

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

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2005

OR

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

For the transition period from _____ to _____.

Commission file number: 001-14057

KINDRED HEALTHCARE, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of

incorporation or organization)

680 South Fourth Street

61-1323993
(I.R.S. Employer

Identification No.)

40202-2412

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Louisville, KY
(Address of principal executive offices)

(Zip Code)

(502) 596-7300

(Registrant's telephone number, including area code)

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

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

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

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

| <u>Class of Common Stock</u> | <u>Outstanding at July 31, 2005</u> |
|--------------------------------|-------------------------------------|
| Common stock, \$0.25 par value | 38,671,316 shares |

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

| | Three months ended | | Six months ended | |
|--|--------------------|------------------|-------------------|------------------|
| | June 30, | | June 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Revenues | \$ 1,045,923 | \$ 885,819 | \$ 1,985,912 | \$ 1,743,834 |
| Salaries, wages and benefits | 542,416 | 486,542 | 1,057,436 | 970,591 |
| Supplies | 146,043 | 119,442 | 274,326 | 234,938 |
| Rent | 69,579 | 65,121 | 137,575 | 128,740 |
| Other operating expenses | 179,200 | 147,300 | 331,367 | 289,621 |
| Depreciation and amortization | 25,586 | 22,241 | 49,700 | 43,802 |
| Interest expense | 2,439 | 4,713 | 4,439 | 8,367 |
| Investment income | (3,031) | (1,823) | (5,379) | (3,037) |
| | <u>962,232</u> | <u>843,536</u> | <u>1,849,464</u> | <u>1,673,022</u> |
| Income from continuing operations before reorganization items and income taxes | 83,691 | 42,283 | 136,448 | 70,812 |
| Reorganization items | | (304) | (1,371) | (304) |
| Income from continuing operations before income taxes | 83,691 | 42,587 | 137,819 | 71,116 |
| Provision for income taxes | 33,673 | 17,533 | 55,541 | 29,529 |
| Income from continuing operations | 50,018 | 25,054 | 82,278 | 41,587 |
| Discontinued operations, net of income taxes: | | | | |
| Income (loss) from operations | 13,402 | (2,222) | 18,032 | (4,915) |
| Gain (loss) on divestiture of operations | 2,647 | (1,063) | 2,647 | (1,063) |
| Net income | <u>\$ 66,067</u> | <u>\$ 21,769</u> | <u>\$ 102,957</u> | <u>\$ 35,609</u> |
| Earnings per common share: | | | | |
| Basic: | | | | |
| Income from continuing operations | \$ 1.33 | \$ 0.70 | \$ 2.23 | \$ 1.17 |
| Discontinued operations: | | | | |
| Income (loss) from operations | 0.36 | (0.06) | 0.49 | (0.14) |
| Gain (loss) on divestiture of operations | 0.07 | (0.03) | 0.07 | (0.03) |
| Net income | <u>\$ 1.76</u> | <u>\$ 0.61</u> | <u>\$ 2.79</u> | <u>\$ 1.00</u> |
| Diluted: | | | | |
| Income from continuing operations | \$ 1.08 | \$ 0.60 | \$ 1.81 | \$ 0.98 |

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| | | | | |
|---|-------------------|-------------------|-------------------|-------------------|
| Discontinued operations: | | | | |
| Income (loss) from operations | 0.29 | (0.05) | 0.40 | (0.11) |
| Gain (loss) on divestiture of operations | 0.06 | (0.03) | 0.06 | (0.03) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net income | \$ 1.43 | \$ 0.52 | \$ 2.27 | \$ 0.84 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Shares used in computing earnings per common share: | | | | |
| Basic | 37,495 | 35,536 | 36,907 | 35,475 |
| Diluted | 46,367 | 41,913 | 45,456 | 42,333 |

See accompanying notes.

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

| | June 30, | December 31, |
|--|-------------------|---------------------|
| | 2005 | 2004 |
| | <u> </u> | <u> </u> |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 33,369 | \$ 69,128 |
| Cash restricted | 5,552 | 6,054 |
| Insurance subsidiary investments | 206,561 | 238,856 |
| Accounts receivable less allowance for loss of \$69,201 June 30, 2005 and \$60,320 December 31, 2004 | 572,528 | 400,517 |
| Inventories | 40,549 | 35,025 |
| Deferred tax assets | 70,137 | 70,137 |
| Assets held for sale | 10,336 | 22,672 |
| Other | 30,785 | 31,954 |
| | <u> </u> | <u> </u> |
| | 969,817 | 874,343 |
| Property and equipment | 821,638 | 765,586 |
| Accumulated depreciation | (323,745) | (273,880) |
| | <u> </u> | <u> </u> |
| | 497,893 | 491,706 |
| Goodwill | 59,335 | 31,582 |
| Insurance subsidiary investments | 64,156 | 41,651 |
| Deferred tax assets | 91,466 | 91,180 |
| Other | 84,920 | 62,831 |
| | <u> </u> | <u> </u> |
| | \$ 1,767,587 | \$ 1,593,293 |
| | <u> </u> | <u> </u> |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 109,142 | \$ 122,176 |
| Salaries, wages and other compensation | 249,091 | 230,056 |
| Due to third party payors | 18,031 | 33,910 |
| Professional liability risks | 69,678 | 82,609 |
| Other accrued liabilities | 99,189 | 76,985 |
| Income taxes | 92,188 | 26,748 |
| Long-term debt due within one year | 5,737 | 5,282 |
| | <u> </u> | <u> </u> |
| | 643,056 | 577,766 |
| Long-term debt | 29,571 | 32,544 |
| Professional liability risks | 187,629 | 204,713 |
| Deferred credits and other liabilities | 62,108 | 58,485 |
| Commitments and contingencies | | |

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Stockholders' equity:

| | | | |
|---|-------------------|---------------------|---------------------|
| Common stock, \$0.25 par value; authorized 175,000 shares; issued 38,709 shares | June 30, 2005 | 9,677 | 9,297 |
| shares | December 31, 2004 | | |
| Capital in excess of par value | | 662,873 | 636,015 |
| Deferred compensation | | (9,687) | (7,353) |
| Accumulated other comprehensive income (loss) | | (30) | 468 |
| Retained earnings | | 182,390 | 81,358 |
| | | <u>845,223</u> | <u>719,785</u> |
| | | <u>\$ 1,767,587</u> | <u>\$ 1,593,293</u> |

See accompanying notes.

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

| | Three months ended | | Six months ended | |
|---|--------------------|-----------------|------------------|-----------------|
| | June 30, | | June 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Cash flows from operating activities: | | | | |
| Net income | \$ 66,067 | \$ 21,769 | \$ 102,957 | \$ 35,609 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Depreciation and amortization | 25,586 | 22,613 | 49,700 | 44,659 |
| Amortization of deferred compensation costs | 2,084 | 1,535 | 3,996 | 3,278 |
| Provision for doubtful accounts | 4,487 | 5,134 | 9,474 | 13,250 |
| (Gain) loss on divestiture of discontinued operations | (2,647) | 1,063 | (2,647) | 1,063 |
| Reorganization items | | (304) | (1,371) | (304) |
| Other | (1,012) | 5,040 | (1,198) | 4,938 |
| Change in operating assets and liabilities: | | | | |
| Accounts receivable | (106,228) | 39,247 | (165,360) | (15,057) |
| Inventories and other assets | 4,840 | 4,221 | (5,519) | (5,247) |
| Accounts payable | 2,708 | (1,625) | 263 | (4,809) |
| Income taxes | 38,552 | 13,823 | 63,884 | 23,735 |
| Due to third party payors | (5,300) | (11,797) | (15,879) | (15,534) |
| Other accrued liabilities | 9,534 | 15,543 | 18,325 | 6,481 |
| Net cash provided by operating activities | 38,671 | 116,262 | 56,625 | 92,062 |
| Cash flows from investing activities: | | | | |
| Purchase of property and equipment | (28,598) | (17,657) | (46,561) | (35,538) |
| Acquisition of healthcare facilities | (46,277) | (8,346) | (73,877) | (8,346) |
| Acquisition deposit | 31,500 | | | |
| Sale of assets | 10,049 | 6,514 | 11,104 | 6,884 |
| Surety bond deposits | 2,700 | 4,402 | 2,700 | 4,402 |
| Purchase of insurance subsidiary investments | (91,312) | (4,767) | (205,196) | (14,543) |
| Sale of insurance subsidiary investments | 105,771 | 8,209 | 190,362 | 13,881 |
| Net change in insurance subsidiary cash and cash equivalents | 11,286 | (18,395) | 24,397 | (35,215) |
| Net change in other investments | 3,719 | 2,628 | 3,719 | 4,405 |
| Other | (94) | 236 | (193) | 374 |
| Net cash used in investing activities | (1,256) | (27,176) | (93,545) | (63,696) |
| Cash flows from financing activities: | | | | |
| Net change in revolving credit borrowings | (25,200) | 63,100 | | 80,000 |
| Repayment of long-term debt | (1,302) | (101,615) | (2,518) | (102,647) |
| Payment of deferred financing costs | (165) | (3,355) | (203) | (3,355) |
| Issuance of common stock | 6,036 | 3,049 | 22,735 | 3,516 |

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| | | | | |
|---|-----------|-----------|-----------|-----------|
| Other | 1,014 | (3,023) | (18,853) | (7,335) |
| Net cash (used in) provided by financing activities | (19,617) | (41,844) | 1,161 | (29,821) |
| Change in cash and cash equivalents | 17,798 | 47,242 | (35,759) | (1,455) |
| Cash and cash equivalents at beginning of period | 15,571 | 17,827 | 69,128 | 66,524 |
| Cash and cash equivalents at end of period | \$ 33,369 | \$ 65,069 | \$ 33,369 | \$ 65,069 |
| Supplemental information: | | | | |
| Interest payments | \$ 1,477 | \$ 3,469 | \$ 2,511 | \$ 6,741 |
| Income tax payments | 3,512 | 2,319 | 2,946 | 2,717 |

See accompanying notes.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 BASIS OF PRESENTATION

Business

Kindred Healthcare, Inc. (Kindred or the Company) through its subsidiaries operates hospitals, nursing centers, institutional pharmacies and a contract rehabilitation services business across the United States. At June 30, 2005, the Company s hospital division operated 73 hospitals in 24 states. The Company s health services division operated 248 nursing centers in 29 states. The Company s pharmacy division operated an institutional pharmacy business with 38 pharmacies in 23 states and a pharmacy management business servicing substantially all of the Company s hospitals. The Company also operated a contract rehabilitation services business which began operating as a separate division on January 1, 2004.

During 2004 and 2003, the Company completed several transactions related to the divestiture of unprofitable hospitals, nursing centers and other healthcare businesses. For accounting purposes, the operating results of these businesses and the losses associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at June 30, 2005 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet. See Note 2.

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

Impact of Recent Accounting Pronouncement

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

Stock Option Accounting

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

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

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

| | Three months ended | | Six months ended | |
|--|---------------------------|------------------|-------------------------|------------------|
| | June 30, | | June 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Net income, as reported | \$ 66,067 | \$ 21,769 | \$ 102,957 | \$ 35,609 |
| Adjustments: | | | | |
| Stock-based employee compensation expense included in reported net income | 1,287 | 976 | 2,478 | 2,082 |
| Stock-based employee compensation expense determined under fair value based method | (3,100) | (2,522) | (6,027) | (5,302) |
| Pro forma net income | \$ 64,254 | \$ 20,223 | \$ 99,408 | \$ 32,389 |
| Earnings per common share: | | | | |
| As reported: | | | | |
| Basic | \$ 1.76 | \$ 0.61 | \$ 2.79 | \$ 1.00 |
| Diluted | \$ 1.43 | \$ 0.52 | \$ 2.27 | \$ 0.84 |
| Pro forma: | | | | |
| Basic | \$ 1.71 | \$ 0.57 | \$ 2.69 | \$ 0.91 |
| Diluted | \$ 1.34 | \$ 0.47 | \$ 2.12 | \$ 0.75 |

Comprehensive income

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

Six months ended

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| | Three months ended | | June 30, | |
|---|--------------------|-----------|------------|-----------|
| | June 30, | | | |
| | 2005 | 2004 | 2005 | 2004 |
| Net income | \$ 66,067 | \$ 21,769 | \$ 102,957 | \$ 35,609 |
| Net unrealized investment losses, net of income taxes | (36) | (638) | (498) | (490) |
| Comprehensive income | \$ 66,031 | \$ 21,131 | \$ 102,459 | \$ 35,119 |

Other information

The accompanying unaudited condensed consolidated financial statements do not include all of the disclosures normally required by generally accepted accounting principles or those normally required in annual reports on Form 10-K. Accordingly, these financial statements should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2004 filed with the SEC on Form 10-K.

