIS OF PRESENTATION (Continued)**

*Other information (Continued)*

at December 31, 2006 was derived from audited 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.

*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 liquidity.

**NOTE 2 PROPOSED SPIN-OFF TRANSACTION**

In October 2006, the Company signed a definitive agreement with AmerisourceBergen Corporation ( AmerisourceBergen ) to combine their respective institutional pharmacy businesses, Kindred Pharmacy Services ( KPS ) and PharMerica Long-Term Care ( PharMerica LTC ), into a new, independent, publicly traded company. The proposed transaction (the Proposed Pharmacy Transaction ) is intended to be tax-free to the Company and to the shareholders of both AmerisourceBergen and the Company. The Proposed Pharmacy Transaction is expected to be completed in the second quarter of 2007.

Under the terms of the Proposed Pharmacy Transaction, both KPS and PharMerica LTC are expected to each borrow up to \$125 million and use such proceeds to fund a one-time cash distribution, intended to be tax-free, to their respective parent companies. Following the cash distribution, each institutional pharmacy business is expected to be spun off to the shareholders of their respective parent companies. Immediately thereafter, a stock-for-stock merger will be effected that would result in the Company and AmerisourceBergen shareholders each owning 50% of the new publicly traded company. The Proposed Pharmacy Transaction is subject to certain conditions, including the completion of the registration statement that has been filed with the SEC. The closing of the Proposed Pharmacy Transaction also will require the receipt of required regulatory approvals and the satisfaction of certain other conditions.

**NOTE 3 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 gains or 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, 2007, the Company held one nursing center for sale.

*Nursing center dispositions*

On January 31, 2007, the Company acquired from Health Care Property Investors, Inc. ( HCP ) the real estate related to 11 unprofitable leased nursing centers operated by the Company for resale in exchange for the real estate related to three hospitals previously owned by the Company (the HCP Transaction ). As part of the HCP Transaction, the Company will continue to operate the hospitals under a long-term lease arrangement with HCP. In addition, the Company paid HCP a one-time cash payment of approximately \$36 million. The Company



**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 3 DISCONTINUED OPERATIONS (Continued)***Nursing center dispositions (Continued)*

also amended its existing master lease with HCP to (1) terminate the current annual rent of approximately \$9.9 million on the 11 nursing centers, (2) add the three hospitals to the master lease with a current annual rent of approximately \$6.3 million and (3) extend the initial expiration date of the master lease until January 31, 2017 except for one hospital which has an expiration date of January 31, 2022.

During the first quarter of 2007, the Company sold ten of the nursing centers and received proceeds of approximately \$75 million. On April 30, 2007, the Company sold the remaining nursing center for approximately \$3 million. The Company recorded a pretax loss related to these divestitures of \$12.7 million (\$7.8 million net of income taxes) in the first quarter of 2007.

*Discontinued operations summary*

Discontinued operations for the first quarter of 2006 included a favorable pretax adjustment of \$7.0 million (\$4.3 million net of income taxes) resulting from a change in estimate for professional liability reserves related primarily to the Company's former nursing centers in Florida and Texas.

A summary of discontinued operations follows (in thousands):

|   | <b>Three months ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2007</b>                             | <b>2006</b> |
| Revenues  | \$ 9,000                                | \$ 23,589   |
| Salaries, wages and benefits                                  | 5,102                                   | 13,173      |
| Supplies  | 550                                     | 1,865       |
| Rent  | 841                                     | 2,543       |
| Other operating expenses                                      | 3,479                                   | 2,368       |
| Depreciation  |   | 608         |
| Interest expense  | 1                                       |             |
| Investment income   | (1)                                     | (2)         |
|   | 9,972                                   | 20,555      |
| Income (loss) from operations before income taxes             | (972)                                   | 3,034       |
| Income tax provision (benefit)                                | (374)                                   | 1,168       |
| Income (loss) from operations                                 | (598)                                   | 1,866       |
| Gain (loss) on divestiture of operations, net of income taxes | (7,266)                                 | 157         |
|   | \$ (7,864)                              | \$ 2,023    |



**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 3 DISCONTINUED OPERATIONS (Continued)***Discontinued operations summary (Continued)*

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

|                                 | <b>Three months ended<br/>March 31,</b> |             |
|---------------------------------|---|-------------|
|                                 | <b>2007</b>                             | <b>2006</b> |
| <b>Revenues:</b>                |   |             |
| Hospital division:              |   |             |
| Hospitals                       | \$ 25                                   | \$ 2,076    |
| Ancillary services              |   | 1           |
|                                 | 25                                      | 2,077       |
| Health services division        | 8,975                                   | 21,512      |
|                                 | \$ 9,000                                | \$ 23,589   |
| <b>Operating income (loss):</b> |   |             |
| Hospital division:              |   |             |
| Hospitals                       | \$ 225                                  | \$ (310)    |
| Ancillary services              |   |             |
|                                 | 225                                     | (310)       |
| Health services division        | (356)                                   | 6,493       |
|                                 | \$ (131)                                | \$ 6,183    |
| <b>Rent:</b>                    |   |             |
| Hospital division:              |   |             |
| Hospitals                       | \$                                      | \$ 37       |
| Ancillary services              |   |             |
|                                 |   | 37          |
| Health services division        | 841                                     | 2,506       |
|                                 | \$ 841                                  | \$ 2,543    |
| <b>Depreciation:</b>            |   |             |
| Hospital division:              |   |             |
| Hospitals                       | \$                                      | \$          |
| Ancillary services              |   |             |



|                          |        |
|--------------------------|--------|
| Health services division | 608    |
|                          | \$     |
|                          | \$ 608 |

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 3 DISCONTINUED OPERATIONS (Continued)***Discontinued operations summary (Continued)*

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

|   | March 31,<br>2007 | December 31,<br>2006 |
|---|-------------------|----------------------|
| Current assets:   |                   |                      |
| Property and equipment, net                                 | \$ 3,186          | \$ 8,802             |
| Other   | 19                | 311                  |
|   | 3,205             | 9,113                |
| Current liabilities (included in other accrued liabilities) | (119)             | (1,376)              |
|   | \$ 3,086          | \$ 7,737             |

**NOTE 4 SIGNIFICANT QUARTERLY ADJUSTMENTS**

Operating results for the first quarter of 2007 included a pretax charge of \$4.1 million for professional fees and other costs incurred in connection with the Proposed Pharmacy Transaction.

Operating results for the first quarter of 2006 included pretax income of \$1.9 million related to the favorable settlement of prior year hospital Medicare cost reports, a \$1.3 million pretax gain from an institutional pharmacy joint venture transaction, a pretax charge of \$2.7 million related primarily to revisions to prior estimates for accrued contract labor costs in the Company's rehabilitation division, and a pretax charge of \$1.3 million for investment banking services and costs related to the rent reset issue with Ventas, Inc. ( Ventas ), the Company's primary landlord.

**NOTE 5 ACQUISITIONS***Commonwealth transaction*

In February 2006, the Company acquired the operations of the LTAC hospitals, skilled nursing facilities and assisted living facilities operated by Commonwealth Communities Holdings LLC and certain of its affiliates (the Commonwealth Transaction). The Commonwealth Transaction was financed primarily through the use of the Company's revolving credit facility. Goodwill recorded in connection with the Commonwealth Transaction aggregated \$31.7 million. The purchase price also included identifiable intangible assets of \$75.9 million related to the value of acquired certificates of need with indefinite lives and other intangible assets of \$5.2 million which will be amortized over approximately three years. Additional adjustments to the purchase price of approximately \$7 million may occur through February 2008 as a result of contingent consideration in accordance with the acquisition agreement.

A summary of the Commonwealth Transaction follows (in thousands):

|   |            |
|---|------------|
| Fair value of assets acquired, including goodwill and other intangible assets | \$ 130,746 |
|---|------------|

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|   |            |
|---|------------|
| Fair value of liabilities assumed       | (7,675)    |
| Net cash paid through March 31, 2006    | 123,071    |
| Additional payment of transaction costs | 631        |
| Net cash paid through March 31, 2007    | \$ 123,702 |

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 5 ACQUISITIONS (Continued)***Commonwealth transaction (Continued)*

The pro forma effect of the Commonwealth Transaction assuming the transaction occurred on January 1, 2006 follows (in thousands, except per share amounts):

|                                   | <b>Three months ended</b> |           |
|-----------------------------------|---------------------------|-----------|
|                                   | <b>March 31, 2006</b>     |           |
| Revenues                          | \$                        | 1,070,521 |
| Income from continuing operations |                           | 21,962    |
| Net income                        |                           | 23,985    |
| Earnings per common share:        |                           |           |
| Basic:                            |                           |           |
| Income from continuing operations | \$                        | 0.60      |
| Net income                        | \$                        | 0.65      |
| Diluted:                          |                           |           |
| Income from continuing operations | \$                        | 0.53      |
| Net income                        | \$                        | 0.58      |

Pro forma financial data has been derived by combining the historical financial results of the Company and the operations acquired in the Commonwealth Transaction for the period presented.

**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 and other third party payors.

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

|                   | <b>Three months ended</b> |             |
|-------------------|---------------------------|-------------|
|                   | <b>March 31,</b>          |             |
|                   | <b>2007</b>               | <b>2006</b> |
| Medicare          | \$ 537,063                | \$ 497,129  |
| Medicaid          | 292,911                   | 259,281     |
| Private and other | 413,761                   | 362,818     |
|                   | 1,243,735                 | 1,119,228   |
| Eliminations:     |                           |             |
| Rehabilitation    | (61,670)                  | (53,975)    |
| Pharmacy          | (37,885)                  | (34,523)    |
|                   | (99,555)                  | (88,498)    |

\$ 1,144,180    \$ 1,030,730

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****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 warrants, stock options and non-vested restricted stock.

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

|   | <b>Three months ended<br/>March 31,</b> |                  |
|---|---|------------------|
|   | <b>2007</b>                             | <b>2006</b>      |
| <b>Earnings:</b>  |   |                  |
| Income from continuing operations   | \$ 15,697                               | \$ 21,936        |
| <b>Discontinued operations, net of income taxes:</b>                      |   |                  |
| Income (loss) from operations   | (598)                                   | 1,866            |
| Gain (loss) on divestiture of operations                                  | (7,266)                                 | 157              |
| <b>Net income</b>   | <b>\$ 7,833</b>                         | <b>\$ 23,959</b> |
| <b>Shares used in the computation:</b>                                    |   |                  |
| Weighted average shares outstanding - basic computation                   | 39,212                                  | 36,576           |
| <b>Dilutive effect of certain securities:</b>                             |   |                  |
| Warrants  |   | 3,995            |
| Employee stock options  | 576                                     | 386              |
| Non-vested restricted stock   | 209                                     | 134              |
| <b>Adjusted weighted average shares outstanding - diluted computation</b> | <b>39,997</b>                           | <b>41,091</b>    |
| <b>Earnings per common share:</b>   |   |                  |
| <b>Basic:</b>   |   |                  |
| Income from continuing operations   | \$ 0.40                                 | \$ 0.60          |
| <b>Discontinued operations:</b>   |   |                  |
| Income (loss) from operations   | (0.01)                                  | 0.05             |
| Gain (loss) on divestiture of operations                                  | (0.19)                                  |                  |
| <b>Net income</b>   | <b>\$ 0.20</b>                          | <b>\$ 0.65</b>   |
| <b>Diluted:</b>   |   |                  |
| Income from continuing operations   | \$ 0.39                                 | \$ 0.53          |
| <b>Discontinued operations:</b>   |   |                  |
| Income (loss) from operations   | (0.01)                                  | 0.05             |
| Gain (loss) on divestiture of operations                                  | (0.18)                                  |                  |
| <b>Net income</b>   | <b>\$ 0.20</b>                          | <b>\$ 0.58</b>   |

**NOTE 8 BUSINESS SEGMENT DATA**

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The Company operates four business segments: the hospital division, the health services division, the rehabilitation division and the pharmacy division. The hospital division operates LTAC hospitals and the health services division operates nursing centers. The rehabilitation division provides rehabilitation services in long-term care settings and 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.

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 8 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 following table sets forth certain data by business segment (in thousands):

|   | Three months ended<br>March 31, |              |
|---|---------------------------------|--------------|
|   | 2007                            | 2006         |
| <b>Revenues:</b>                                      |                                 |              |
| Hospital division                                     | \$ 463,812                      | \$ 430,814   |
| Health services division                              | 521,463                         | 460,038      |
| Rehabilitation division                               | 83,756                          | 71,162       |
| Pharmacy division                                     | 174,704                         | 157,214      |
|   | 1,243,735                       | 1,119,228    |
| <b>Eliminations:</b>                                  |                                 |              |
| Rehabilitation  | (61,670)                        | (53,975)     |
| Pharmacy  | (37,885)                        | (34,523)     |
|   | (99,555)                        | (88,498)     |
|   | \$ 1,144,180                    | \$ 1,030,730 |
| <b>Income from continuing operations:</b>             |                                 |              |
| Operating income (loss):                              |                                 |              |
| Hospital division                                     | \$ 100,505                      | \$ 104,064   |
| Health services division                              | 63,409                          | 47,925       |
| Rehabilitation division                               | 10,044                          | 4,239        |
| Pharmacy division                                     | 9,243                           | 16,729       |
| Corporate:  |                                 |              |
| Overhead  | (37,794)                        | (37,334)     |
| Insurance subsidiary                                  | (1,542)                         | (1,847)      |
|   | (39,336)                        | (39,181)     |
| Operating income                                      | 143,865                         | 133,776      |
| Rent  | (87,297)                        | (69,293)     |
| Depreciation and amortization                         | (29,421)                        | (27,846)     |
| Interest, net   | 238                             | 1,042        |
| Income from continuing operations before income taxes | 27,385                          | 37,679       |
| Provision for income taxes                            | 11,688                          | 15,743       |



\$ 15,697      \$ 21,936

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 8 BUSINESS SEGMENT DATA (Continued)**

|  | Three months ended<br>March 31, |              |
|--|---------------------------------|--------------|
|  | 2007                            | 2006         |
| <b>Rent:</b>   |                                 |              |
| Hospital division  | \$ 34,909                       | \$ 26,619    |
| Health services division   | 49,603                          | 40,447       |
| Rehabilitation division  | 1,069                           | 869          |
| Pharmacy division  | 1,642                           | 1,280        |
| Corporate  | 74                              | 78           |
|  | \$ 87,297                       | \$ 69,293    |
| <b>Depreciation and amortization:</b>  |                                 |              |
| Hospital division  | \$ 9,182                        | \$ 11,107    |
| Health services division   | 12,101                          | 9,287        |
| Rehabilitation division  | 236                             | 80           |
| Pharmacy division  | 2,816                           | 1,797        |
| Corporate  | 5,086                           | 5,575        |
|  | \$ 29,421                       | \$ 27,846    |
| <b>Capital expenditures, excluding acquisitions (including discontinued operations):</b> |                                 |              |
| Hospital division  | \$ 20,765                       | \$ 15,365    |
| Health services division   | 6,696                           | 5,225        |
| Rehabilitation division  | 118                             | 19           |
| Pharmacy division  | 1,712                           | 2,057        |
| Corporate:   |                                 |              |
| Information systems  | 4,457                           | 2,514        |
| Other  | 274                             | 115          |
|  | \$ 34,022                       | \$ 25,295    |
|  | March 31,                       | December 31, |
|  | 2007                            | 2006         |
| <b>Assets at end of period:</b>  |                                 |              |
| Hospital division  | \$ 756,264                      | \$ 762,943   |
| Health services division   | 442,952                         | 427,376      |
| Rehabilitation division  | 12,870                          | 10,621       |
| Pharmacy division  | 227,966                         | 225,684      |
| Corporate  | 570,913                         | 589,503      |
|  | \$ 2,010,965                    | \$ 2,016,127 |

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|                   |            |            |
|-------------------|------------|------------|
| Hospital division | \$ 61,549  | \$ 62,613  |
| Pharmacy division | 45,819     | 45,239     |
|                   | \$ 107,368 | \$ 107,852 |

**Table of Contents****KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 9 INSURANCE RISKS**

The Company insures a substantial portion of its professional liability risks and workers compensation risks through a wholly owned limited purpose insurance subsidiary. Provisions for loss for these risks are based upon independent 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 subsequent 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):

|                         | <b>Three months ended<br/>March 31,</b> |             |
|-------------------------|---|-------------|
|                         | <b>2007</b>                             | <b>2006</b> |
| Professional liability: |   |             |
| Continuing operations   | \$ 19,863                               | \$ 20,069   |
| Discontinued operations | 859                                     | (4,499)     |
| Workers compensation:   |   |             |
| Continuing operations   | \$ 11,977                               | \$ 12,562   |
| Discontinued operations | 40                                      | 476         |

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

|                                  | <b>March 31, 2007</b>             |                                 |              | <b>December 31, 2006</b>          |                                 |              |
|----------------------------------|-----------------------------------|---------------------------------|--------------|-----------------------------------|---------------------------------|--------------|
|                                  | <b>Professional<br/>liability</b> | <b>Workers<br/>compensation</b> | <b>Total</b> | <b>Professional<br/>liability</b> | <b>Workers<br/>compensation</b> | <b>Total</b> |
| <b>Assets:</b>                   |                                   |                                 |              |                                   |                                 |              |
| Current:                         |                                   |                                 |              |                                   |                                 |              |
| Insurance subsidiary investments | \$ 141,611                        | \$ 72,503                       | \$ 214,114   | \$ 158,245                        | \$ 69,620                       | \$ 227,865   |
| Reinsurance recoverables         | 211                               |                                 | 211          | 2,291                             |                                 | 2,291        |
|                                  | 141,822                           | 72,503                          | 214,325      | 160,536                           | 69,620                          | 230,156      |
| Non-current:                     |                                   |                                 |              |                                   |                                 |              |
| Insurance subsidiary investments | 41,372                            |                                 | 41,372       | 52,977                            |                                 | 52,977       |
| Reinsurance recoverables         | 9,188                             |                                 | 9,188        | 8,565                             |                                 | 8,565        |
| Deposits                         | 6,250                             | 1,510                           | 7,760        | 7,250                             | 1,507                           | 8,757        |
| Other                            |                                   | 274                             | 274          |                                   | 275                             | 275          |
|                                  | 56,810                            | 1,784                           | 58,594       | 68,792                            | 1,782                           | 70,574       |
|                                  | \$ 198,632                        | \$ 74,287                       | \$ 272,919   | \$ 229,328                        | \$ 71,402                       | \$ 300,730   |

**Liabilities:**

Allowance for insurance risks:

|             |            |           |            |            |           |            |
|-------------|------------|-----------|------------|------------|-----------|------------|
| Current     | \$ 62,895  | \$ 26,727 | \$ 89,622  | \$ 65,497  | \$ 27,920 | \$ 93,417  |
| Non-current | 195,719    | 61,263    | 256,982    | 184,749    | 56,971    | 241,720    |
|             | \$ 258,614 | \$ 87,990 | \$ 346,604 | \$ 250,246 | \$ 84,891 | \$ 335,137 |

**Table of Contents**

**KINDRED HEALTHCARE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**NOTE 9 INSURANCE RISKS (Continued)**

Provisions for loss for professional liability risks retained by the limited purpose insurance subsidiary have been discounted based upon independent actuarial estimates of claim payment patterns using a discount rate of 5% in each period presented. 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 \$271.4 million at March 31, 2007 and \$262.9 million at December 31, 2006.