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

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

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

NOTE 2 DISCONTINUED OPERATIONS

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the divestitures discussed in Note 1 have been accounted for as discontinued operations. Accordingly, the results of operations of these businesses for all periods presented and the losses related to these divestitures have been classified as discontinued operations, net of income taxes, in the accompanying unaudited condensed consolidated statement of operations. At June 30, 2005, the Company held for sale two hospitals and one nursing center.

Discontinued operations included a favorable pretax adjustment of \$23.0 million for the second quarter of 2005 and \$32.6 million for the six months ended June 30, 2005 resulting from a change in estimate for professional liability reserves related to the Company's former nursing centers in Florida and Texas.

Net gains associated with the divestiture of discontinued operations totaled \$2.7 million in the second quarter of 2005 compared to net losses of \$1.1 million in the second quarter of 2004.

A summary of discontinued operations follows (in thousands):

| | Three months ended | | Six months ended | |
|----------|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Revenues | \$ 3,048 | \$ 26,378 | \$ 9,567 | \$ 55,903 |

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| | | | | |
|---|-----------|------------|-----------|------------|
| Salaries, wages and benefits | 1,723 | 17,598 | 6,188 | 37,643 |
| Supplies | 560 | 1,935 | 1,496 | 3,982 |
| Rent | 197 | 1,060 | 427 | 2,183 |
| Other operating expenses (income) | (21,058) | 9,212 | (27,533) | 19,644 |
| Depreciation | | 372 | | 857 |
| Interest expense | | | | 2 |
| Investment income | (167) | (186) | (332) | (416) |
| | (18,745) | 29,991 | (19,754) | 63,895 |
| Income (loss) from operations before income taxes | 21,793 | (3,613) | 29,321 | (7,992) |
| Income tax provision (benefit) | 8,391 | (1,391) | 11,289 | (3,077) |
| Income (loss) from operations | 13,402 | (2,222) | 18,032 | (4,915) |
| Gain (loss) on divestiture of operations, net of income taxes | 2,647 | (1,063) | 2,647 | (1,063) |
| | \$ 16,049 | \$ (3,285) | \$ 20,679 | \$ (5,978) |

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

| | Three months ended | | Six months ended | |
|---------------------------------|--------------------|-------------------|------------------|-------------------|
| | June 30, | | June 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Revenues: | | | | |
| Hospital division: | | | | |
| Hospitals | \$ 3,083 | \$ 7,337 | \$ 8,724 | \$ 14,868 |
| Ancillary services | 5 | (5) | 11 | (96) |
| | <u>3,088</u> | <u>7,332</u> | <u>8,735</u> | <u>14,772</u> |
| Health services division | (40) | 19,078 | 832 | 41,195 |
| Pharmacy division | | (32) | | (64) |
| | <u>\$ 3,048</u> | <u>\$ 26,378</u> | <u>\$ 9,567</u> | <u>\$ 55,903</u> |
| Operating income (loss): | | | | |
| Hospital division: | | | | |
| Hospitals | \$ 145 | \$ (653) | \$ 157 | \$ (2,420) |
| Ancillary services | 5 | 35 | 11 | (151) |
| | <u>150</u> | <u>(618)</u> | <u>168</u> | <u>(2,571)</u> |
| Health services division | 21,671 | (1,852) | 29,238 | (2,971) |
| Pharmacy division | 2 | 103 | 10 | 176 |
| | <u>\$ 21,823</u> | <u>\$ (2,367)</u> | <u>\$ 29,416</u> | <u>\$ (5,366)</u> |
| Rent: | | | | |
| Hospital division: | | | | |
| Hospitals | \$ 31 | \$ 404 | \$ 81 | \$ 817 |
| Ancillary services | | (9) | | (14) |
| | <u>31</u> | <u>395</u> | <u>81</u> | <u>803</u> |
| Health services division | 166 | 662 | 346 | 1,333 |

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| | | | | |
|--------------------------|--------|----------|--------|----------|
| Pharmacy division | | 3 | | 47 |
| | \$ 197 | \$ 1,060 | \$ 427 | \$ 2,183 |
| Depreciation: | | | | |
| Hospital division: | | | | |
| Hospitals | \$ | \$ 216 | \$ | \$ 423 |
| Ancillary services | | | | |
| | | 216 | | 423 |
| Health services division | | 156 | | 434 |
| Pharmacy division | | | | |
| | \$ | \$ 372 | \$ | \$ 857 |

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

| | June 30, | December 31, |
|---|-------------------|---------------------|
| | 2005 | 2004 |
| | <u> </u> | <u> </u> |
| Current assets: | | |
| Property and equipment, net | \$ 9,813 | \$ 18,793 |
| Other | 523 | 3,879 |
| | <u>10,336</u> | <u>22,672</u> |
| Current liabilities (included in other accrued liabilities) | (121) | (1,245) |
| | <u>\$ 10,215</u> | <u>\$ 21,427</u> |

NOTE 3 SIGNIFICANT QUARTERLY ADJUSTMENTS

Operating results for the second quarter of 2005 included pretax income of \$54.6 million related primarily to the settlement of a prior year hospital Medicare cost report issue which was under appeal. For the six months ended June 30, 2005, the Company recorded pretax income of approximately \$57.5 million related to the settlement of prior year hospital Medicare cost report issues. For the second quarter and six months ended June 30, 2004, the Company recorded pretax income of approximately \$3.9 million and \$6.1 million, respectively, related to settlements of prior year hospital Medicare cost reports.

Operating results for the second quarter of 2005 also included pretax charges of \$15.0 million related to a special recognition payment to non-executive caregivers and employees and \$5.0 million related to a charitable donation. The allocation of these costs by segment follows (in thousands):

| | Recognition | Charitable |
|-------------------|--------------------|-------------------|
| | payment | donation |
| | <u> </u> | <u> </u> |
| Hospital division | \$ 3,863 | \$ |

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| | | |
|--------------------------|---------------|--------------|
| Health services division | 9,215 | |
| Rehabilitation division | 1,039 | |
| Pharmacy division | 658 | |
| Corporate | 225 | 5,000 |
| | <u>15,000</u> | <u>5,000</u> |
| | \$ 15,000 | \$ 5,000 |

Operating results for the second quarter of 2005 also included pretax income of \$15.9 million related to recently approved retroactive nursing center Medicaid rate increases in the state of Indiana, of which approximately \$2.1 million related to the first quarter of 2005 and approximately \$13.8 million related to prior years. Operating results for the second quarter of 2004 included pretax income of \$5.9 million related to retroactive nursing center Medicaid rate increases in the state of North Carolina, approximately one-half of which related to the first quarter of 2004 and one-half of which related to the fourth quarter of 2003.

Interest expense in the second quarter of 2004 included a pretax charge of \$1.2 million resulting from the refinancing of the Company's credit facilities.

Second quarter 2004 pretax income also included \$0.6 million of investment income resulting from the recovery of certain surety deposits.

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 4 REORGANIZATION ITEMS**

Transactions related to the Plan of Reorganization have been classified separately in the accompanying unaudited condensed consolidated statement of operations. Operating results for the six months ended June 30, 2005 included income of \$1.4 million resulting from changes in estimates for accrued professional and administrative costs in connection with the completion of legal proceedings related to the Plan of Reorganization in March 2005. Operating results for the second quarter of 2004 included a favorable adjustment of \$0.3 million related to accrued reorganization costs.

NOTE 5 PHARMACY ACQUISITIONS

On March 2, 2005, the Company acquired the assets of Pharmacy Partners, Inc., an operator of two institutional pharmacies in Pennsylvania (the PPI Acquisition). The transaction was financed through the use of existing cash. Goodwill recorded in connection with the PPI Acquisition aggregated \$10.7 million. The purchase price also included acquired identifiable intangible assets totaling \$11.3 million that will be amortized over approximately 12 years. Additional adjustments to the purchase price of up to \$1.0 million may occur through September 2006 as a result of contingent consideration in accordance with the acquisition agreement.

On April 1, 2005, the Company acquired the assets of Skilled Care Pharmacy, an operator of two institutional pharmacies in California (the SCP Acquisition). The transaction was financed through the use of existing cash and the Company's revolving credit facility. Goodwill recorded in connection with the SCP Acquisition aggregated \$16.6 million. The purchase price also included acquired identifiable intangible assets totaling \$10.4 million that will be amortized over approximately 13 years.

A preliminary summary of both the PPI Acquisition and the SCP Acquisition follows (in thousands):

| | PPI | SCP |
|---|--------------------|--------------------|
| | Acquisition | Acquisition |
| | <u> </u> | <u> </u> |
| Fair value of assets acquired, including goodwill and other intangible assets | \$ 31,086 | \$ 37,479 |
| Fair value of liabilities assumed | (214) | (773) |
| | <u> </u> | <u> </u> |
| Net cash paid | <u>\$ 30,872</u> | <u>\$ 36,706</u> |

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The purchase price of the assets acquired in both the PPI Acquisition and the SCP Acquisition resulted from negotiations with each respective seller and their shareholders that were based upon both the historical and expected future cash flows of the enterprise.

The operating results of these acquisitions have been included in the accompanying unaudited condensed consolidated financial statements of the Company since the respective acquisition dates.

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****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):

| | Three months ended | | Six months ended | |
|-------------------|---------------------|-------------------|---------------------|---------------------|
| | June 30, | | June 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Medicare | \$ 468,309 | \$ 376,767 | \$ 882,325 | \$ 763,591 |
| Medicaid | 341,154 | 294,046 | 628,543 | 557,767 |
| Private and other | 318,387 | 269,038 | 636,973 | 530,285 |
| | <u>1,127,850</u> | <u>939,851</u> | <u>2,147,841</u> | <u>1,851,643</u> |
| Eliminations: | | | | |
| Rehabilitation | (50,137) | (36,579) | (99,682) | (72,602) |
| Pharmacy | (31,790) | (17,453) | (62,247) | (35,207) |
| | <u>(81,927)</u> | <u>(54,032)</u> | <u>(161,929)</u> | <u>(107,809)</u> |
| | <u>\$ 1,045,923</u> | <u>\$ 885,819</u> | <u>\$ 1,985,912</u> | <u>\$ 1,743,834</u> |

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

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 7 EARNINGS PER SHARE (Continued)**

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

| | Three months ended | | Six months ended | |
|---|--------------------|------------------|-------------------|------------------|
| | June 30, | | June 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Earnings: | | | | |
| Income from continuing operations | \$ 50,018 | \$ 25,054 | \$ 82,278 | \$ 41,587 |
| Discontinued operations, net of income taxes: | | | | |
| Income (loss) from operations | 13,402 | (2,222) | 18,032 | (4,915) |
| Gain (loss) on divestiture of operations | 2,647 | (1,063) | 2,647 | (1,063) |
| Net income | \$ 66,067 | \$ 21,769 | \$ 102,957 | \$ 35,609 |
| Shares used in the computation: | | | | |
| Weighted average shares outstanding basic computation | 37,495 | 35,536 | 36,907 | 35,475 |
| Dilutive effect of certain securities: | | | | |
| Warrants | 7,201 | 4,905 | 6,937 | 5,305 |
| Employee stock options | 1,146 | 917 | 1,069 | 1,005 |
| Non-vested restricted stock | 525 | 555 | 543 | 548 |
| Adjusted weighted average shares outstanding diluted computation | 46,367 | 41,913 | 45,456 | 42,333 |
| Earnings per common share: | | | | |
| Basic: | | | | |
| Income from continuing operations | \$ 1.33 | \$ 0.70 | \$ 2.23 | \$ 1.17 |
| Discontinued operations: | | | | |
| Income (loss) from operations | 0.36 | (0.06) | 0.49 | (0.14) |
| Gain (loss) on divestiture of operations | 0.07 | (0.03) | 0.07 | (0.03) |
| Net income | \$ 1.76 | \$ 0.61 | \$ 2.79 | \$ 1.00 |
| Diluted: | | | | |
| Income from continuing operations | \$ 1.08 | \$ 0.60 | \$ 1.81 | \$ 0.98 |
| Discontinued operations: | | | | |
| Income (loss) from operations | 0.29 | (0.05) | 0.40 | (0.11) |
| Gain (loss) on divestiture of operations | 0.06 | (0.03) | 0.06 | (0.03) |

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| | | | | |
|------------|---------|---------|---------|---------|
| Net income | \$ 1.43 | \$ 0.52 | \$ 2.27 | \$ 0.84 |
|------------|---------|---------|---------|---------|

NOTE 8 BUSINESS SEGMENT DATA

The Company operates four business segments: the hospital division, the health services division, the rehabilitation division and the pharmacy division. The hospital division operates long-term acute care hospitals. The health services division operates nursing centers. The rehabilitation division provides rehabilitation services primarily to nursing centers and long-term acute care hospitals. The pharmacy division provides pharmacy services to nursing centers and other healthcare providers. The Company defines operating income as earnings before interest, income taxes, depreciation, amortization and rent. Operating income reported for each of the Company's business segments excludes the allocation of corporate overhead.