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

**NOTE 10 INCOME TAXES**

In July 2006, the FASB issued FASB Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes. The interpretation clarifies the accounting for uncertain income tax issues recognized in an entity's financial statements in accordance with FASB Statement No. 109,

Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return.

The Company adopted the provisions of FIN 48 on January 1, 2007. As of the date of adoption, the Company's unrecognized income tax benefits were \$7.4 million (\$4.9 million after deduction of state income tax benefits on federal income tax return). The Company records accrued interest and penalties associated with uncertain tax positions as income tax expense in the consolidated statement of operations. As of January 1, 2007, the Company recorded \$2.1 million (\$1.4 million after income tax impact) of accrued interest related to uncertain tax positions. To the extent the unrecognized income tax benefits become realized or the related accrued interest is no longer necessary, the Company's provision for income taxes would be favorably impacted.

The federal statute of limitations remains open for tax years 2000 through 2006. In 2006, the Company reached a settlement with the Internal Revenue Service (the IRS), pending final documentation, related to all disputed federal income tax issues for tax years 2000 and 2001. The IRS is currently examining tax years 2002 through 2005.

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

Within the next 12 months, the statutes of limitations associated with certain state income tax filing positions will expire and may decrease the amount of unrecognized income tax benefits. A reduction of the liability of up to approximately \$2.9 million (\$1.9 million after deduction of state income tax benefits on federal income tax return) for unrecognized income tax benefits and up to \$1.1 million (\$0.7 million after income tax impact) of accrued interest is reasonably possible and may favorably impact the Company's financial position and results of operations.

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**KINDRED HEALTHCARE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**NOTE 11 CONTINGENCIES**

Management continually evaluates contingencies based upon the best available evidence. In addition, allowances for loss are provided currently for disputed items that have continuing significance, such as certain third party reimbursements and deductions that continue to be claims 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 programs. The Company is contesting certain issues raised in audits of prior year cost reports.

*Professional liability risks* The Company has provided for loss for professional liability risks based upon actuarially determined estimates. Ultimate claims costs may differ from the provisions for loss. See Notes 3 and 9.

*Income taxes* The Company is subject to various income tax audits at the federal and state levels in the ordinary course of business. These audits could result in increased tax payments, interest and penalties. See Note 10.

*Litigation* The Company is a party to various legal actions (some of which are not insured), and regulatory and other government investigations and sanctions arising in the ordinary course of its business. The Company is unable to predict the ultimate outcome of pending litigation and regulatory and other government investigations. The U.S. Department of Justice (the DOJ), the Centers for Medicare and Medicaid Services (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 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 against 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 would be initiated by a breach of the terms of the contract or by a third party claim or event.

**NOTE 12 SUBSEQUENT EVENTS**

***Agreements with Ventas***

On April 27, 2007, the Company entered into agreements with Ventas in which the Company will purchase for resale 22 under-performing facilities (the Facility Acquisitions) currently leased from Ventas. In connection with these agreements, the Company renewed the leases for all of the remaining facilities that were scheduled to expire in April 2008. In addition, the Company and Ventas amended and restated the master lease agreements (the Amended Master Leases) to reflect several amendments. Ventas also has agreed that it will not contest the Proposed Pharmacy Transaction. The Facility Acquisitions are expected to close by June 30, 2007.

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**KINDRED HEALTHCARE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**NOTE 12 SUBSEQUENT EVENTS (Continued)**

***Agreements with Ventas (Continued)***

*Facility acquisitions*

The Company will acquire 21 nursing centers and one LTAC hospital (collectively, the Facilities ) for \$171.5 million. In addition, the Company will pay Ventas a lease termination fee of \$3.5 million. The current aggregate annual rents for the Facilities are approximately \$10.3 million.

The Facilities, which contain 2,634 licensed nursing center beds and 220 licensed hospital beds, generated pretax losses of approximately \$10 million for the year ended December 31, 2006. Upon closing, the Company will account for the operations of the Facilities as discontinued operations.

The Company intends to complete the divestiture of all of the Facilities by December 31, 2007. The Company expects to generate between \$80 million and \$90 million in proceeds from the sale of the Facilities and the related operations. The Company expects to record a net loss of approximately \$60 million to \$70 million in the second quarter of 2007 relating to these divestitures.

The Facility Acquisitions are subject to certain approvals and other customary conditions to closing.

*Renewal of Leases Scheduled to Expire in 2008*

The Company renewed the leases for an additional five years for 49 nursing centers (approximately 5,844 licensed beds) and eight LTAC hospitals (approximately 635 licensed beds) (collectively, the Renewal Facilities ). The initial lease term for the Renewal Facilities was scheduled to expire in April 2008. The existing rent payments and the annual escalators are not effected by the renewals.

*Amended Master Leases*

In connection with the Facility Acquisitions, the Company and Ventas entered into the Amended Master Leases, which became effective immediately. The Amended Master Leases include, among other things, the following amendments:

The Company has an ongoing right to de-license 35% of the hospital beds in any hospital and 10% of the hospital beds in any Amended Master Lease for the development of sub-acute units.

The Company is permitted to de-license 912 beds in 70 nursing centers, which will allow the Company to reduce multiple bed wards and enhance the quality of life for its residents and improve the marketability of these facilities to Medicare, managed care and private pay patients and residents.

Insurance provisions have been modified (1) to expand the number of third-party insurers that are permitted to insure the Company's professional liability exposure and (2) to provide a one-time right for the Company to commute certain insurance policies that may result in the refund of insurance premiums for prior years.

Two lease renewal bundles contained in the Amended Master Lease No. 3 have been combined.

Ventas has enhanced reporting and inspection rights.

***Credit Facility Consents***

In connection with the Ventas agreements, the Company entered into a consent and waiver pursuant to its revolving credit facility to, among other things, permit the Amended Master Leases and waive compliance with certain requirements and restrictions otherwise applicable to the Facility Acquisitions.





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**KINDRED HEALTHCARE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**NOTE 12 SUBSEQUENT EVENTS (Continued)**

***Medicare LTAC Payment Rule***

On May 1, 2007, CMS issued regulatory changes regarding Medicare reimbursement for LTAC hospitals (the Final Rule ). The changes finalized a regulation originally proposed on January 25, 2007 and will become effective for discharges occurring on or after July 1, 2007. The Final Rule projects an overall decrease in payments to all Medicare certified LTAC hospitals of approximately 3.8%. Included in the Final Rule are (1) an increase to the standard federal payment rate of 0.71%; (2) revisions to payment methodologies impacting short stay outliers, which reduce payments by 0.9%; (3) adjustments to the wage index component of the federal payment resulting in projected reductions in payments of 1.0%; (4) an increase in the high cost outlier threshold per discharge to \$22,954, resulting in projected reductions of 2.5%; and (5) an extension of the policy known as the 25 Percent Rule to all LTAC hospitals, with a three-year phase-in, which CMS projects will not result in payment reductions for the first year of implementation. The Final Rule also states that the annual update to the long-term care diagnostic related groups ( LTC DRG ) classifications and relative weights will be made in a budget neutral manner, effective October 1, 2007. Accordingly, the estimated aggregate payments under the Medicare prospective payment system for LTAC hospitals ( LTAC PPS ) would be unaffected by the annual recalibration of LTC DRG payment weights.

The Company estimates that the Final Rule will result in a 2.5% reduction in payments to the Company s LTAC hospitals. For the second half of 2007, the Company believes that the Final Rule could reduce its hospital Medicare payments by approximately \$25 million.

The Final Rule expands the so-called 25 Percent Rule to all LTAC hospitals, regardless of whether they are co-located within another hospital. Under the Final Rule, all LTAC hospitals will be paid LTAC PPS rates for admissions from a single referral source up to 25% of aggregate Medicare admissions. Admissions beyond the 25% threshold would be paid at a lower amount based upon short-term acute care hospital rates.

Under the Final Rule, the 25% threshold would be phased in over three years. Hospitals having fiscal years beginning on or after July 1, 2007 and before October 1, 2007, including most of the Company s hospitals, will have their admission cap initially established at the lesser of 75% of Medicare referrals or the actual percentage of Medicare referrals received from a primary referral source for that hospital in the base year of 2005. For most of the Company s hospitals, this initial first year cap would begin on September 1, 2007. Beginning on September 1, 2008, the cap would be reduced to the lesser of 50% of Medicare referrals or the actual percentage of Medicare referrals for that hospital in the 2005 base year. The fully phased-in cap of 25% would apply to most of the Company s hospitals after September 1, 2009.

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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 of 1933, as amended, 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 the words such as anticipate, approximate, believe, plan, estimate, expect, project, could, 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 Company's ability to operate pursuant to the terms of its debt obligations and its Amended Master Leases with Ventas,

the Company's ability to meet its rental and debt service obligations,

the Company's ability to complete the Facility Acquisitions with Ventas, including the satisfaction of all closing conditions, and its ability to complete the resale of the Facilities,

the Company's and AmerisourceBergen's ability to complete the Proposed Pharmacy Transaction, including the receipt of all required regulatory approvals and the satisfaction of other closing conditions to the Proposed Pharmacy Transaction,

adverse developments with respect to the Company's results of operations or liquidity,

the Company's ability to attract and retain key executives and other healthcare personnel,

increased operating costs due to shortages in qualified nurses, therapists and other healthcare personnel,

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

changes in the reimbursement rates or methods of payment from third party payors, including the Medicare and Medicaid programs, changes arising from and related to LTAC PPS, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 ( Medicare Part D ), and changes in Medicare and Medicaid reimbursements for the Company's nursing centers,

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national and regional economic conditions, including their effect on the availability and cost of labor, materials and other services,

the Company's ability to control costs, particularly labor and employee benefit costs,

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

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

**Cautionary Statement (Continued)**

the increase in the costs of defending and insuring against alleged professional liability claims and the Company's ability to predict the estimated costs related to such claims,

the Company's ability to successfully reduce (by divestiture of operations or otherwise) its exposure to professional liability claims,

the Company's ability to successfully dispose of unprofitable facilities, and

the Company's ability to ensure and maintain an effective system of internal controls 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 quarterly adjustment information in Note 4 and the business segment data in Note 8 of the accompanying Notes to Condensed Consolidated Financial Statements should be read in conjunction with the following discussion and analysis.

The Company is a healthcare services company that through its subsidiaries operates hospitals, nursing centers, a contract rehabilitation services business and institutional pharmacies across the United States. At March 31, 2007, the Company's hospital division operated 82 LTAC hospitals (6,539 licensed beds) in 24 states. The Company's health services division operated 249 nursing centers (31,457 licensed beds) in 28 states. The Company operated a contract rehabilitation services business which provides rehabilitative services primarily in long-term care settings. The Company's pharmacy division operated an institutional pharmacy business with 44 pharmacies in 25 states and a pharmacy management business servicing substantially all of the Company's hospitals.

In October 2006, the Company signed a definitive agreement with AmerisourceBergen to combine their respective institutional pharmacy businesses, KPS and PharMerica LTC, into a new, independent, publicly traded company. See Note 2 of the accompanying Notes to Condensed Consolidated Financial Statements.

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 or 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, 2007 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 3 of the accompanying Notes to Condensed Consolidated Financial Statements.

**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

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

**Critical Accounting Policies (Continued)**

contingencies. The Company relies on historical experience and on 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, 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.

Operating results included income related to the favorable settlement of prior year hospital Medicare cost reports that aggregated \$2 million for the first quarter of 2006. See Note 6 of the accompanying Notes to Condensed Consolidated Financial Statements for a summary of the Company's revenues.

*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. 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 \$6 million and \$8 million for the first quarter of 2007 and 2006, respectively.

*Allowances for insurance risks*

The Company insures a substantial portion of its professional liability risks and workers compensation risks through a wholly owned limited purpose insurance subsidiary. Provisions for loss for these risks are based upon independent 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 subsequent expected ultimate claims costs vary from historical provisions for loss, future earnings will be charged or credited.

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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 (Continued)*

Provisions for loss for professional liability risks retained by the limited purpose insurance subsidiary have been discounted based upon independent actuarial estimates of claim payment patterns using a discount rate of 5% in each period presented. 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 \$259 million at March 31, 2007 and \$250 million at December 31, 2006. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated \$271 million at March 31, 2007 and \$263 million at December 31, 2006.

As a result of improved professional liability underwriting results of the Company's limited purpose insurance subsidiary, the Company received distributions of \$37 million and \$25 million during the first quarter of 2007 and 2006, respectively, from its limited purpose insurance subsidiary. These 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 ultimate 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 March 31, 2007 would impact the Company's operating income by approximately \$3 million. The Company recorded a favorable pretax adjustment of approximately \$7 million in the first quarter of 2006 resulting from a change in estimate for professional liability reserves related primarily to the Company's former nursing centers in Florida and Texas (included in discontinued operations).

The provision for professional liability risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated \$20 million for the first quarter of both 2007 and 2006.

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 \$88 million at March 31, 2007 and \$85 million at December 31, 2006. The provision for workers compensation risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated \$12 million and \$13 million for the first quarter of 2007 and 2006, respectively.

See Note 9 of the accompanying Notes to Condensed Consolidated Financial Statements for a summary of the Company's insurance activities.

*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.

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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 (Continued)*

The Company's effective income tax rate was 42.7% in the first quarter of 2007 compared to 41.8% in the first quarter of 2006.

There are significant uncertainties with respect to capital loss and net operating loss carryforwards which 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 the realizability of the deferred tax assets is uncertain. The Company recognized deferred tax assets totaling \$163 million at March 31, 2007 and \$159 million at December 31, 2006.

The Company is subject to various income tax audits at the federal and state levels in the ordinary course of business. Such audits could result in increased tax payments, interest and penalties. 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. See Note 10 of the accompanying Notes to Condensed Consolidated Financial Statements.

*Valuation of long-lived assets and goodwill*

The Company regularly reviews the carrying value of certain long-lived assets and the related identifiable intangible assets with respect to any events or circumstances that may indicate whether an impairment or an adjustment to the carrying value or amortization period is necessary. If circumstances suggest 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 (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 are aggregated for purposes of evaluating the carrying values of long-lived assets.

In accordance with SFAS No. 142 ( SFAS 142 ), 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 impairment test at the end of each year. No impairment charge was recorded at December 31, 2006 in connection with the annual impairment test.

The Company's other intangible assets with finite lives are amortized under SFAS 142 using the straight-line method over their estimated useful lives, ranging from one to 13 years.



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

**Results of Operations – Continuing Operations**

***Hospital Division***

Revenues increased 8% to \$464 million in the first quarter of 2007 from \$431 million in the first quarter of 2006. Revenue growth was primarily a result of growth in non-government admissions, new hospital development and the Commonwealth Transaction. On a same-store basis, revenues increased 3% in the first quarter of 2007 compared to the first quarter of 2006. Revenues associated with the Commonwealth Transaction approximated \$29 million and \$10 million in the first quarter of 2007 and 2006, respectively.

Admissions rose 5% in the first quarter of 2007 compared to the first quarter of 2006 and non-government admissions grew 20% in the first quarter of 2007 compared to the first quarter of 2006. On a same-store basis, admissions were relatively unchanged in the first quarter of 2007 compared to the first quarter of 2006. Medicare same-store admissions declined 5% in the first quarter of 2007 compared to the first quarter of 2006, while non-government same-store admissions increased 14% in the first quarter of 2007 compared to the first quarter of 2006.

Hospital wage and benefit costs increased 10% to \$206 million in the first quarter of 2007 from \$187 million in the first quarter of 2006. Average hourly wage rates grew 3% for the first quarter of 2007 compared to the first quarter of 2006, while employee benefit costs increased 10% in the first quarter of 2007 compared to the first quarter of 2006.

Professional liability costs were \$6 million in the first quarter of both 2007 and 2006.

Hospital operating income declined 3% to \$101 million in the first quarter of 2007 from \$104 million in the first quarter of 2006. Despite increases in non-government revenues, hospital operating income declined in the first quarter of 2007 primarily as a result of weakness in Medicare patient volumes. Operating margins were 21.7% in the first quarter of 2007 compared to 24.2% in the first quarter of 2006. Aggregate operating costs per patient day were relatively unchanged in the first quarter of 2007 compared to the first quarter of 2006. Operating income associated with the Commonwealth Transaction approximated \$2 million and \$1 million in the first quarter of 2007 and 2006, respectively.

***Health Services Division***

Revenues increased 13% to \$521 million in the first quarter of 2007 compared to \$460 million in the first quarter of 2006, primarily as a result of generally favorable reimbursement rates, new nursing center development and the Commonwealth Transaction. Aggregate revenues per patient day increased 7% in the first quarter of 2007 compared to the first quarter of 2006, while aggregate patient days increased 6% in the first quarter of 2007 compared to the first quarter of 2006. On a same-store basis, aggregate revenues increased 6% in the first quarter of 2007 compared to the first quarter of 2006, while aggregate patient days were relatively unchanged in the first quarter of 2007 compared to the first quarter of 2006. Revenues associated with the Commonwealth Transaction approximated \$33 million and \$10 million in the first quarter of 2007 and 2006, respectively.

Nursing center wage and benefit costs increased 11% to \$276 million in the first quarter of 2007 compared to \$248 million in the first quarter of 2006. Average hourly wage rates increased 5% in the first quarter of 2007 compared to the first quarter of 2006, while employee benefit costs increased 9% in the first quarter of 2007 compared to the first quarter of 2006.

Professional liability costs were \$14 million in the first quarter of both 2007 and 2006.

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**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)****Results of Operations - Continuing Operations (Continued)*****Health Services Division (Continued)***

Nursing center operating income increased 32% to \$63 million in the first quarter of 2007 compared to \$48 million in the first quarter of 2006. Operating income increased in the first quarter of 2007 primarily due to improved reimbursement rates and increases in patient days (particularly Medicare and non-government patient days). Operating margins were 12.2% in the first quarter of 2007 compared to 10.4% in the first quarter of 2006. Aggregate operating costs per patient day increased 5% in the first quarter of 2007 compared to the first quarter of 2006. Operating income associated with the Commonwealth Transaction approximated \$4 million and \$1 million in the first quarter of 2007 and 2006, respectively.

***Rehabilitation Division***

Revenues increased 18% to \$84 million in the first quarter of 2007 from \$71 million in the first quarter of 2006. The increase in revenues in the first quarter of 2007 was primarily attributable to growth in new customers and the volume of services provided to existing customers. Revenues derived from non-affiliated customers aggregated \$22 million in the first quarter of 2007 compared to \$17 million in the first quarter of 2006.

Operating income increased to \$10 million in the first quarter of 2007 from \$4 million in the first quarter of 2006. Operating income for the first quarter of 2006 included a pretax charge of approximately \$3 million related primarily to revisions to prior estimates for accrued contract labor costs. Operating income for the first quarter of 2007 was favorably impacted by growth in revenues and increased therapist productivity compared to the first quarter of 2006.