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

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

The Company identifies its segments in accordance with the aggregation provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. This information is consistent with information used by the Company in managing its businesses and aggregates businesses with similar economic characteristics. The information provided in Note 8 should be read in conjunction with the discussion and analysis contained in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

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

| | Three months ended | | Six months ended | |
|---|---------------------|-------------------|---------------------|---------------------|
| | June 30, | | June 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Revenues: | | | | |
| Hospital division | \$ 434,562 | \$ 350,097 | \$ 827,602 | \$ 693,446 |
| Health services division | 496,074 | 452,820 | 950,121 | 888,818 |
| Rehabilitation division | 65,365 | 52,588 | 130,312 | 105,287 |
| Pharmacy division | 131,849 | 84,346 | 239,806 | 164,092 |
| | <u>1,127,850</u> | <u>939,851</u> | <u>2,147,841</u> | <u>1,851,643</u> |
| Eliminations: | | | | |
| Rehabilitation | (50,137) | (36,579) | (99,682) | (72,602) |
| Pharmacy | (31,790) | (17,453) | (62,247) | (35,207) |
| | <u>(81,927)</u> | <u>(54,032)</u> | <u>(161,929)</u> | <u>(107,809)</u> |
| | <u>\$ 1,045,923</u> | <u>\$ 885,819</u> | <u>\$ 1,985,912</u> | <u>\$ 1,743,834</u> |
| Income from continuing operations: | | | | |
| Operating income (loss): | | | | |
| Hospital division | \$ 134,263 | \$ 86,120 | \$ 236,064 | \$ 165,807 |
| Health services division | 64,383 | 63,001 | 117,404 | 111,946 |

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| | | | | |
|---|------------------|------------------|------------------|------------------|
| Rehabilitation division | 6,989 | 7,265 | 16,700 | 15,784 |
| Pharmacy division | 13,298 | 7,729 | 24,752 | 15,338 |
| Corporate: | | | | |
| Overhead | (38,052) | (30,356) | (67,167) | (57,190) |
| Insurance subsidiary | (2,617) | (1,224) | (4,970) | (3,001) |
| | <u>(40,669)</u> | <u>(31,580)</u> | <u>(72,137)</u> | <u>(60,191)</u> |
| | 178,264 | 132,535 | 322,783 | 248,684 |
| Reorganization items | | 304 | 1,371 | 304 |
| | <u>178,264</u> | <u>132,839</u> | <u>324,154</u> | <u>248,988</u> |
| Operating income | 178,264 | 132,839 | 324,154 | 248,988 |
| Rent | (69,579) | (65,121) | (137,575) | (128,740) |
| Depreciation and amortization | (25,586) | (22,241) | (49,700) | (43,802) |
| Interest, net | 592 | (2,890) | 940 | (5,330) |
| | <u>83,691</u> | <u>42,587</u> | <u>137,819</u> | <u>71,116</u> |
| Income from continuing operations before income taxes | 83,691 | 42,587 | 137,819 | 71,116 |
| Provision for income taxes | 33,673 | 17,533 | 55,541 | 29,529 |
| | <u>\$ 50,018</u> | <u>\$ 25,054</u> | <u>\$ 82,278</u> | <u>\$ 41,587</u> |

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

| | Three months ended | | Six months ended | |
|--|---------------------------|------------------|-------------------------|---------------------|
| | June 30, | | June 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Rent: | | | | |
| Hospital division | \$ 25,244 | \$ 23,168 | \$ 49,961 | \$ 45,656 |
| Health services division | 42,225 | 40,398 | 83,711 | 80,197 |
| Rehabilitation division | 817 | 708 | 1,617 | 1,319 |
| Pharmacy division | 1,169 | 790 | 2,095 | 1,452 |
| Corporate | 124 | 57 | 191 | 116 |
| | <u>\$ 69,579</u> | <u>\$ 65,121</u> | <u>\$ 137,575</u> | <u>\$ 128,740</u> |
| Depreciation and amortization: | | | | |
| Hospital division | \$ 9,836 | \$ 8,496 | \$ 19,390 | \$ 16,753 |
| Health services division | 8,287 | 6,796 | 16,109 | 13,411 |
| Rehabilitation division | 56 | 37 | 110 | 70 |
| Pharmacy division | 1,521 | 583 | 2,447 | 1,113 |
| Corporate | 5,886 | 6,329 | 11,644 | 12,455 |
| | <u>\$ 25,586</u> | <u>\$ 22,241</u> | <u>\$ 49,700</u> | <u>\$ 43,802</u> |
| Capital expenditures, excluding acquisitions (including discontinued operations): | | | | |
| Hospital division | \$ 11,289 | \$ 5,177 | \$ 19,524 | \$ 10,583 |
| Health services division | 10,986 | 6,487 | 17,943 | 14,937 |
| Rehabilitation division | 96 | 56 | 98 | 103 |
| Pharmacy division | 1,506 | 1,075 | 2,581 | 1,848 |
| Corporate: | | | | |
| Information systems | 4,171 | 4,033 | 5,633 | 6,684 |
| Other | 550 | 829 | 782 | 1,383 |
| | <u>\$ 28,598</u> | <u>\$ 17,657</u> | <u>\$ 46,561</u> | <u>\$ 35,538</u> |
| | | | June 30, | December 31, |
| | | | 2005 | 2004 |

Assets at end of period:

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| | | |
|--------------------------|---------------------|---------------------|
| Hospital division | \$ 607,098 | \$ 515,353 |
| Health services division | 411,711 | 366,164 |
| Rehabilitation division | 8,071 | 7,701 |
| Pharmacy division | 149,468 | 60,146 |
| Corporate | 591,239 | 643,929 |
| | <u>\$ 1,767,587</u> | <u>\$ 1,593,293</u> |
| Goodwill: | | |
| Hospital division | \$ 30,877 | \$ 30,877 |
| Pharmacy division | 28,458 | 705 |
| | <u>\$ 59,335</u> | <u>\$ 31,582</u> |

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.

As a result of improved professional liability underwriting results of the Company's limited purpose insurance subsidiary, the Company received a return of capital of approximately \$30 million from its limited purpose insurance subsidiary during the second quarter of 2005 to be used for general corporate purposes.

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

| | Three months ended | | Six months ended | |
|--------------------------------|---------------------------|-------------|-------------------------|-------------|
| | June 30, | | June 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Professional liability: | | | | |
| Continuing operations | \$ 20,497 | \$ 20,176 | \$ 42,469 | \$ 42,586 |
| Discontinued operations | (22,548) | 1,741 | (31,681) | 3,620 |
| Workers compensation: | | | | |
| Continuing operations | \$ 12,653 | \$ 12,697 | \$ 25,779 | \$ 25,038 |
| Discontinued operations | 137 | 806 | 275 | 1,567 |

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

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

| | June 30, 2005 | | | December 31, 2004 | | |
|----------------------------------|-------------------|------------------|-------------------|-------------------|------------------|-------------------|
| | Professional | Workers | Total | Professional | Workers | Total |
| | liability | compensation | | liability | compensation | |
| Assets: | | | | | | |
| Current: | | | | | | |
| Insurance subsidiary investments | \$ 119,732 | \$ 86,829 | \$ 206,561 | \$ 172,266 | \$ 66,590 | \$ 238,856 |
| Reinsurance recoverables | 2,871 | | 2,871 | 2,103 | | 2,103 |
| | <u>122,603</u> | <u>86,829</u> | <u>209,432</u> | <u>174,369</u> | <u>66,590</u> | <u>240,959</u> |
| Non-current: | | | | | | |
| Insurance subsidiary investments | 64,156 | | 64,156 | 41,651 | | 41,651 |
| Reinsurance recoverables | 7,978 | | 7,978 | 8,306 | | 8,306 |
| Deposits | 7,250 | 1,711 | 8,961 | 6,750 | 1,705 | 8,455 |
| Other | 5 | 125 | 130 | 6 | 160 | 166 |
| | <u>79,389</u> | <u>1,836</u> | <u>81,225</u> | <u>56,713</u> | <u>1,865</u> | <u>58,578</u> |
| | <u>\$ 201,992</u> | <u>\$ 88,665</u> | <u>\$ 290,657</u> | <u>\$ 231,082</u> | <u>\$ 68,455</u> | <u>\$ 299,537</u> |
| Liabilities: | | | | | | |
| Allowance for insurance risks: | | | | | | |
| Current | \$ 69,678 | \$ 23,923 | \$ 93,601 | \$ 82,609 | \$ 23,571 | \$ 106,180 |
| Non-current | 187,629 | 52,091 | 239,720 | 204,713 | 48,724 | 253,437 |
| | <u>\$ 257,307</u> | <u>\$ 76,014</u> | <u>\$ 333,321</u> | <u>\$ 287,322</u> | <u>\$ 72,295</u> | <u>\$ 359,617</u> |

Provisions for loss for professional liability risks retained by the limited purpose insurance subsidiary have been discounted based upon management's estimate of long-term investment yields and independent actuarial estimates of claim payment patterns. The interest rate used to discount funded professional liability risks in each period presented was 5%. 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,

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these balances would have approximated \$270.7 million at June 30, 2005 and \$302.3 million at December 31, 2004.

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.

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 10 LEASES**

The Company leases real estate and equipment under cancelable and non-cancelable arrangements. The following table sets forth rent expense by business segment (in thousands):

| | Three months ended | | Six months ended | |
|---------------------------|--------------------|------------------|-------------------|-------------------|
| | June 30, | | June 30, | |
| | 2005 | 2004 | 2005 | 2004 |
| Hospital division: | | | | |
| Buildings: | | | | |
| Ventas, Inc. (Ventas) | \$ 15,851 | \$ 15,159 | \$ 31,355 | \$ 29,972 |
| Other landlords | 3,681 | 2,893 | 7,253 | 5,692 |
| Equipment | 5,712 | 5,116 | 11,353 | 9,992 |
| | <u>25,244</u> | <u>23,168</u> | <u>49,961</u> | <u>45,656</u> |
| Health services division: | | | | |
| Buildings: | | | | |
| Ventas | 31,565 | 30,191 | 62,444 | 59,694 |
| Other landlords | 9,838 | 9,432 | 19,735 | 18,974 |
| Equipment | 822 | 775 | 1,532 | 1,529 |
| | <u>42,225</u> | <u>40,398</u> | <u>83,711</u> | <u>80,197</u> |
| Rehabilitation division: | | | | |
| Buildings | 20 | 18 | 35 | 37 |
| Equipment | 797 | 690 | 1,582 | 1,282 |
| | <u>817</u> | <u>708</u> | <u>1,617</u> | <u>1,319</u> |
| Pharmacy division: | | | | |
| Buildings | 999 | 690 | 1,776 | 1,253 |
| Equipment | 170 | 100 | 319 | 199 |
| | <u>1,169</u> | <u>790</u> | <u>2,095</u> | <u>1,452</u> |
| Corporate: | | | | |
| Buildings | 112 | 48 | 167 | 99 |
| Equipment | 12 | 9 | 24 | 17 |
| | <u>124</u> | <u>57</u> | <u>191</u> | <u>116</u> |
| | <u>\$ 69,579</u> | <u>\$ 65,121</u> | <u>\$ 137,575</u> | <u>\$ 128,740</u> |

Under the Plan of Reorganization, the Company assumed the original master lease agreements with Ventas and its affiliates and simultaneously amended and restated the agreements into four new master leases (the Master Leases). Under the Master Leases, Ventas has a right to sever properties from the existing leases in order to create additional leases, a device adopted to facilitate its financing flexibility. In such circumstances, the aggregate lease obligations remain unchanged. Ventas exercised this severance right in December 2001 with respect to Master Lease No. 1 to create a new lease of 40 nursing centers (the CMBS Lease) and mortgaged these properties in connection with a securitized mortgage financing. In September 2004, Ventas exercised this severance right with respect to Master Lease No. 1 to create a new lease of one hospital and seven nursing centers (Master Lease No. 1A). The CMBS Lease and Master Lease No. 1A are in substantially the same form as the other Master Leases with certain modifications requested by Ventas's lenders and required to be made by the Company pursuant to the Master Leases.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 10 LEASES (Continued)

The Master Leases, the CMBS Lease and Master Lease No. 1A are referred to collectively as, the Master Lease Agreements. At June 30, 2005, the Company leased from Ventas 39 long-term acute care hospitals and 186 nursing centers.