***Pharmacy Division***

Revenues increased 11% to \$175 million in the first quarter of 2007 compared to \$157 million in the first quarter of 2006 due primarily to growth in non-affiliated customers, higher drug utilization and acquisitions. Revenues associated with the three pharmacy acquisitions completed in the third quarter of 2006 approximated \$7 million in the first quarter of 2007. At March 31, 2007, the Company provided pharmacy services to customers containing 103,300 licensed beds, including 28,300 licensed beds that the Company operates. At March 31, 2006, the Company provided pharmacy services to customers containing 94,100 licensed beds, including 30,400 licensed beds that the Company operates.

Pharmacy operating income declined 45% to \$9 million in the first quarter of 2007 from \$17 million in the first quarter of 2006. The decline in pharmacy operating income in the first quarter of 2007 compared to the first quarter of 2006 was primarily attributable to costs associated with the Proposed Pharmacy Transaction, weaker results from pharmacies acquired in 2005 and competitive pricing pressures. Operating income associated with the three pharmacy acquisitions completed in the third quarter of 2006 approximated \$1 million in the first quarter of 2007. Operating margins were 5.3% and 10.6% in the first quarter of 2007 and 2006, respectively. The cost of goods sold as a percentage of institutional pharmacy revenues increased to 66.6% in the first quarter of 2007 compared to 65.5% in the first quarter of 2006 primarily due to pricing pressures.

Pharmacy operating income for the first quarter of 2007 included approximately \$3 million of professional fees and other costs incurred in connection with the Proposed Pharmacy Transaction. Pharmacy operating income for the first quarter of 2006 included a \$1 million gain on a joint venture transaction.

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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)**

***Corporate Overhead***

Operating income for the Company's operating divisions excludes allocations of corporate overhead. These costs aggregated \$38 million in the first quarter of 2007 compared to \$37 million in the first quarter of 2006. Corporate overhead for the first quarter of 2007 included approximately \$1 million of professional fees and other costs incurred in connection with the Proposed Pharmacy Transaction. Corporate overhead for the first quarter of 2006 included a pretax charge of \$1 million for investment banking services and costs related to the 2006 rent reset issue with Ventas. As a percentage of consolidated revenues, corporate overhead totaled 3.3% in the first quarter of 2007 and 3.6% in the first quarter of 2006.

Corporate expenses included the operating losses of the Company's limited purpose insurance subsidiary of \$1 million and \$2 million in the first quarter of 2007 and 2006, respectively.

***Capital Costs***

Rent expense increased 26% to \$87 million in the first quarter of 2007 compared to \$70 million in the first quarter of 2006. A substantial portion of the increase resulted from the Ventas rent reset, contractual inflation increases, growth in the number of leased facilities, and other development and acquisition activities. The Ventas rent reset increased rent expense by approximately \$8 million in the first quarter of 2007 compared to the first quarter of 2006.

Depreciation and amortization expense increased 6% to \$30 million in the first quarter of 2007 compared to \$27 million in the first quarter of 2006. The increase was primarily a result of the Company's ongoing capital expenditure program, and development and acquisition activities.

Interest expense increased to \$4 million in the first quarter of 2007 compared to \$3 million in the first quarter of 2006. The increase was primarily a result of increased borrowings under the Company's revolving credit facility.

Investment income, related primarily to the Company's insurance subsidiary investments, approximated \$4 million in the first quarter of both 2007 and 2006.

***Consolidated Results***

Income from continuing operations before income taxes declined 27% to \$27 million in the first quarter of 2007 compared to \$38 million in the first quarter of 2006. Net income from continuing operations in the first quarter of 2007 declined 28% to \$16 million compared to \$22 million in the first quarter of 2006.

***Discontinued Operations***

Net loss from discontinued operations aggregated \$1 million in the first quarter of 2007 compared to net income of \$2 million in the first quarter of 2006. Net income from discontinued operations for the first quarter of 2006 included a favorable pretax adjustment of \$7 million (\$4 million net of income taxes) resulting from a change in estimate for professional liability reserves related primarily to the Company's former nursing centers in Florida and Texas. See Notes 3 and 9 of the accompanying Notes to Condensed Consolidated Financial Statements.

The Company recorded a pretax loss on divestiture of operations related to the HCP Transaction of \$13 million (\$8 million net of income taxes) in the first quarter of 2007.

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

**Liquidity**

Cash flows provided by operations (including discontinued operations) aggregated \$7 million in the first quarter of 2007 compared to cash flows used in operations of \$24 million in the first quarter of 2006. Operating cash flows for the first quarter of both 2007 and 2006 were negatively impacted by the growth in accounts receivable. During both periods, the Company maintained sufficient liquidity to fund its ongoing capital expenditure program, and finance acquisitions and development activities.

Cash and cash equivalents totaled \$20 million at March 31, 2007 compared to \$21 million at December 31, 2006. Based upon the Company's existing cash levels, expected operating cash flows, capital spending (including planned acquisitions) and the availability of borrowings under the Company's revolving credit facility, management believes that the Company has the necessary financial resources to satisfy its expected short-term and long-term liquidity needs.

Long-term debt at March 31, 2007 aggregated \$113 million. The Company expects to continue to utilize its revolving credit facility in 2007 to fund working capital and development needs. The Company was in compliance with the terms of its revolving credit facility at March 31, 2007.

On April 27, 2007, the Company entered into agreements with Ventas related to the Facility Acquisitions. In connection with these agreements, the Company renewed the leases for all of the remaining facilities that were scheduled to expire in April 2008. In addition, the Company and Ventas entered into the Amended Master Leases that reflected several amendments. Ventas also has agreed that it will not contest the Proposed Pharmacy Transaction.

The Company will acquire the Facilities for approximately \$171 million. In addition, the Company will pay Ventas a lease termination fee of approximately \$4 million. The current aggregate annual rents for the Facilities are approximately \$10 million. The Facility Acquisitions are expected to close by June 30, 2007.

The Facilities, which contain 2,634 licensed nursing center beds and 220 licensed hospital beds, generated pretax losses of approximately \$10 million for the year ended December 31, 2006. Upon closing, the Company will account for the operations of the Facilities as discontinued operations.

The Company intends to complete the divestiture of all of the Facilities by December 31, 2007. The Company expects to generate between \$80 million and \$90 million in proceeds from the sale of the Facilities and the related operations. The Company expects to record a net loss of approximately \$60 million to \$70 million in the second quarter of 2007 relating to these divestitures.

In the first quarter of 2007, the Company paid \$37 million to complete the HCP Transaction. The Company also divested ten of the eleven nursing centers acquired in the HCP Transaction in the first quarter of 2007 and received proceeds of approximately \$75 million which were used to repay borrowings under the Company's revolving credit facility. On April 30, 2007, the Company sold the remaining nursing center for approximately \$3 million.

As a result of improved professional liability underwriting results of the Company's limited purpose insurance subsidiary, the Company received distributions of \$37 million and \$25 million during the first quarter of 2007 and 2006, respectively, from its limited purpose insurance subsidiary. These proceeds were used primarily to repay borrowings under the Company's revolving credit facility.

As discussed in Note 2 of the accompanying Notes to Condensed Consolidated Financial Statements, the Company expects to receive up to \$125 million on a tax-free basis as a result of the Proposed Pharmacy Transaction.

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

**Capital Resources**

Excluding acquisitions, capital expenditures totaled \$34 million in the first quarter of 2007 compared to \$25 million in the first quarter of 2006. Capital expenditures (excluding the Facility Acquisitions and other acquisitions) could approximate \$175 million to \$225 million in 2007. Management believes that its capital expenditure program is adequate to improve and equip existing facilities and complete its construction in progress. The Company's capital expenditure program is financed generally through the use of internally generated funds. At March 31, 2007, the estimated cost to complete and equip construction in progress approximated \$91 million.

In the first quarter of 2006, the Company completed the Commonwealth Transaction at a cost of \$123 million and financed the acquisition primarily through borrowings under the Company's revolving credit facility.

The terms of the Company's revolving credit facility include certain covenants which limit the Company's acquisitions and annual capital expenditures. At March 31, 2007, the Company's remaining permitted acquisition amount under its revolving credit facility aggregated \$216 million. The Facility Acquisitions will not be measured against the remaining permitted acquisition limitation.

**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 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.

On May 1, 2007, CMS issued the Final Rule. The changes finalized a regulation originally proposed on January 25, 2007 and will become effective for discharges occurring on or after July 1, 2007. The Final Rule projects an overall decrease in payments to all Medicare certified LTAC hospitals of approximately 3.8%. Included in the Final Rule are (1) an increase to the standard federal payment rate of 0.71%; (2) revisions to payment methodologies impacting short stay outliers, which reduce payments by 0.9%; (3) adjustments to the wage index component of the federal payment resulting in projected reductions in payments of 1.0%; (4) an increase in the high cost outlier threshold per discharge to \$22,954, resulting in projected reductions of 2.5%; and (5) an extension of the policy known as the 25 Percent Rule to all LTAC hospitals, with a three-year phase-in, which CMS projects will not result in payment reductions for the first year of implementation. The Final Rule also states that the annual update to the LTC DRG classifications and relative weights will be made in a budget neutral manner, effective October 1, 2007. Accordingly, the estimated aggregate payments under LTAC PPS would be unaffected by the annual recalibration of LTC DRG payment weights.

The Company estimates that the Final Rule will result in a 2.5% reduction in payments to the Company's LTAC hospitals. For the second half of 2007, the Company believes that the Final Rule could reduce its hospital Medicare payments by approximately \$25 million.

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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)*

The Final Rule expands the so-called 25 Percent Rule to all LTAC hospitals, regardless of whether they are co-located within another hospital. Under the Final Rule, all LTAC hospitals will be paid LTAC PPS rates for admissions from a single referral source up to 25% of aggregate Medicare admissions. Admissions beyond the 25% threshold would be paid at a lower amount based upon short-term acute care hospital rates.

Under the Final Rule, the 25% threshold would be phased in over three years. Hospitals having fiscal years beginning on or after July 1, 2007 and before October 1, 2007, including most of the Company's hospitals, will have their admission cap initially established at the lesser of 75% of Medicare referrals or the actual percentage of Medicare referrals received from a primary referral source for that hospital in the base year of 2005. For most of the Company's hospitals, this initial first year cap would begin on September 1, 2007. Beginning on September 1, 2008, the cap would be reduced to the lesser of 50% of Medicare referrals or the actual percentage of Medicare referrals for that hospital in the 2005 base year. The fully phased-in cap of 25% would apply to most of the Company's hospitals after September 1, 2009.

On April 13, 2007, CMS issued proposed regulations regarding Medicare hospital inpatient payments to short-term acute care hospitals as well as certain provisions affecting LTAC hospitals. These regulations propose a new system for classifying patients into diagnostic categories called Medicare Severity Diagnosis Related Groups or more specifically, for LTAC hospitals, ( MS-LTC-DRGs ). This new MS-LTC-DRG system is intended to replace the current diagnostic related group system for LTAC hospitals and would become effective for discharges occurring on or after October 1, 2007. The MS-LTC-DRG system would create additional severity-adjusted categories for most diagnoses, resulting in an expansion of the aggregate number of diagnostic groups from 538 to 745. CMS states in this proposal that MS-LTC-DRG weights were developed in a budget neutral manner, which is consistent with recent recommendations by CMS regarding Medicare reimbursement for LTAC hospitals. As such, the estimated aggregate payments under LTAC PPS would be unaffected by the annual recalibration of MS-LTC-DRG payment weights. However, CMS applied a 2.4% reduction factor to each of the budget neutral weights to account for anticipated case mix increases resulting from improved coding by LTAC hospitals. Based upon the Company's historical Medicare patient volumes, the Company believes that the proposed regulations will not have a material affect on its hospital Medicare revenues.

Currently, CMS has regulations governing payment to LTAC hospitals that are co-located within another hospital, such as a hospital-in-hospital. Most co-located hospitals can admit up to 25% of its patients from its host hospital and be paid according to LTAC PPS. Admissions that exceed this 25 Percent Rule are paid using the short-term hospital payment system. Patients reaching high cost outlier status in the short-term hospital are not counted when computing the 25% limit. CMS is currently phasing-in this policy which will become fully effective on September 1, 2008.

In August 2006, CMS issued the final rule to reweight LTAC DRGs, among other things, which began October 1, 2006 for the Company. CMS estimated that the effect of this rule would decrease Medicare reimbursements to LTAC hospitals by an additional 1.3%. The revised LTAC DRG reweighting is not expected to have a material impact on the Company's financial position, results of operations or liquidity.

In May 2006, CMS issued final regulatory changes regarding Medicare reimbursement to LTAC hospitals (the 2006 Hospital Medicare Rule ). The 2006 Hospital Medicare Rule became effective for discharges occurring after June 30, 2006. Based upon the Company's historical Medicare patient volumes, the Company expects the 2006 Hospital Medicare Rule will reduce Medicare revenues to its hospitals associated with short-stay outliers and high cost outliers by approximately \$42 million on an annual basis. This estimate does not

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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)*

include the negative impact resulting from the elimination of the annual market basket adjustment to the Medicare payment rates that also is contained in the 2006 Hospital Medicare Rule. The annual market basket adjustment has typically ranged between 3% and 4%, or approximately \$25 million to \$30 million annually. The 2006 Hospital Medicare Rule also extends until July 1, 2008 CMS's authority to impose a one-time prospective budget neutrality adjustment to LTAC hospital rates. This authority was previously scheduled to expire on October 1, 2006.

Operating results under LTAC PPS are subject to changes in patient acuity and expense levels in the Company's hospitals. These factors, among others, are subject to significant change. Slight variations in patient acuity 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 as patient acuity levels change. Under this system, Medicare reimbursements to the Company's hospitals are based upon a fixed payment system. Operating margins in the hospital division could be negatively impacted if the Company is unable to control the operating costs of the division. As a result of these uncertainties, the Company cannot predict the ultimate long-term impact of LTAC PPS on its hospital operating results and there can be no assurances that such regulations or operational changes resulting from these regulations will not have a material adverse impact on the Company's financial position, results of operations or liquidity. In addition, the Company can provide no assurances that LTAC PPS will not have a material adverse effect on revenues from private and commercial third party payors. Various factors, including a reduction in average length of stay, have had a negative impact on revenues from private and commercial third party payors.

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 Medicare patients must be at least 25 days. Under the previous system, compliance with the 25-day average length of stay threshold was based upon all patient discharges.

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.

In February 2006, Congress passed the Deficit Reduction Act of 2005. This legislation allows, among other things, an annual \$1,740 Medicare Part B outpatient therapy cap, effective January 1, 2006. The legislation also requires CMS to implement a broad process for reviewing medically necessary therapy claims, creating an exception to the cap. This exception process, which was set to expire on January 1, 2007, was included in the Tax Relief and Health Care Act of 2006 and will continue to function as an exception to the Medicare Part B outpatient therapy cap until January 1, 2008.

In January 2006, Medicare Part D implemented a major expansion of the Medicare program through the introduction of a prescription drug benefit. Medicare beneficiaries who also are entitled to benefits under a state Medicaid program (so-called "dual eligibles") will have their outpatient prescription drug costs covered by the Medicare drug benefit, subject to certain limitations. Most of the nursing center residents that we serve whose drug costs were previously covered by state Medicaid programs are dual eligibles who qualify for the new Medicare drug benefit. Accordingly, Medicaid is no longer a primary payor for the pharmacy services provided to these residents.

The first year of Medicare Part D resulted in significant challenges to the Company's institutional pharmacy business as well as the institutional pharmacy industry. These challenges included, but were not limited 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)*

inability of the Medicare Part D program to accurately reflect dual eligible residents, inaccurate reimbursement associated with Medicare co-payments and extensive prior authorization and other processes mandated by the private prescription drug plan sponsors. There can be no assurance that the challenges presented by Medicare Part D and the regulations promulgated under Medicare Part D will not have a material adverse effect on the Company's institutional pharmacy business.

The Company believes that its operating margins may continue to be under pressure as the growth in operating expenses, particularly professional liability, and 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.



**Table of Contents****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)**

|   | 2006 Quarters |              |              |              |              | First<br>Quarter<br>2007 |
|---|---------------|--------------|--------------|--------------|--------------|--------------------------|
|   | First         | Second       | Third        | Fourth       | Year         |                          |
| Revenues  | \$ 1,030,730  | \$ 1,073,994 | \$ 1,058,892 | \$ 1,103,045 | \$ 4,266,661 | \$ 1,144,180             |
| Salaries, wages and benefits                          | 562,461       | 582,354      | 589,753      | 594,814      | 2,329,382    | 625,417                  |
| Supplies  | 163,583       | 167,609      | 170,815      | 183,877      | 685,884      | 184,013                  |
| Rent  | 69,293        | 74,921       | 81,252       | 84,938       | 310,404      | 87,297                   |
| Other operating expenses                              | 170,910       | 176,789      | 176,546      | 177,321      | 701,566      | 190,885                  |
| Depreciation and amortization                         | 27,846        | 29,828       | 32,046       | 32,476       | 122,196      | 29,421                   |
| Interest expense                                      | 2,649         | 3,534        | 4,667        | 3,071        | 13,921       | 3,595                    |
| Investment income                                     | (3,691)       | (3,444)      | (3,530)      | (3,835)      | (14,500)     | (3,833)                  |
|   | 993,051       | 1,031,591    | 1,051,549    | 1,072,662    | 4,148,853    | 1,116,795                |
| Income from continuing operations before income taxes | 37,679        | 42,403       | 7,343        | 30,383       | 117,808      | 27,385                   |
| Provision for income taxes                            | 15,743        | 18,163       | 3,774        | 8,889        | 46,569       | 11,688                   |
| Income from continuing operations                     | 21,936        | 24,240       | 3,569        | 21,494       | 71,239       | 15,697                   |
| Discontinued operations, net of<br>income taxes:      |               |              |              |              |              |                          |
| Income (loss) from operations                         | 1,866         | 5,741        | (757)        | 654          | 7,504        | (598)                    |
| Gain (loss) on divestiture<br>of operations           | 157           | (308)        | 126          | (7)          | (32)         | (7,266)                  |
| Net income  | \$ 23,959     | \$ 29,673    | \$ 2,938     | \$ 22,141    | \$ 78,711    | \$ 7,833                 |
| Earnings per common share:                            |               |              |              |              |              |                          |
| Basic:  |               |              |              |              |              |                          |
| Income from continuing operations                     | \$ 0.60       | \$ 0.58      | \$ 0.09      | \$ 0.55      | \$ 1.82      | \$ 0.40                  |
| Discontinued operations:                              |               |              |              |              |              |                          |
| Income (loss) from operations                         | 0.05          | 0.14         | (0.02)       | 0.02         | 0.19         | (0.01)                   |
| Gain (loss) on divestiture<br>of operations           |               | (0.01)       |              |              |              | (0.19)                   |
| Net income  | \$ 0.65       | \$ 0.71      | \$ 0.07      | \$ 0.57      | \$ 2.01      | \$ 0.20                  |
| Diluted:  |               |              |              |              |              |                          |
| Income from continuing operations                     | \$ 0.53       | \$ 0.57      | \$ 0.09      | \$ 0.54      | \$ 1.74      | \$ 0.39                  |
| Discontinued operations:                              |               |              |              |              |              |                          |
| Income (loss) from operations                         | 0.05          | 0.13         | (0.02)       | 0.02         | 0.18         | (0.01)                   |
| Gain (loss) on divestiture<br>of operations           |               | (0.01)       |              |              |              | (0.18)                   |
| Net income  | \$ 0.58       | \$ 0.69      | \$ 0.07      | \$ 0.56      | \$ 1.92      | \$ 0.20                  |