Ventas has a one-time option to reset the rent and the related rent escalators under each of its original Master Leases with the Company to the Fair Market Rental of the leased properties. Fair Market Rental is determined through an appraisal procedure set forth in the Master Leases.

Generally, the Master Leases provide that Ventas can initiate the rent reset procedure under each Master Lease at any time between January 20, 2006 and July 19, 2007 by delivering a notice to the Company proposing the Fair Market Rental (as described below) for the balance of the lease term (the Reset Proposal Notice). If the Company and Ventas are unable to reach an agreement on the Fair Market Rental within 30 days following delivery of the Reset Proposal Notice, the Company and Ventas each must select an appraiser. These two appraisers then will have ten days to select a third independent appraiser (the Independent Appraiser). The Independent Appraiser will have 60 days to complete its determination of Fair Market Rental and the annual rent escalator, which determination will be final and binding on the parties. Within 30 days following the Independent Appraiser's determination, Ventas may elect to exercise its right to reset Fair Market Rental by sending the Company a final exercise notice (the Final Exercise Notice).

Alternatively, Ventas may decide not to exercise its rental reset option, in which event the rent and the existing 3 1/2% contingent annual escalator would remain at their then current levels under the Master Leases. Provided that Ventas exercises its reset right in accordance with the Master Leases, the rent reset will become effective on the later of July 19, 2006 or the date of delivery of the Reset Proposal Notice, which can be no later than July 19, 2007.

As a condition to exercising its rent reset right, upon delivery of the Final Exercise Notice, Ventas is required to pay the Company a reset fee equal to a prorated portion of \$5 million based upon the proportion of base rent payable under the Master Lease(s) with respect to which rent is reset to the total base rent payable under all of the Master Leases.

Fair Market Rental is generally defined under the Master Leases as the amount (including escalations) that a willing tenant would pay, and a willing landlord would accept, for leasing the leased properties for the term (including renewal terms). Fair Market Rental is to be determined on the basis of certain assumptions, including (1) all leased properties are in good condition and repair (given their respective ages and prevailing healthcare industry standards with respect to what is considered good condition and repair), without any deferred maintenance (but allowing for ordinary wear and tear), (2) all leased properties are in material compliance with applicable laws and have all authorizations necessary for use as a nursing center or hospital, as applicable, and (3) the replacement cost of the leased properties are not determinative of Fair Market Rental. In addition, Fair Market Rental shall take into account market conditions, market levels of earnings before interest, income taxes, depreciation, amortization, rent and management fees (EBITDARM), the ratio of market levels of EBITDARM to market levels of rent and the actual levels of EBITDARM at the applicable leased properties, as well as historical levels of EBITDARM at the applicable leased properties (including the EBITDARM of the leased properties measured as of April 20, 2001).

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As discussed above, under the Master Leases, Ventas has a right to sever properties from the existing leases in order to create additional leases, a device adopted to facilitate its financing flexibility. For purposes of the reset right, the additional leases are disregarded and the Fair Market Rental is determined on the four original Master Leases.

Additional information regarding the Master Lease Agreements is contained in the Company's Form 10-K for the year ended December 31, 2004 and copies of the Master Lease Agreements filed with the SEC.

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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 information. 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 2 and 9.

Guarantees of indebtedness Letters of credit and guarantees of indebtedness approximated \$5.4 million at June 30, 2005.

Income taxes In November 2004, the Internal Revenue Service (the IRS) proposed certain adjustments to the Company's 2000 and 2001 federal income tax returns which the Company is contesting. The principal proposed adjustment relates to the manner of reduction of the Company's tax attributes, primarily its net operating loss carryforwards (NOLs), in connection with the Company's emergence from proceedings under the Bankruptcy Code. These proposed adjustments could have the effect of substantially eliminating the Company's NOLs.

Litigation The Company is a party to certain material litigation as well as various suits and claims arising in the ordinary course of business. See Note 12.

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 LITIGATION

Summary descriptions of various significant litigation follow.

A shareholder derivative suit entitled *Thomas G. White on behalf of Vencor, Inc. and Ventas, Inc. v. W. Bruce Lunsford, et al.*, Case No. 98CI03669, was filed on July 2, 1998 in the Jefferson County, Kentucky, Circuit Court. The suit was brought on behalf of the Company and Ventas against certain former executive officers and directors of the Company and Ventas. The complaint alleges that the defendants damaged the Company and Ventas by engaging in violations of the securities laws, engaging in insider trading, fraud and securities fraud and damaging the reputation of the Company and Ventas. The plaintiff asserts that such actions were taken deliberately, in bad faith and constitute breaches of the defendants' duties of loyalty and due care. The complaint alleges that certain of the Company's and Ventas's former executive officers during a specified time frame violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the Exchange Act), by, among other things, issuing to the investing public a series of false and misleading statements concerning

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 12 LITIGATION (Continued)

Ventas's then current operations and the inherent value of its common stock. The complaint further alleges that as a result of these purported false and misleading statements concerning Ventas's revenues and successful acquisitions, the price of its common stock was artificially inflated. In particular, the complaint alleges that the defendants issued false and misleading financial statements during the first, second and third calendar quarters of 1997 which misrepresented and understated the impact that changes in Medicare reimbursement policies would have on Ventas's core services and profitability. The complaint further alleges that the defendants issued a series of materially false statements concerning the purportedly successful integration of Ventas's acquisitions and prospective earnings per share for 1997 and 1998, which the defendants knew lacked any reasonable basis and were not being achieved. The suit seeks unspecified damages, interest, punitive damages, reasonable attorneys fees, expert witness fees and other costs, and any extraordinary equitable and/or injunctive relief permitted by law or equity to assure that the Company and Ventas have an effective remedy. In October 2002, the defendants filed a motion to dismiss for failure to prosecute the case. The court granted the motion to dismiss but the plaintiff subsequently moved the court to vacate the dismissal. The defendants filed an opposition to the plaintiff's motion to vacate the dismissal, but in August 2003 the court reinstated the lawsuit. In September 2003, the Company filed a renewed motion to dismiss, as to all defendants, based on the plaintiff's failure to make a demand for remedy upon the appropriate board of directors. On July 26, 2005, the court granted defendants' motion to dismiss based on the plaintiff's failure to make a statutorily required demand for remedy upon the appropriate board of directors. This is a final order from which the plaintiff has until August 25, 2005 to appeal. The Company believes that the allegations in the complaint are without merit and intends to defend this action vigorously.

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. In addition, there can be no assurance that 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 will not initiate additional investigations related to the Company's businesses in the future, nor can there be any assurance that the resolution of any litigation or investigations, either individually or in the aggregate, would not have a material adverse effect on the Company's financial position, results of operations and liquidity.

NOTE 13 SUBSEQUENT EVENTS

On August 2, 2005, the Company announced the completion of certain amendments to its revolving credit facility. The amendments (a) increase the amount permitted for acquisitions and certain investments by the Company from \$150 million to \$400 million, (b) provide the Company with the additional flexibility to repurchase up to \$150 million of its common stock and warrants, and (c) increase the Company's permitted capital expenditures in each fiscal year. The amendments also expand the borrowing base of the revolving credit facility to include certain additional real estate holdings. In addition, the amendments clarify certain regulatory issues and expand certain representations and covenants of the Company, none of which are expected to impact the Company's financial flexibility.

The Company also announced on August 2, 2005 that its Board of Directors has authorized up to \$100 million in common stock and warrant repurchases. The Company intends to finance any repurchases from operating cash flows or borrowings under its revolving credit facility. The authorization includes both open market purchases as well as private transactions.

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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 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, 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 Master Lease Agreements with Ventas,

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

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 the Medicare prospective payment system for long-term acute care hospitals (LTAC PPS), the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA), and changes in nursing center Medicare reimbursement resulting from revised resource utilization groupings (RUGs) payments,

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, including labor and employee benefit costs,

the Company's ability to comply with the terms of its Corporate Integrity Agreement,

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,

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,

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

Cautionary Statement (Continued)

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

the Company's ability to ensure and maintain an effective system of internal control over financial reporting.

Many of these factors are beyond the Company's control. The Company cautions investors that any forward-looking statements made by the Company are not guarantees of future performance. The Company disclaims any obligation to update any such factors or to announce publicly the results of any revisions to any of the forward-looking statements to reflect future events or developments.

General

The 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 through its subsidiaries operates hospitals, nursing centers, institutional pharmacies and a contract rehabilitation services business across the United States. At June 30, 2005, the Company's hospital division operated 73 hospitals (5,603 licensed beds) in 24 states. The Company's health services division operated 248 nursing centers (31,880 licensed beds) in 29 states. The Company's pharmacy division operated an institutional pharmacy business with 38 pharmacies in 23 states and a pharmacy management business servicing substantially all of the Company's hospitals. The Company also operated a contract rehabilitation services business which began operating as a separate division on January 1, 2004.

On July 1, 2004, the Company completed the Hospital Services Reorganization.

During 2004 and 2003, the Company effected certain strategic divestitures to improve its future operating results. For accounting purposes, the operating results of these businesses and the losses associated with these transactions have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at June 30, 2005 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet. See Note 2 of the accompanying Notes to Condensed Consolidated Financial Statements.

In April 2001, the Company and its subsidiaries emerged from proceedings under the Bankruptcy Code pursuant to the terms of the Plan of Reorganization.

Critical Accounting Policies

Management's discussion and analysis of financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that affect the reported amounts and related disclosures of commitments and contingencies. The Company relies on historical experience and 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.

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

Critical Accounting Policies (Continued)

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 reported 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 final settlements.

Operating results for the second quarter of 2005 included pretax income of \$55 million related primarily to the settlement of a prior year hospital Medicare cost report issue which was under appeal. For the six months ended June 30, 2005, the Company recorded pretax income of approximately \$58 million related to the settlement of prior year hospital Medicare cost report issues. For the second quarter and six months ended June 30, 2004, the Company recorded pretax income of approximately \$4 million and \$6 million, respectively, related to settlements of prior year hospital Medicare cost reports.

Operating results for the second quarter of 2005 also included pretax income of \$16 million related to recently approved retroactive nursing center Medicaid rate increases in the state of Indiana, of which approximately \$2 million related to the first quarter of 2005 and approximately \$14 million related to prior years. Operating results for the second quarter of 2004 included pretax income of \$6 million related to retroactive nursing center Medicaid rate increases in the state of North Carolina, approximately one-half of which related to the first quarter of 2004 and one-half of which related to the fourth quarter of 2003.

See Note 3 of the accompanying Notes to Condensed Consolidated Financial Statements.

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

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these estimates are charged or credited to the results of operations in the period of the change.

The provision for doubtful accounts totaled \$4 million and \$5 million for the second quarter of 2005 and 2004, respectively and totaled \$9 million and \$13 million for the six months ended June 30, 2005 and 2004, 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.

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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)

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.

Provisions for loss for professional liability risks retained by the limited purpose insurance subsidiary have been discounted based upon management's estimate of long-term investment yields and independent actuarial estimates of claim payment patterns. The interest rate used to discount funded professional liability risks in each period presented was 5%. 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 \$257 million at June 30, 2005 and \$287 million at December 31, 2004. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated \$271 million at June 30, 2005 and \$302 million at December 31, 2004.

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 June 30, 2005 would impact the Company's operating income by approximately \$3 million. During the second quarter and six months ended June 30, 2005, the Company recorded a favorable pretax change in estimate aggregating approximately \$23 million and \$33 million, respectively, for professional liability reserves related to its 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 and \$21 million in the second quarter of 2005 and 2004, respectively, and \$42 million and \$43 million for the six months ended June 30, 2005 and 2004, respectively.

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. The allowance for workers compensation risks aggregated \$76 million at June 30, 2005 and \$72 million at December 31, 2004. The provision for workers compensation risks, including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated \$13 million for the second quarter of both 2005 and 2004, and \$26 million and \$25 million for the six months ended June 30, 2005 and 2004, respectively.

See Note 9 of the accompanying Notes to Condensed Consolidated Financial Statements.

Accounting for income taxes

The provision for income taxes is based upon the Company's estimate of 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

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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)

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.

There are significant uncertainties with respect to professional liability costs and future government payments to both the Company's hospitals and nursing centers which, among other things, 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 approximately \$161 million at June 30, 2005 and December 31, 2004.

In November 2004, the IRS proposed certain adjustments to the Company's 2000 and 2001 federal income tax returns which the Company is contesting. The principal proposed adjustment relates to the manner of reduction of the Company's tax attributes, primarily its NOLs, in connection with the Company's emergence from proceedings under the Bankruptcy Code. These proposed adjustments could have the effect of substantially eliminating the Company's NOLs. However, management believes at this time that the ultimate resolution of these issues will not have a material adverse effect on the Company's financial position, results of operations or liquidity.

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.

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 indicate an impairment or an adjustment to the 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,

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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 the master lease agreement as the lowest level for which there are independent, identifiable cash flows. Accordingly, the estimated cash flows of all facilities within a master lease agreement are aggregated for purposes of evaluating the carrying values of long-lived assets.

In connection with SFAS No. 142, Goodwill and Other Intangible Assets, the Company is required to perform an impairment test for goodwill 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, 2004 in connection with the annual impairment test.

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

Recent Developments

Medicare payments to the Company's nursing centers are based upon certain RUGs payment rates developed by CMS that provide various levels of reimbursement based upon patient acuity. On July 28, 2005, CMS published the final rules related to revised payment rates to nursing centers. Among other things, the final rules provide for a 3.1% inflation update to all RUGs categories effective October 1, 2005. Based upon current Part A Medicare payment rates, the Company expects that these rates will increase from approximately \$348 per patient day to approximately \$358 per patient day on October 1, 2005.

In addition, the final rules increase the indexing of RUGs categories, expand the total RUGs categories from 44 to 53 and eliminate the 20% payment add-on for the care of higher acuity patients that had been in effect since 2000 under the Balanced Budget Refinement Act (the BBRA). These changes are expected to reduce Medicare Part A per diem rates to the Company's nursing centers from \$358 per patient day to approximately \$343 per patient day beginning on January 1, 2006.

On April 25, 2005, CMS published the proposed rules related to the weights for diagnosis related groups (DRGs) and the geometric length-of-stay thresholds that would take effect for hospital Medicare discharges occurring on or after October 1, 2005. Following a public comment period, CMS issued these rules in their final form on August 1, 2005. In connection with the final rules, CMS estimated that these changes could result in an aggregate reduction in payments to long-term acute care hospitals of approximately 4.2%. The Company expects these changes to reduce Medicare revenues to the Company's hospitals between \$35 million to \$40 million on an annual basis based upon the Company's historical Medicare patient volumes.

Results of Operations - Continuing Operations

Hospital Division

Revenues increased 24% to \$435 million in the second quarter of 2005 from \$351 million in the same period a year ago and 19% to \$828 million for the six months ended June 30, 2005 from \$694 million in the same period last year. Revenue growth in both periods resulted primarily from the previously discussed \$55 million Medicare settlement, growth in admissions and new hospital development. On a same-store basis, revenues increased 7% in the second quarter of 2005 and 9% for the six months ended June 30, 2005 compared to the same periods a year ago.

Admissions rose 6% in the second quarter of 2005 and 9% for the six months ended June 30, 2005 compared to the respective prior year periods, while patient days rose 4% in both the second quarter and six months ended June 30, 2005 compared to the same periods a year ago. On a same-store basis, admissions increased 4% in both the second quarter and six months ended June 30, 2005 compared to the respective prior year periods, while patient days increased 1% in the second quarter of 2005 and were relatively unchanged for the six months ended June 30, 2005 compared to the respective prior year periods as a result of reduced length of stay.

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Hospital wage and benefit costs increased 3% to \$175 million for the second quarter of 2005 compared to \$169 million in the same period last year and increased 1% to \$343 million for the six months ended June 30, 2005 compared to \$339 million reported in the same period last year. Average hourly wage rates grew 4% for both the second quarter and six months ended June 30, 2005 compared to the respective prior year periods. Wage and benefit costs for the second quarter and six months ended June 30, 2005 were favorably impacted by the Hospital Services Reorganization.

Hospital operating income increased 56% to \$134 million in the second quarter of 2005 from \$87 million in the same period a year ago and increased 42% to \$236 million for the six months ended June 30, 2005 from \$166 million in the same period a year ago.

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

Results of Operations - Continuing Operations (Continued)

Hospital Division (Continued)

As previously discussed in Note 3 of the accompanying Notes to Condensed Consolidated Financial Statements, favorable Medicare reimbursement settlements increased hospital operating income by approximately \$55 million and \$4 million in the second quarter of 2005 and 2004, respectively, and \$58 million and \$6 million for the six months ended June 30, 2005 and 2004, respectively. Operating income in the second quarter of 2005 was reduced by \$4 million related to a special recognition payment to the Company's non-executive caregivers and employees. Excluding the Medicare reimbursement settlements and special recognition payment, operating margins were 22.0% and 23.7% in the second quarter and six months ended June 30, 2005, respectively, compared to 23.8% and 23.2% in the same prior year periods. Growth in hospital operating income in both periods was primarily attributable to growth in admissions (particularly private and commercial admissions) and generally favorable reimbursement rates. Operating income in the second quarter and six months ended June 30, 2005 was reduced by approximately \$4 million and \$8 million, respectively, in connection with the Hospital Services Reorganization. Aggregate operating costs per admission, including costs associated with the Hospital Services Reorganization, increased 7% and 3% in the second quarter and six months ended June 30, 2005, respectively, compared to the same prior year periods.

Professional liability costs were \$5 million in the second quarter of both 2005 and 2004 and \$11 million for both six-month periods ended June 30, 2005 and 2004.

Excluding the Medicare reimbursement settlements and special recognition payment, the rate of growth in hospital operating income slowed in the second quarter of 2005 primarily as a result of various operating issues at five hospitals related to admissions and non-government revenues that negatively impacted overall divisional results.

Health Services Division

Revenues increased 10% to \$496 million in the second quarter of 2005 compared to \$453 million in the same period a year ago and increased 7% to \$950 million for the six months ended June 30, 2005 from \$889 million in the same period last year. Revenues increased primarily as a result of recently approved retroactive Medicaid rate increases in the state of Indiana and generally favorable reimbursement rates.

As previously discussed, the Company's nursing centers recorded favorable retroactive Medicaid rate increases in the second quarter of 2005 and 2004. Retroactive rate increases in the state of Indiana for periods prior to April 1, 2005 increased second quarter 2005 nursing center revenues by approximately \$32 million. In the second quarter of 2004, similar rate increases in the state of North Carolina increased nursing center revenues by approximately \$9 million. The Company also recorded the related provider tax expense associated with these programs aggregating \$16 million and \$3 million (included in other operating expenses) in the second quarter of 2005 and 2004, respectively.

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Excluding the previously discussed retroactive Medicaid rate increases, aggregate revenues per patient day increased 6% in both the second quarter and six months ended June 30, 2005 compared to the respective prior year periods. Aggregate patient days declined 2% in both the second quarter and six months ended June 30, 2005 compared to the respective prior year periods.

Nursing center wage and benefit costs increased 8% to \$256 million in the second quarter of 2005 compared to \$237 million for the same period a year ago and increased 5% to \$500 million for the six months ended June 30, 2005 compared to \$474 million for the same period a year ago. Wage and benefit costs for the second

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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)

Health Services Division (Continued)

quarter of 2005 included \$9 million related to a special recognition payment to the Company's non-executive caregivers and employees. Average hourly wage rates increased 4% in both the second quarter and six months ended June 30, 2005 compared to the same periods a year ago, while employee benefit costs increased 1% in the respective periods.

Nursing center operating income increased 2% to \$64 million in the second quarter of 2005 compared to \$63 million in the second quarter of 2004 and increased 5% to \$117 million for the six months ended June 30, 2005 compared to \$112 million in the same period a year ago. Excluding the impact of the retroactive Medicaid rate increases and special recognition payment, operating margins were 12.4% and 12.2% in the second quarter and six months ended June 30, 2005, respectively, compared to 12.9% and 12.3% in the same periods last year. Excluding the impact of the retroactive Medicaid rate increases and special recognition payment, nursing center operating income was relatively unchanged in the second quarter of 2005 compared to the same period last year and increased 4% for the respective six month periods. Despite a decline in patient days, adjusted nursing center operating income for the first half of 2005 improved primarily due to favorable reimbursement rates and operating efficiencies.

Professional liability costs were \$15 million and \$16 million in the second quarter of 2005 and 2004, respectively, and \$31 million and \$32 million for the six months ended June 30, 2005 and 2004, respectively.

Rehabilitation Division

Revenues increased 24% to \$65 million in the second quarter of 2005 from \$52 million for the same period a year ago and increased 24% to \$130 million for the six months ended June 30, 2005 from \$105 million for the same period a year ago. Operating income decreased 4% in the second quarter of 2005 compared to the same period a year ago and increased 6% for the six months ended June 30, 2005 compared to the same period a year ago. The increase in revenues in the second quarter and six months ended June 30, 2005 was primarily attributable to the Hospital Services Reorganization. Intercompany revenues for services provided to the Company's nursing centers totaled \$39 million and \$37 million in the second quarter of 2005 and 2004, respectively, and \$78 million and \$73 million for the six months ended June 30, 2005 and 2004, respectively. Intercompany revenues and operating income associated with the Hospital Services Reorganization aggregated \$11 million and \$1 million, respectively, in the second quarter of 2005 and \$22 million and \$2 million, respectively, for the six months ended June 30, 2005. Operating income for the second quarter of 2005 included a \$1 million charge related to a special recognition payment to the Company's non-executive caregivers and employees. The Company continues to face challenges related to wage pressures, recruitment costs and retention of therapists in a highly competitive marketplace.

Pharmacy Division

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Revenues increased 56% to \$132 million in the second quarter of 2005 compared to \$84 million for the same period a year ago and increased 46% to \$240 million for the six months ended June 30, 2005 compared to \$164 million for the same period a year ago. Revenues associated with the Hospital Services Reorganization aggregated \$12 million and \$22 million in the second quarter and six months ended June 30, 2005, respectively. In addition, the increase in revenues in the second quarter of 2005 and six months ended June 30, 2005 resulted from acquisitions, growth in the number of non-affiliated customers and price increases. At June 30, 2005, the Company provided pharmacy services to nursing centers containing 84,800 licensed beds, including 28,700 licensed beds that it operates. At June 30, 2004, the Company provided pharmacy services to nursing centers containing 64,500 licensed beds, including 28,200 licensed beds that it operates. Aggregate revenues associated

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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)

Pharmacy Division (Continued)

with both the PPI Acquisition and the SCP Acquisition totaled \$25 million and \$28 million in the second quarter and six months ended June 30, 2005, respectively.