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Shares used in computing earnings per common share:

|         |        |        |        |        |        |        |
|---------|--------|--------|--------|--------|--------|--------|
| Basic   | 36,576 | 41,695 | 39,014 | 39,120 | 39,108 | 39,212 |
| Diluted | 41,091 | 42,956 | 39,769 | 39,784 | 40,923 | 39,997 |

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
(Continued)**Operating Data**

(Unaudited)

(In thousands)

|  | 2006 Quarters |              |              |              |              | First<br>Quarter<br>2007 |
|--|---------------|--------------|--------------|--------------|--------------|--------------------------|
|  | First         | Second       | Third        | Fourth       | Year         |                          |
| <b>Revenues:</b>   |               |              |              |              |              |                          |
| Hospital division  | \$ 430,814    | \$ 439,308   | \$ 406,923   | \$ 449,771   | \$ 1,726,816 | \$ 463,812               |
| Health services division                                 | 460,038       | 493,067      | 499,072      | 504,995      | 1,957,172    | 521,463                  |
| Rehabilitation division                                  | 71,162        | 74,376       | 76,003       | 78,565       | 300,106      | 83,756                   |
| Pharmacy division  | 157,214       | 159,926      | 170,443      | 165,025      | 652,608      | 174,704                  |
|  | 1,119,228     | 1,166,677    | 1,152,441    | 1,198,356    | 4,636,702    | 1,243,735                |
| <b>Eliminations:</b>                                     |               |              |              |              |              |                          |
| Rehabilitation   | (53,975)      | (57,071)     | (57,019)     | (57,871)     | (225,936)    | (61,670)                 |
| Pharmacy   | (34,523)      | (35,612)     | (36,530)     | (37,440)     | (144,105)    | (37,885)                 |
|  | (88,498)      | (92,683)     | (93,549)     | (95,311)     | (370,041)    | (99,555)                 |
|  | \$ 1,030,730  | \$ 1,073,994 | \$ 1,058,892 | \$ 1,103,045 | \$ 4,266,661 | \$ 1,144,180             |
| <b>Income from continuing operations:</b>                |               |              |              |              |              |                          |
| <b>Operating income (loss):</b>                          |               |              |              |              |              |                          |
| Hospital division  | \$ 104,064    | \$ 105,307   | \$ 74,793    | \$ 104,258   | \$ 388,422   | \$ 100,505               |
| Health services division                                 | 47,925        | 63,297       | 61,293       | 74,351       | 246,866      | 63,409                   |
| Rehabilitation division                                  | 4,239         | 8,453        | 8,857        | 8,813        | 30,362       | 10,044                   |
| Pharmacy division  | 16,729        | 15,139       | 16,152       | 441          | 48,461       | 9,243 (a)                |
| Corporate:   |               |              |              |              |              |                          |
| Overhead   | (37,334)      | (43,257)     | (37,683)     | (38,883)     | (157,157)    | (37,794)(a)              |
| Insurance subsidiary                                     | (1,847)       | (1,697)      | (1,634)      | (1,947)      | (7,125)      | (1,542)                  |
|  | (39,181)      | (44,954)     | (39,317)     | (40,830)     | (164,282)    | (39,336)                 |
| Operating income   | 133,776       | 147,242      | 121,778      | 147,033      | 549,829      | 143,865                  |
| Rent   | (69,293)      | (74,921)     | (81,252)     | (84,938)     | (310,404)    | (87,297)                 |
| Depreciation and amortization                            | (27,846)      | (29,828)     | (32,046)     | (32,476)     | (122,196)    | (29,421)                 |
| Interest, net  | 1,042         | (90)         | (1,137)      | 764          | 579          | 238                      |
| Income from continuing operations before<br>income taxes | 37,679        | 42,403       | 7,343        | 30,383       | 117,808      | 27,385                   |
| Provision for income taxes                               | 15,743        | 18,163       | 3,774        | 8,889        | 46,569       | 11,688                   |
|  | \$ 21,936     | \$ 24,240    | \$ 3,569     | \$ 21,494    | \$ 71,239    | \$ 15,697                |

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- (a) Includes professional fees and other costs incurred in connection with the Proposed Pharmacy Transaction of \$3.2 million (pharmacy division) and \$0.9 million (corporate overhead).

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
(Continued)**Operating Data (Continued)**

(Unaudited)

(In thousands)

|  | 2006 Quarters |           |           |           |            | First       |
|--|---------------|-----------|-----------|-----------|------------|-------------|
|  | First         | Second    | Third     | Fourth    | Year       | Quarter     |
| <b>Rent:</b>   |               |           |           |           |            | <b>2007</b> |
| Hospital division  | \$ 26,619     | \$ 29,588 | \$ 32,245 | \$ 34,180 | \$ 122,632 | \$ 34,909   |
| Health services division   | 40,447        | 43,048    | 46,552    | 48,161    | 178,208    | 49,603      |
| Rehabilitation division  | 869           | 897       | 932       | 999       | 3,697      | 1,069       |
| Pharmacy division  | 1,280         | 1,316     | 1,448     | 1,510     | 5,554      | 1,642       |
| Corporate  | 78            | 72        | 75        | 88        | 313        | 74          |
|  | \$ 69,293     | \$ 74,921 | \$ 81,252 | \$ 84,938 | \$ 310,404 | \$ 87,297   |
| <b>Depreciation and amortization:</b>  |               |           |           |           |            |             |
| Hospital division  | \$ 11,107     | \$ 11,658 | \$ 12,363 | \$ 11,995 | \$ 47,123  | \$ 9,182    |
| Health services division   | 9,287         | 10,260    | 10,966    | 11,674    | 42,187     | 12,101      |
| Rehabilitation division  | 80            | 115       | 127       | 211       | 533        | 236         |
| Pharmacy division  | 1,797         | 1,857     | 2,594     | 2,587     | 8,835      | 2,816       |
| Corporate  | 5,575         | 5,938     | 5,996     | 6,009     | 23,518     | 5,086       |
|  | \$ 27,846     | \$ 29,828 | \$ 32,046 | \$ 32,476 | \$ 122,196 | \$ 29,421   |
| <b>Capital expenditures, excluding acquisitions (including discontinued operations):</b> |               |           |           |           |            |             |
| Hospital division  | \$ 15,365     | \$ 14,105 | \$ 16,535 | \$ 24,149 | \$ 70,154  | \$ 20,765   |
| Health services division   | 5,225         | 11,151    | 12,849    | 12,004    | 41,229     | 6,696       |
| Rehabilitation division  | 19            | 130       | 146       | 308       | 603        | 118         |
| Pharmacy division  | 2,057         | 2,219     | 2,581     | 2,994     | 9,851      | 1,712       |
| Corporate:   |               |           |           |           |            |             |
| Information systems  | 2,514         | 8,958     | 5,376     | 11,298    | 28,146     | 4,457       |
| Other  | 115           | 177       | 232       | 567       | 1,091      | 274         |
|  | \$ 25,295     | \$ 36,740 | \$ 37,719 | \$ 51,320 | \$ 151,074 | \$ 34,022   |

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)****Operating Data (Continued)****(Unaudited)**

|                               | 2006 Quarters |           |           |           |           | First Quarter |
|-------------------------------|---------------|-----------|-----------|-----------|-----------|---------------|
|                               | First         | Second    | Third     | Fourth    | Year      | 2007          |
| <b>Hospital data:</b>         |               |           |           |           |           |               |
| End of period data:           |               |           |           |           |           |               |
| Number of hospitals           | 80            | 80        | 80        | 81        |           | 82            |
| Number of licensed beds       | 6,347         | 6,363     | 6,359     | 6,419     |           | 6,539         |
| Revenue mix % (a):            |               |           |           |           |           |               |
| Medicare                      | 64            | 62        | 60        | 59        | 61        | 60            |
| Medicaid                      | 7             | 9         | 10        | 12        | 10        | 10            |
| Private and other             | 29            | 29        | 30        | 29        | 29        | 30            |
| Admissions:                   |               |           |           |           |           |               |
| Medicare                      | 7,810         | 7,330     | 6,978     | 7,457     | 29,575    | 7,818         |
| Medicaid                      | 913           | 1,018     | 1,031     | 1,023     | 3,985     | 1,069         |
| Private and other             | 1,919         | 1,957     | 1,891     | 1,994     | 7,761     | 2,306         |
|                               | 10,642        | 10,305    | 9,900     | 10,474    | 41,321    | 11,193        |
| Admissions mix %:             |               |           |           |           |           |               |
| Medicare                      | 73            | 71        | 71        | 71        | 71        | 70            |
| Medicaid                      | 9             | 10        | 10        | 10        | 10        | 9             |
| Private and other             | 18            | 19        | 19        | 19        | 19        | 21            |
| Patient days:                 |               |           |           |           |           |               |
| Medicare                      | 212,116       | 211,255   | 200,154   | 214,403   | 837,928   | 215,402       |
| Medicaid                      | 37,635        | 50,232    | 51,743    | 53,667    | 193,277   | 53,583        |
| Private and other             | 66,399        | 70,880    | 71,991    | 76,157    | 285,427   | 84,074        |
|                               | 316,150       | 332,367   | 323,888   | 344,227   | 1,316,632 | 353,059       |
| Average length of stay:       |               |           |           |           |           |               |
| Medicare                      | 27.2          | 28.8      | 28.7      | 28.8      | 28.3      | 27.6          |
| Medicaid                      | 41.2          | 49.3      | 50.2      | 52.5      | 48.5      | 50.1          |
| Private and other             | 34.6          | 36.2      | 38.1      | 38.2      | 36.8      | 36.5          |
| Weighted average              | 29.7          | 32.3      | 32.7      | 32.9      | 31.9      | 31.5          |
| Revenues per admission (a):   |               |           |           |           |           |               |
| Medicare                      | \$ 35,247     | \$ 37,025 | \$ 34,866 | \$ 35,252 | \$ 35,599 | \$ 35,509     |
| Medicaid                      | 34,228        | 40,231    | 40,604    | 54,081    | 42,508    | 42,905        |
| Private and other             | 64,766        | 64,874    | 64,394    | 65,984    | 65,015    | 60,857        |
| Weighted average              | 40,483        | 42,631    | 41,103    | 42,942    | 41,790    | 41,438        |
| Revenues per patient day (a): |               |           |           |           |           |               |
| Medicare                      | \$ 1,298      | \$ 1,285  | \$ 1,216  | \$ 1,226  | \$ 1,256  | \$ 1,289      |
| Medicaid                      | 830           | 815       | 809       | 1,031     | 876       | 856           |
| Private and other             | 1,872         | 1,791     | 1,691     | 1,728     | 1,768     | 1,669         |
| Weighted average              | 1,363         | 1,322     | 1,256     | 1,307     | 1,312     | 1,314         |