Pharmacy operating income increased 72% to \$14 million in the second quarter of 2005 from \$7 million in the same period a year ago and increased 61% to \$25 million for the six months ended June 30, 2005 from \$15 million for the same period a year ago. Operating income associated with the Hospital Services Reorganization aggregated \$2 million and \$4 million in the second quarter and six months ended June 30, 2005, respectively. Aggregate operating income associated with both the PPI Acquisition and the SCP Acquisition totaled \$3 million in both the second quarter and six months ended June 30, 2005. Operating income for the second quarter of 2005 included a \$1 million charge related to a special recognition payment to the Company's non-executive caregivers and employees. Excluding the special recognition payment, operating margins were 10.6% in both the second quarter and six months ended June 30, 2005 compared to 9.2% and 9.3% in the respective prior year periods. The cost of goods sold as a percentage of institutional pharmacy revenues was 65.1% and 64.9% in the second quarter and six months ended June 30, 2005, respectively, compared to 65.5% and 65.1% in the respective prior year periods. Aggregate pharmacy operating margins improved compared to the same period last year primarily due to administrative cost efficiencies associated with volume growth and the favorable impact of the Hospital Services Reorganization.

Corporate Overhead

Operating income for the Company's operating divisions excludes allocations of corporate overhead. These costs aggregated \$38 million and \$67 million in the second quarter and six months ended June 30, 2005, respectively, compared to \$30 million and \$57 million in the respective prior year periods. Corporate overhead for the second quarter of 2005 included a \$5 million charge related to a charitable donation. As a percentage of consolidated revenues, corporate overhead totaled 3.6% and 3.4% in the second quarter and six months ended June 30, 2005, respectively, and 3.4% and 3.3% in the respective prior year periods.

Corporate expenses included the operating losses of the Company's limited purpose insurance subsidiary of \$3 million and \$5 million in the second quarter and six months ended June 30, 2005, respectively, and \$1 million and \$3 million in the respective prior year periods.

Reorganization Items

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Operating results for the six months ended June 30, 2005 included income of \$1.4 million resulting from changes in estimates for accrued professional and administrative costs in connection with the completion of legal proceedings related to the Plan of Reorganization in March 2005. Operating results for the second quarter of 2004 included a favorable adjustment of \$0.3 million related to accrued reorganization costs.

Capital Costs

Rent expense increased 7% to \$70 million in the second quarter of 2005 compared to \$65 million for the same period a year ago and increased 7% to \$138 million for the six months ended June 30, 2005 compared to \$129 million for the same period a year ago. A substantial portion of the increase in both periods resulted from contractual inflation increases, including those associated with the Master Lease Agreements, and growth in the number of leased hospitals operated by the Company.

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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)

Capital Costs (Continued)

Depreciation and amortization expense increased 15% to \$25 million in the second quarter of 2005 compared to \$23 million for the same period a year ago and increased 13% to \$49 million for the six months ended June 30, 2005 compared to \$44 million for the same period a year ago. The increase in both periods was primarily a result of the Company's ongoing capital expenditure program.

Interest expense aggregated \$2 million in the second quarter of 2005 compared to \$4 million for the same period a year ago and \$4 million for the six months ended June 30, 2005 compared to \$8 million for the same period a year ago. The decline in both periods was primarily a result of the repayment of long-term debt in 2004. In addition, interest expense in the second quarter of 2004 included a pretax charge of approximately \$1 million resulting from the refinancing of the Company's credit facilities.

Investment income, related primarily to the Company's excess cash balances and insurance subsidiary investments, approximated \$3 million in the second quarter of 2005 compared to \$2 million for the same period a year ago and \$5 million for the six months ended June 30, 2005 compared to \$3 million for the same period a year ago. Investment income in the second quarter of 2004 included a credit of \$0.6 million related to the recovery of certain surety deposits.

Consolidated Results

Income from continuing operations before income taxes totaled \$84 million for the second quarter of 2005 compared to \$42 million for the same period a year ago and \$138 million for the six months ended June 30, 2005 compared to \$71 million for the same period a year ago. Income from continuing operations in the second quarter of 2005 aggregated \$50 million compared to \$25 million for the same period a year ago and \$82 million for the six months ended June 30, 2005 compared to \$42 million for the same period a year ago.

Discontinued Operations

Net income from discontinued operations aggregated \$13 million in the second quarter of 2005 compared to a net loss of \$2 million for the same period a year ago. Net income from discontinued operations aggregated \$18 million for the six months ended June 30, 2005 compared to a net loss of \$5 million for the same period in 2004. Net income from discontinued operations included a favorable pretax adjustment of \$23 million (\$14 million net of income taxes) for the second quarter of 2005 and \$33 million (\$20 million net of income taxes) for the six months ended June 30, 2005 resulting from a change in estimate for professional liability reserves related to the Company's former nursing centers in Florida and Texas. See Notes 2 and 9 of the accompanying Notes to Condensed Consolidated Financial Statements.

Net gains associated with the divestiture of discontinued operations totaled \$3 million in the second quarter of 2005 compared to net losses of \$1 million in the second quarter of 2004.

Liquidity

Cash flows provided by operations (including discontinued operations) aggregated \$57 million for the six months ended June 30, 2005 compared to \$92 million for the same period a year ago. Operating cash flows were negatively impacted in the first six months of 2005 by growth in accounts receivable. During both periods, the Company maintained sufficient liquidity to fund its ongoing capital expenditure program and finance acquisitions.

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

Liquidity (Continued)

Cash and cash equivalents totaled \$33 million at June 30, 2005 compared to \$69 million at December 31, 2004. Based upon existing cash levels, expected operating cash flows and capital spending, and the availability of borrowings under the Company's revolving credit facility, management believes that the Company has the necessary financial resources to satisfy expected short-term and long-term liquidity needs. There were no outstanding borrowings under the revolving credit facility at June 30, 2005.

As a result of improved professional liability underwriting results of the Company's limited purpose insurance subsidiary, the Company received a return of capital of approximately \$30 million from its limited purpose insurance subsidiary during the second quarter of 2005 to be used for general corporate purposes. These proceeds were used primarily to repay borrowings under the revolving credit facility.

The Company expects to receive the cash proceeds from the \$55 million favorable hospital prior year Medicare cost report settlement recorded in the second quarter of 2005 on or before April 30, 2006.

On August 2, 2005, the Company announced the completion of certain amendments to its revolving credit facility. The amendments (a) increase the amount permitted for acquisitions and certain investments by the Company from \$150 million to \$400 million, (b) provide the Company with the additional flexibility to repurchase up to \$150 million of its common stock and warrants, and (c) increase the Company's permitted capital expenditures in each fiscal year. The amendments also expand the borrowing base of the revolving credit facility to include certain additional real estate holdings. In addition, the amendments clarify certain regulatory issues and expand certain representations and covenants of the Company, none of which are expected to impact the Company's financial flexibility. The Company was in compliance with the terms of its revolving credit facility at June 30, 2005.

The Company also announced on August 2, 2005 that its Board of Directors has authorized up to \$100 million in common stock and warrant repurchases. The Company intends to finance any repurchases from operating cash flows or borrowings under its revolving credit facility.

Capital Resources

Excluding acquisitions, capital expenditures totaled \$47 million for the six months ended June 30, 2005 compared to \$36 million for the six months ended June 30, 2004. Capital expenditures (excluding acquisitions) could approximate \$120 million to \$130 million in 2005. Management believes that its capital expenditure program is adequate to improve and equip existing facilities. The Company's capital expenditure program is financed generally through the use of operating cash flows. At June 30, 2005, the estimated cost to complete and equip construction in progress approximated \$46 million.

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For the six months ended June 30, 2005, the Company acquired a hospital and completed both the PPI Acquisition and the SCP Acquisition at a total cost of \$74 million. The Company financed these acquisitions through the use of operating cash flows and the Company's revolving credit facility.

The terms of the revolving credit facility include certain covenants which limit the Company's acquisitions and annual capital expenditures.

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

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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)

measures limiting the Company's ability to recover its cost increases through increased pricing of its healthcare services. Medicare revenues in the Company's long-term acute care 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 on 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.

Medicare payments to the Company's nursing centers are based upon certain RUGs payment rates developed by CMS that provide various levels of reimbursement based upon patient acuity. On July 28, 2005, CMS published the final rules related to revised payment rates to nursing centers. Among other things, the final rules provide for a 3.1% inflation update to all RUGs categories effective October 1, 2005. Based upon current Part A Medicare payment rates, the Company expects that these rates will increase from approximately \$348 per patient day to approximately \$358 per patient day on October 1, 2005.

In addition, the final rules increase the indexing of RUGs categories, expand the total RUGs categories from 44 to 53 and eliminate the 20% payment add-on for the care of higher acuity patients that had been in effect since 2000 under the BBRA. These changes are expected to reduce Medicare Part A per diem rates to the Company's nursing centers from \$358 per patient day to approximately \$343 per patient day beginning on January 1, 2006.

Most of the Company's hospitals have been operating under LTAC PPS since September 1, 2003. Operating results under this system 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 on a fixed payment system. Operating margins in the hospital division could be negatively impacted if the Company is unable to control its operating costs. As a result of these uncertainties, the Company cannot predict the ultimate long-term impact of LTAC PPS on its hospital operating results and the Company can make no assurances that such regulations or operational changes resulting from these regulations will not have a material adverse impact on its financial position, results of operations or liquidity. In addition, the Company can make 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.

On April 25, 2005, CMS published the proposed rules related to the weights for DRGs and the geometric length-of-stay thresholds that would take effect for hospital Medicare discharges occurring on or after October 1, 2005. Following a public comment period, CMS issued these rules in their final form on August 1, 2005. In connection with the final rules, CMS estimated that these changes could result in an aggregate reduction in payments to long-term acute care hospitals of approximately 4.2%. The Company expects these changes to reduce Medicare revenues to the Company's hospitals between \$35 million to \$40 million on an annual basis based upon the Company's historical Medicare patient volumes.

In January 2005, CMS issued final regulations on MMA which will be effective on January 1, 2006. 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 new Medicare drug benefit, subject to certain limitations. Most of the nursing center residents that the Company serves whose drug costs are currently

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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)

covered by state Medicaid programs are dual eligibles who will qualify for the new Medicare drug benefit. Accordingly, Medicaid will no longer be a payor for the pharmacy services provided to these residents.

The Company continues to review the final MMA regulations but it cannot assess the overall impact of MMA on its institutional pharmacy business. The impact of this legislation depends upon a variety of factors, including the sub-regulatory guidance from CMS, the Company's ultimate relationships with the private prescription drug plans which will provide coverage for prescription drugs under MMA and the patient mix of its customers. This legislation may reduce revenue and impose additional costs to the industry. In addition, since CMS may issue additional federal regulations and guidance related to the MMA, there can be no assurance that the MMA and related regulations promulgated under it will not have a material adverse effect on the Company's institutional pharmacy business.

Management believes that the Company's operating margins may continue to be under pressure as the growth in operating expenses, particularly professional liability, labor and employee benefits costs, exceeds payment increases from third party payors. In addition, as a result of competitive pressures, the Company's ability to maintain operating margins through price increases to private patients is limited.

Litigation

The Company is a party to certain material litigation. See Note 12 of the accompanying Notes to Condensed Consolidated Financial Statements.

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)**

| | 2004 Quarters | | | | 2005 Quarters | |
|--|---------------|------------|------------|------------|---------------|--------------|
| | First | Second | Third | Fourth | First | Second |
| Revenues | \$ 858,015 | \$ 885,819 | \$ 884,254 | \$ 903,135 | \$ 939,989 | \$ 1,045,923 |
| Salaries, wages and benefits | 484,049 | 486,542 | 496,678 | 494,872 | 515,020 | 542,416 |
| Supplies | 115,496 | 119,442 | 121,409 | 122,873 | 128,283 | 146,043 |
| Rent | 63,619 | 65,121 | 66,441 | 66,749 | 67,996 | 69,579 |
| Other operating expenses | 142,321 | 147,300 | 145,177 | 151,431 | 152,167 | 179,200 |
| Depreciation and amortization | 21,561 | 22,241 | 22,960 | 23,476 | 24,114 | 25,586 |
| Interest expense | 3,654 | 4,713 | 2,535 | 1,912 | 2,000 | 2,439 |
| Investment income | (1,214) | (1,823) | (1,603) | (1,791) | (2,348) | (3,031) |
| | 829,486 | 843,536 | 853,597 | 859,522 | 887,232 | 962,232 |
| Income from continuing operations before reorganization items and income taxes | 28,529 | 42,283 | 30,657 | 43,613 | 52,757 | 83,691 |
| Reorganization items | | (304) | | | (1,371) | |
| Income from continuing operations before income taxes | 28,529 | 42,587 | 30,657 | 43,613 | 54,128 | 83,691 |
| Provision for income taxes | 11,996 | 17,533 | 12,130 | 17,804 | 21,868 | 33,673 |
| Income from continuing operations | 16,533 | 25,054 | 18,527 | 25,809 | 32,260 | 50,018 |
| Discontinued operations, net of income taxes: | | | | | | |
| Income (loss) from operations | (2,693) | (2,222) | 4,598 | 796 | 4,630 | 13,402 |
| Gain (loss) on divestiture of operations | | (1,063) | (7,557) | (7,202) | | 2,647 |
| Net income | \$ 13,840 | \$ 21,769 | \$ 15,568 | \$ 19,403 | \$ 36,890 | \$ 66,067 |
| Earnings per common share: | | | | | | |
| Basic: | | | | | | |
| Income from continuing operations | \$ 0.47 | \$ 0.70 | \$ 0.51 | \$ 0.71 | \$ 0.89 | \$ 1.33 |
| Discontinued operations: | | | | | | |
| Income (loss) from operations | (0.08) | (0.06) | 0.13 | 0.02 | 0.13 | 0.36 |
| Gain (loss) on divestiture of operations | | (0.03) | (0.21) | (0.20) | | 0.07 |
| Net income | \$ 0.39 | \$ 0.61 | \$ 0.43 | \$ 0.53 | \$ 1.02 | \$ 1.76 |

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| | | | | | | |
|---|----------------|----------------|----------------|----------------|----------------|----------------|
| Diluted: | | | | | | |
| Income from continuing operations | \$ 0.38 | \$ 0.60 | \$ 0.44 | \$ 0.61 | \$ 0.73 | \$ 1.08 |
| Discontinued operations: | | | | | | |
| Income (loss) from operations | (0.06) | (0.05) | 0.11 | 0.02 | 0.10 | 0.29 |
| Gain (loss) on divestiture of operations | | (0.03) | (0.18) | (0.17) | | 0.06 |
| Net income | <u>\$ 0.32</u> | <u>\$ 0.52</u> | <u>\$ 0.37</u> | <u>\$ 0.46</u> | <u>\$ 0.83</u> | <u>\$ 1.43</u> |
| Shares used in computing earnings per common share: | | | | | | |
| Basic | 35,414 | 35,536 | 35,939 | 36,200 | 36,312 | 37,495 |
| Diluted | 42,721 | 41,913 | 42,293 | 42,639 | 44,410 | 46,367 |

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

Operating Data**(Unaudited)****(In thousands)**

| | 2004 Quarters | | | | 2005 Quarters | |
|---|-------------------|-------------------|-------------------|-------------------|-------------------|---------------------|
| | First | Second | Third | Fourth | First | Second |
| Revenues: | | | | | | |
| Hospital division | \$ 343,349 | \$ 350,097 | \$ 350,852 | \$ 354,360 | \$ 393,040 | \$ 434,562 (b) |
| Health services division | 435,998 | 452,820 | 449,674 | 462,880 | 454,047 | 496,074 (c) |
| Rehabilitation division | 52,699 | 52,588 | 61,157 (a) | 61,982 | 64,947 | 65,365 |
| Pharmacy division | 79,746 | 84,346 | 96,591 (a) | 99,352 | 107,957 | 131,849 |
| | <u>911,792</u> | <u>939,851</u> | <u>958,274</u> | <u>978,574</u> | <u>1,019,991</u> | <u>1,127,850</u> |
| Eliminations: | | | | | | |
| Rehabilitation | (36,023) | (36,579) | (46,642)(a) | (46,743) | (49,545) | (50,137) |
| Pharmacy | (17,754) | (17,453) | (27,378)(a) | (28,696) | (30,457) | (31,790) |
| | <u>(53,777)</u> | <u>(54,032)</u> | <u>(74,020)</u> | <u>(75,439)</u> | <u>(80,002)</u> | <u>(81,927)</u> |
| | <u>\$ 858,015</u> | <u>\$ 885,819</u> | <u>\$ 884,254</u> | <u>\$ 903,135</u> | <u>\$ 939,989</u> | <u>\$ 1,045,923</u> |
| Income from continuing operations: | | | | | | |
| Operating income (loss): | | | | | | |
| Hospital division | \$ 79,687 | \$ 86,120 | \$ 79,210 (a) | \$ 83,933 | \$ 101,801 | \$ 134,263 (b,d) |
| Health services division | 48,945 | 63,001 | 57,978 | 67,057 | 53,021 | 64,383 (c,d) |
| Rehabilitation division | 8,519 | 7,265 | 7,737 (a) | 7,910 | 9,711 | 6,989 (d) |
| Pharmacy division | 7,609 | 7,729 | 10,853 (a) | 10,871 | 11,454 | 13,298 (d) |
| Corporate: | | | | | | |
| Overhead | (26,834) | (30,356) | (33,028) | (33,531) | (29,115) | (38,052)(d,e) |
| Insurance subsidiary | (1,777) | (1,224) | (1,760) | (2,281) | (2,353) | (2,617) |
| | <u>(28,611)</u> | <u>(31,580)</u> | <u>(34,788)</u> | <u>(35,812)</u> | <u>(31,468)</u> | <u>(40,669)</u> |
| | <u>116,149</u> | <u>132,535</u> | <u>120,990</u> | <u>133,959</u> | <u>144,519</u> | <u>178,264</u> |
| Reorganization items | | 304 | | | 1,371 | |
| Operating income | 116,149 | 132,839 | 120,990 | 133,959 | 145,890 | 178,264 |
| Rent | (63,619) | (65,121) | (66,441) | (66,749) | (67,996) | (69,579) |
| Depreciation and amortization | (21,561) | (22,241) | (22,960) | (23,476) | (24,114) | (25,586) |
| Interest, net | (2,440) | (2,890) | (932) | (121) | 348 | 592 |

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| | | | | | | |
|---|-----------|-----------|-----------|-----------|-----------|-----------|
| Income from continuing operations before income taxes | 28,529 | 42,587 | 30,657 | 43,613 | 54,128 | 83,691 |
| Provision for income taxes | 11,996 | 17,533 | 12,130 | 17,804 | 21,868 | 33,673 |
| | \$ 16,533 | \$ 25,054 | \$ 18,527 | \$ 25,809 | \$ 32,260 | \$ 50,018 |

- (a) Effective July 1, 2004, the rehabilitation division and pharmacy division began providing services to the Company's hospital division. Revenues in the third quarter of 2004 associated with these new arrangements aggregated \$10.3 million in the rehabilitation division and \$9.4 million in the pharmacy division. These new arrangements reduced hospital division operating income in the third quarter of 2004 by approximately \$4.1 million while increasing rehabilitation division operating income by approximately \$1.4 million and pharmacy division operating income by approximately \$2.1 million.
- (b) Includes income of approximately \$54.6 million related primarily to the settlement of a prior year hospital Medicare cost report issue which was under appeal.
- (c) Includes revenues of \$32.2 million and operating income of \$15.9 million for periods prior to April 1, 2005 related to recently approved retroactive Medicaid rate increases in the state of Indiana.
- (d) Includes a special employee recognition payment of approximately \$15.0 million allocated to the hospital division (\$3.9 million), health services division (\$9.2 million), rehabilitation division (\$1.0 million), pharmacy division (\$0.7 million) and corporate office (\$0.2 million).
- (e) Includes a charge of \$5.0 million related to a charitable donation.

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

Operating Data (Continued)**(Unaudited)****(In thousands)**

| | 2004 Quarters | | | | 2005 Quarters | |
|--|------------------|------------------|------------------|------------------|------------------|------------------|
| | First | Second | Third | Fourth | First | Second |
| Rent: | | | | | | |
| Hospital division | \$ 22,488 | \$ 23,168 | \$ 23,898 | \$ 24,077 | \$ 24,717 | \$ 25,244 |
| Health services division | 39,799 | 40,398 | 40,923 | 41,064 | 41,486 | 42,225 |
| Rehabilitation division | 611 | 708 | 747 | 773 | 800 | 817 |
| Pharmacy division | 662 | 790 | 812 | 780 | 926 | 1,169 |
| Corporate | 59 | 57 | 61 | 55 | 67 | 124 |
| | <u>\$ 63,619</u> | <u>\$ 65,121</u> | <u>\$ 66,441</u> | <u>\$ 66,749</u> | <u>\$ 67,996</u> | <u>\$ 69,579</u> |
| Depreciation and amortization: | | | | | | |
| Hospital division | \$ 8,257 | \$ 8,496 | \$ 8,923 | \$ 9,401 | \$ 9,554 | \$ 9,836 |
| Health services division | 6,615 | 6,796 | 6,901 | 7,290 | 7,822 | 8,287 |
| Rehabilitation division | 33 | 37 | 38 | 51 | 54 | 56 |
| Pharmacy division | 530 | 583 | 603 | 718 | 926 | 1,521 |
| Corporate | 6,126 | 6,329 | 6,495 | 6,016 | 5,758 | 5,886 |
| | <u>\$ 21,561</u> | <u>\$ 22,241</u> | <u>\$ 22,960</u> | <u>\$ 23,476</u> | <u>\$ 24,114</u> | <u>\$ 25,586</u> |
| Capital expenditures, excluding acquisitions (including discontinued operations): | | | | | | |
| Hospital division | \$ 5,406 | \$ 5,177 | \$ 8,867 | \$ 10,697 | \$ 8,235 | \$ 11,289 |
| Health services division | 8,450 | 6,487 | 7,074 | 14,692 | 6,957 | 10,986 |
| Rehabilitation division | 47 | 56 | 19 | 246 | 2 | 96 |
| Pharmacy division | 773 | 1,075 | 1,004 | 1,977 | 1,075 | 1,506 |
| Corporate: | | | | | | |
| Information systems | 2,651 | 4,033 | 4,251 | 4,892 | 1,462 | 4,171 |
| Other | 554 | 829 | 1,175 | 1,956 | 232 | 550 |
| | <u>\$ 17,881</u> | <u>\$ 17,657</u> | <u>\$ 22,390</u> | <u>\$ 34,460</u> | <u>\$ 17,963</u> | <u>\$ 28,598</u> |

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

Operating Data (Continued)**(Unaudited)**

| | 2004 Quarters | | | | 2005 Quarters | |
|-----------------------------|----------------|----------------|----------------|----------------|----------------|----------------|
| | First | Second | Third | Fourth | First | Second |
| Hospital data: | | | | | | |
| End of period data: | | | | | | |
| Number of hospitals | 66 | 68 | 72 | 72 | 73 | 73 |
| Number of licensed beds | 5,245 | 5,396 | 5,569 | 5,569 | 5,603 | 5,603 |
| Revenue mix % (a): | | | | | | |
| Medicare | 67 | 64 | 63 | 63 | 65 | 71 |
| Medicaid | 7 | 8 | 8 | 7 | 6 | 6 |
| Private and other | 26 | 28 | 29 | 30 | 29 | 23 |
| Admissions: | | | | | | |
| Medicare | 6,780 | 6,674 | 6,550 | 6,719 | 7,397 | 7,080 |
| Medicaid | 682 | 789 | 763 | 741 | 727 | 823 |
| Private and other | 1,243 | 1,401 | 1,369 | 1,495 | 1,564 | 1,528 |
| | <u>8,705</u> | <u>8,864</u> | <u>8,682</u> | <u>8,955</u> | <u>9,688</u> | <u>9,431</u> |
| Admissions mix %: | | | | | | |
| Medicare | 78 | 75 | 75 | 75 | 76 | 75 |
| Medicaid | 8 | 9 | 9 | 8 | 8 | 9 |
| Private and other | 14 | 16 | 16 | 17 | 16 | 16 |
| Patient days: | | | | | | |
| Medicare | 206,256 | 200,628 | 190,466 | 190,772 | 207,670 | 209,670 |
| Medicaid | 27,670 | 29,228 | 30,435 | 30,200 | 26,660 | 28,361 |
| Private and other | 51,856 | 52,640 | 53,571 | 56,160 | 61,052 | 55,622 |
| | <u>285,782</u> | <u>282,496</u> | <u>274,472</u> | <u>277,132</u> | <u>295,382</u> | <u>293,653</u> |
| Average length of stay: | | | | | | |
| Medicare | 30.4 | 30.1 | 29.1 | 28.4 | 28.1 | 29.6 |
| Medicaid | 40.6 | 37.0 | 39.9 | 40.8 | 36.7 | 34.5 |
| Private and other | 41.7 | 37.6 | 39.1 | 37.6 | 39.0 | 36.4 |
| Weighted average | 32.8 | 31.9 | 31.6 | 30.9 | 30.5 | 31.1 |
| Revenues per admission (a): | | | | | | |
| Medicare | \$ 33,722 | \$ 33,902 | \$ 33,963 | \$ 33,466 | \$ 34,750 | \$ 43,798 |
| Medicaid | 34,701 | 34,102 | 35,889 | 33,155 | 30,295 | 30,887 |
| Private and other | 73,248 | 69,184 | 73,784 | 70,188 | 72,872 | 64,824 |
| Weighted average | 39,443 | 39,497 | 40,411 | 39,571 | 40,570 | 46,078 |