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|   |       |       |       |       |       |       |
|---|-------|-------|-------|-------|-------|-------|
| Medicare case mix index<br>(discharged patients only) | 1.12  | 1.12  | 1.11  | 1.06  | 1.10  | 1.11  |
| Average daily census                                  | 3,513 | 3,652 | 3,521 | 3,742 | 3,607 | 3,923 |
| Occupancy %   | 65.3  | 63.3  | 61.2  | 65.1  | 63.7  | 67.6  |

- (a) Includes income related to certain Medicare reimbursement issues of \$1.9 million in the first quarter of 2006, \$4.3 million in the second quarter of 2006 and \$2.3 million in the fourth quarter of 2006.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Continued)****Operating Data (Continued)****(Unaudited)**

|   | 2006 Quarters |           |           |           |           | First Quarter |
|---|---------------|-----------|-----------|-----------|-----------|---------------|
|   | First         | Second    | Third     | Fourth    | Year      | 2007          |
| <b>Nursing center data:</b>                 |               |           |           |           |           |               |
| End of period data:                         |               |           |           |           |           |               |
| Number of nursing centers:                  |               |           |           |           |           |               |
| Owned or leased                             | 237           | 237       | 237       | 237       |           | 245           |
| Managed                                     | 5             | 5         | 5         | 5         |           | 4             |
|   | 242           | 242       | 242       | 242       |           | 249           |
| Number of licensed beds:                    |               |           |           |           |           |               |
| Owned or leased                             | 30,064        | 30,074    | 30,074    | 30,059    |           | 30,972        |
| Managed                                     | 605           | 605       | 605       | 605       |           | 485           |
|   | 30,669        | 30,679    | 30,679    | 30,664    |           | 31,457        |
| Revenue mix %:                              |               |           |           |           |           |               |
| Medicare                                    | 35            | 35        | 33        | 34        | 34        | 35            |
| Medicaid                                    | 46            | 46        | 47        | 47        | 47        | 45            |
| Private and other                           | 19            | 19        | 20        | 19        | 19        | 20            |
| Patient days (excludes managed facilities): |               |           |           |           |           |               |
| Medicare                                    | 393,257       | 413,028   | 392,114   | 395,344   | 1,593,743 | 415,923       |
| Medicaid                                    | 1,484,160     | 1,551,903 | 1,584,093 | 1,575,855 | 6,196,011 | 1,541,317     |
| Private and other                           | 396,482       | 429,822   | 453,304   | 453,200   | 1,732,808 | 456,336       |
|   | 2,273,899     | 2,394,753 | 2,429,511 | 2,424,399 | 9,522,562 | 2,413,576     |
| Patient day mix %:                          |               |           |           |           |           |               |
| Medicare                                    | 17            | 17        | 16        | 16        | 17        | 17            |
| Medicaid                                    | 65            | 65        | 65        | 65        | 65        | 64            |
| Private and other                           | 18            | 18        | 19        | 19        | 18        | 19            |
| Revenues per patient day:                   |               |           |           |           |           |               |
| Medicare Part A                             | \$ 376        | \$ 377    | \$ 381    | \$ 397    | \$ 383    | \$ 404        |
| Total Medicare (including Part B)           | 412           | 411       | 419       | 434       | 419       | 440           |
| Medicaid                                    | 143           | 147       | 149       | 149       | 147       | 151           |
| Private and other                           | 217           | 221       | 219       | 218       | 219       | 231           |
| Weighted average                            | 202           | 206       | 205       | 208       | 206       | 216           |
| Average daily census                        | 25,266        | 26,316    | 26,408    | 26,352    | 26,089    | 26,818        |
| Occupancy %                                 | 87.1          | 87.9      | 88.1      | 88.0      | 87.8      | 87.8          |
| <b>Rehabilitation data:</b>                 |               |           |           |           |           |               |
| Revenue mix %:                              |               |           |           |           |           |               |
| Company-operated                            | 78            | 78        | 75        | 74        | 75        | 74            |
| Non-affiliated                              | 22            | 22        | 25        | 26        | 25        | 26            |
| <b>Pharmacy data:</b>                       |               |           |           |           |           |               |



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| Number of customer licensed beds at end of period: |        |        |         |         |         |
|--|--------|--------|---------|---------|---------|
| Company-operated                                   | 30,449 | 30,287 | 30,232  | 30,232  | 28,341  |
| Non-affiliated                                     | 63,683 | 65,036 | 72,268  | 72,339  | 74,985  |
|  | 94,132 | 95,323 | 102,500 | 102,571 | 103,326 |

**Table of Contents****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. The information presented has been prepared utilizing certain assumptions considered reasonable in light of information currently available to the Company. 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 the London Interbank Offered Rate 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 (Notional) Amount by Expected Maturity****Average Interest Rate****(Dollars in thousands)**

|                           | Expected maturities |       |            |       |       |            |            | Fair       |
|---------------------------|---------------------|-------|------------|-------|-------|------------|------------|------------|
|                           | 2007                | 2008  | 2009       | 2010  | 2011  | Thereafter | Total      | value      |
|                           | 2007                | 2008  | 2009       | 2010  | 2011  | Thereafter | Total      | 3/31/07    |
| <b>Liabilities:</b>       |                     |       |            |       |       |            |            |            |
| Long-term debt, including |                     |       |            |       |       |            |            |            |
| amounts due within one    |                     |       |            |       |       |            |            |            |
| year:                     |                     |       |            |       |       |            |            |            |
| Fixed rate                | \$ 54               | \$ 76 | \$ 81      | \$ 86 | \$ 91 | \$ 556     | \$ 944     | \$ 919     |
| Average interest rate     | 6.0%                | 6.0%  | 6.0%       | 6.0%  | 6.0%  | 6.0%       |            |            |
| Variable rate (a)         | \$                  | \$    | \$ 112,600 | \$    | \$    | \$         | \$ 112,600 | \$ 112,600 |

- (a) Interest on borrowings under the Company's revolving credit facility is payable, at the Company's option, at (1) the London Interbank Offered Rate plus an applicable margin ranging from 2.00% to 2.75% or (2) prime plus an applicable margin ranging from 1.00% to 1.75%. The applicable margin is based upon the Company's adjusted leverage ratio as defined in the Company's revolving credit facility.

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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 March 31, 2007, 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.

There has been no change in the Company's internal control over financial reporting during the quarter ended March 31, 2007, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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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 and sanctions arising in the ordinary course of its business. The Company is unable to predict the ultimate outcome of pending litigation and regulatory and other government investigations. 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 financial position, results of operations and liquidity.

**Item 6. Exhibits**

- 10.1 Consent No. 3 and Waiver dated as of January 19, 2007, pursuant to the \$400,000,000 Amended and Restated Credit Agreement dated as of June 28, 2004 among Kindred Healthcare, Inc., the Lenders party thereto, and JPMorgan Chase Bank, N.A. (formerly known as JPMorgan Chase Bank), as Administrative Agent and Collateral Agent. Exhibit 10.1 to the Company's Current Report on Form 8-K dated January 19, 2007 (Comm. File No. 001-14057) is hereby incorporated by reference.
- 10.2 Fifth Amendment to Master Lease by and among Health Care Property Investors, Inc., Health Care Property Partners and Texas HCP Holding, L.P., collectively, as Lessor and Kindred Nursing Centers East, L.L.C., Kindred Nursing Centers West, L.L.C., Kindred Nursing Centers Limited Partnership and Transitional Hospitals Corporation of Wisconsin, Inc., collectively, as Lessee, dated January 31, 2007. Exhibit 10.72 to the Company's Annual Report on Form 10-K dated December 31, 2006 (Comm. File No. 001-14057) is hereby incorporated by reference.
- 10.3 Employment Agreement dated as of February 22, 2007 by and between Kindred Healthcare, Inc. and Edward L. Kuntz.
- 31 Rule 13a-14(a)/15d-14(a) Certifications.
- 32 Section 1350 Certifications.

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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: May 9, 2007

/s/ PAUL J. DIAZ  
**Paul J. Diaz**  
**President and**  
**Chief Executive Officer**

Date: May 9, 2007

/s/ RICHARD A. LECHLEITER  
**Richard A. Lechleiter**  
**Executive Vice President and**  
**Chief Financial Officer**