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| Revenues per patient day (a): | | | | | | |
|---|----------|----------|----------|----------|----------|----------|
| Medicare | \$ 1,109 | \$ 1,128 | \$ 1,168 | \$ 1,179 | \$ 1,238 | \$ 1,479 |
| Medicaid | 855 | 921 | 900 | 814 | 826 | 896 |
| Private and other | 1,756 | 1,841 | 1,886 | 1,868 | 1,867 | 1,781 |
| Weighted average | 1,202 | 1,239 | 1,278 | 1,279 | 1,331 | 1,480 |
| Medicare case mix index (discharged patients only) | | | | | | |
| | 1.26 | 1.25 | 1.21 | 1.19 | 1.22 | 1.25 |
| Average daily census | 3,140 | 3,104 | 2,983 | 3,012 | 3,282 | 3,227 |
| Occupancy % | 63.1 | 60.7 | 57.0 | 56.3 | 61.2 | 59.9 |

(a) Includes income of \$2.9 million in the first quarter of 2005, \$54.6 million in the second quarter of 2005, \$2.2 million in the first quarter of 2004, \$3.9 million in the second quarter of 2004 and \$1.6 million in the third quarter of 2004 related to certain Medicare reimbursement issues.

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

Operating Data (Continued)**(Unaudited)**

| | 2004 Quarters | | | | 2005 Quarters | |
|---|------------------|------------------|------------------|------------------|------------------|------------------|
| | First | Second | Third | Fourth | First | Second |
| Nursing center data: | | | | | | |
| End of period data: | | | | | | |
| Number of nursing centers: | | | | | | |
| Owned or leased | 242 | 242 | 242 | 242 | 242 | 243 |
| Managed | 7 | 7 | 7 | 7 | 7 | 5 |
| | <u>249</u> | <u>249</u> | <u>249</u> | <u>249</u> | <u>249</u> | <u>248</u> |
| Number of licensed beds: | | | | | | |
| Owned or leased | 31,193 | 31,189 | 31,170 | 31,170 | 31,170 | 31,275 |
| Managed | 803 | 803 | 803 | 803 | 803 | 605 |
| | <u>31,996</u> | <u>31,992</u> | <u>31,973</u> | <u>31,973</u> | <u>31,973</u> | <u>31,880</u> |
| Revenue mix %: | | | | | | |
| Medicare | 36 | 33 | 32 | 32 | 34 | 32 |
| Medicaid | 46 | 49 (a) | 50 | 50 | 48 | 51 (b) |
| Private and other | 18 | 18 | 18 | 18 | 18 | 17 |
| Patient days (excludes managed facilities): | | | | | | |
| Medicare | 423,649 | 400,487 | 377,563 | 380,782 | 402,845 | 405,335 |
| Medicaid | 1,642,585 | 1,657,812 | 1,701,837 | 1,684,972 | 1,616,789 | 1,619,439 |
| Private and other | 396,408 | 399,321 | 404,823 | 410,171 | 393,593 | 391,861 |
| | <u>2,462,642</u> | <u>2,457,620</u> | <u>2,484,223</u> | <u>2,475,925</u> | <u>2,413,227</u> | <u>2,416,635</u> |
| Patient day mix %: | | | | | | |
| Medicare | 17 | 16 | 15 | 15 | 17 | 17 |
| Medicaid | 67 | 68 | 69 | 68 | 67 | 67 |
| Private and other | 16 | 16 | 16 | 17 | 16 | 16 |
| Revenues per patient day: | | | | | | |
| Medicare Part A | \$ 331 | \$ 331 | \$ 336 | \$ 345 | \$ 348 | \$ 347 |
| Total Medicare (including Part B) | 373 | 376 | 386 | 394 | 389 | 390 |
| Medicaid | 121 | 134 (a) | 132 | 137 | 134 | 158 (b) |
| Private and other | 198 | 200 | 197 | 198 | 206 | 210 |
| Weighted average | 177 | 184 | 181 | 187 | 188 | 205 |

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| | | | | | | |
|---|---------------|---------------|---------------|---------------|---------------|---------------|
| Average daily census | 27,062 | 27,007 | 27,002 | 26,912 | 26,814 | 26,556 |
| Occupancy % | 86.4 | 86.3 | 86.2 | 86.0 | 85.7 | 84.9 |
| Rehabilitation data: | | | | | | |
| Revenue mix %: | | | | | | |
| Company-operated | 70 | 71 | 76 | 75 | 76 | 77 |
| Non-affiliated | 30 | 29 | 24 | 25 | 24 | 23 |
| Pharmacy data: | | | | | | |
| Number of customer licensed beds at end of period: | | | | | | |
| Company-operated | 28,188 | 28,164 | 28,476 | 28,634 | 29,105 | 28,649 |
| Non-affiliated | 35,102 | 36,385 | 36,671 | 37,561 | 46,745 | 56,112 |
| | <u>63,290</u> | <u>64,549</u> | <u>65,147</u> | <u>66,195</u> | <u>75,850</u> | <u>84,761</u> |

- (a) Includes income of \$8.7 million for periods prior to April 1, 2004 related to retroactive Medicaid rate increases in the state of North Carolina. Related provider tax expense of \$2.8 million under this program was recorded in other operating expenses.
- (b) Includes income of \$32.2 million for periods prior to April 1, 2005 related to recently approved retroactive Medicaid rate increases in the state of Indiana. Related provider tax expense of \$16.3 million under this program was recorded in other operating expenses.

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 | | | | | | Total | Fair value 6/30/05 |
|--|---------------------|----------|----------|----------|----------|------------|-----------|--------------------------|
| | 2005 | 2006 | 2007 | 2008 | 2009 | Thereafter | | |
| Liabilities: | | | | | | | | |
| Long-term debt, including amounts due within one year: | | | | | | | | |
| Fixed rate: | | | | | | | | |
| Ventas debt obligation: | | | | | | | | |
| Principal | \$ 2,731 | \$ 6,154 | \$ 7,209 | \$ 5,510 | \$ 4,889 | \$ 7,754 | \$ 34,247 | \$ 34,247 |
| Interest | 1,781 | 3,082 | 2,350 | 1,612 | 1,096 | 1,262 | 11,183 | |
| | 4,512 | 9,236 | 9,559 | 7,122 | 5,985 | 9,016 | 45,430 | 34,247 |
| Other | 33 | 67 | 71 | 76 | 81 | 733 | 1,061 | 1,017 |
| | \$ 4,545 | \$ 9,303 | \$ 9,630 | \$ 7,198 | \$ 6,066 | \$ 9,749 | \$ 46,491 | \$ 35,264 |
| Average interest rate | 10.9% | 10.9% | 11.0% | 10.9% | 10.9% | 10.6% | | |
| Variable rate (a) | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ |

(a)

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The Company has no outstanding variable rate long-term debt at June 30, 2005. 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 on 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 June 30, 2005, 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 Company's quarter ended June 30, 2005, 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

Summary descriptions of various significant litigation follow.

A shareholder derivative suit entitled *Thomas G. White on behalf of Vencor, Inc. and Ventas, Inc. v. W. Bruce Lunsford, et al.*, Case No. 98CI03669, was filed on July 2, 1998 in the Jefferson County, Kentucky, Circuit Court. The suit was brought on behalf of the Company and Ventas against certain former executive officers and directors of the Company and Ventas. The complaint alleges that the defendants damaged the Company and Ventas by engaging in violations of the securities laws, engaging in insider trading, fraud and securities fraud and damaging the reputation of the Company and Ventas. The plaintiff asserts that such actions were taken deliberately, in bad faith and constitute breaches of the defendants' duties of loyalty and due care. The complaint alleges that certain of the Company's and Ventas's former executive officers during a specified time frame violated Sections 10(b) and 20(a) of the Exchange Act, by, among other things, issuing to the investing public a series of false and misleading statements concerning Ventas's then current operations and the inherent value of its common stock. The complaint further alleges that as a result of these purported false and misleading statements concerning Ventas's revenues and successful acquisitions, the price of its common stock was artificially inflated. In particular, the complaint alleges that the defendants issued false and misleading financial statements during the first, second and third calendar quarters of 1997 which misrepresented and understated the impact that changes in Medicare reimbursement policies would have on Ventas's core services and profitability. The complaint further alleges that the defendants issued a series of materially false statements concerning the purportedly successful integration of Ventas's acquisitions and prospective earnings per share for 1997 and 1998, which the defendants knew lacked any reasonable basis and were not being achieved. The suit seeks unspecified damages, interest, punitive damages, reasonable attorneys' fees, expert witness fees and other costs, and any extraordinary equitable and/or injunctive relief permitted by law or equity to assure that the Company and Ventas have an effective remedy. In October 2002, the defendants filed a motion to dismiss for failure to prosecute the case. The court granted the motion to dismiss but the plaintiff subsequently moved the court to vacate the dismissal. The defendants filed an opposition to the plaintiff's motion to vacate the dismissal, but in August 2003 the court reinstated the lawsuit. In September 2003, the Company filed a renewed motion to dismiss, as to all defendants, based on the plaintiff's failure to make a demand for remedy upon the appropriate board of directors. On July 26, 2005, the court granted defendants' motion to dismiss based on the plaintiff's failure to make a statutorily required demand for remedy upon the appropriate board of directors. This is a final order from which the plaintiff has until August 25, 2005 to appeal. The Company believes that the allegations in the complaint are without merit and intends to defend this action vigorously.

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. In addition, there can be no assurance that the DOJ, CMS or other federal and state enforcement and regulatory agencies will not initiate additional investigations related to the Company's businesses in the future, nor can there be any assurance that the resolution of any litigation or investigations, either individually or in the aggregate, would not have a material adverse effect on the Company's financial position, results of operations and liquidity.

Table of Contents**PART II. OTHER INFORMATION (Continued)****Item 4. Submission of Matters to a Vote of Security Holders**

The Company's Annual Meeting of Shareholders was held on May 26, 2005 in Louisville, Kentucky. At the meeting, shareholders elected a board of eight directors pursuant to the following votes:

| <u>Director</u> | <u>Votes in Favor</u> | <u>Votes Withheld</u> |
|------------------------|-----------------------|-----------------------|
| Thomas P. Cooper, M.D. | 35,087,963 | 231,325 |
| Paul J. Diaz | 35,044,740 | 274,548 |
| Michael J. Emblar | 34,779,031 | 540,257 |
| Garry N. Garrison | 35,134,531 | 184,757 |
| Isaac Kaufman | 35,134,381 | 184,907 |
| John H. Klein | 34,998,064 | 321,224 |
| Edward L. Kuntz | 33,422,278 | 1,897,010 |
| Eddy J. Rogers, Jr. | 35,133,925 | 185,363 |

In addition to electing directors, shareholders of the Company ratified the appointment of PricewaterhouseCoopers LLP as the Company's independent auditor for fiscal 2005 by the vote of 35,314,220 in favor, 3,552 against, 1,516 abstentions and no non-votes.

Item 6. Exhibits

- 10.1 Amendment No. 1 and Consent dated as of August 2, 2005, under the \$300,000,000 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. (formally known as JPMorgan Chase Bank), as Administrative Agent and Collateral Agent. Exhibit 99.1 to the Company's Current Report on Form 8-K dated August 2, 2005 (Comm. File No. 001-14057) is hereby incorporated by reference.
- 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: August 4, 2005

/s/ PAUL J. DIAZ

Paul J. Diaz

President and

Chief Executive Officer

Date: August 4, 2005

/s/ RICHARD A. LECHLEITER

Richard A. Lechleiter

Executive Vice President and

Chief Financial Officer