

KINDRED HEALTHCARE, INC  
Form 10-Q  
November 06, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2017

OR

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

For the transition period from                      to                      .

Commission file number: 001-14057

KINDRED HEALTHCARE, INC.

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

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

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680 South Fourth Street Louisville, KY 40202  
(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Emerging growth company  
Non-accelerated filer Smaller reporting company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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

Class of Common Stock	Outstanding at October 31, 2017
Common stock, \$0.25 par value	86,932,592 shares

KINDRED HEALTHCARE, INC.

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## KINDRED HEALTHCARE, INC.

## CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(Unaudited)

(In thousands, except per share amounts)

	Three months ended		Nine months ended	
	September 30, 2017	2016	September 30, 2017	2016
Revenues	\$1,477,141	\$1,563,276	\$4,550,841	\$4,774,813
Salaries, wages and benefits	830,558	867,611	2,504,074	2,546,031
Supplies	73,344	85,469	231,229	263,679
Building rent	64,422	66,946	193,939	199,956
Equipment rent	8,537	9,911	26,285	31,280
Other operating expenses	155,949	167,453	496,934	500,787
General and administrative expenses (exclusive of depreciation and amortization expense included below)	258,834	262,051	800,493	848,945
Other income	(638 )	(341 )	(2,895 )	(2,679 )
Litigation contingency expense	4,000	-	4,000	2,840
Impairment charges	-	297,276	136,303	311,195
Restructuring charges	16,500	81,463	31,556	84,213
Depreciation and amortization	24,808	32,995	80,279	99,747
Interest expense	61,146	59,856	181,275	175,398
Investment income	(705 )	(1,797 )	(3,442 )	(2,519 )
	1,496,755	1,928,893	4,680,030	5,058,873
Loss from continuing operations before income taxes	(19,614 )	(365,617 )	(129,189 )	(284,060 )
Provision (benefit) for income taxes	(1,225 )	283,630	(15,107 )	314,106
Loss from continuing operations	(18,389 )	(649,247 )	(114,082 )	(598,166 )
Discontinued operations, net of income taxes:				
Loss from operations	(13,612 )	(22,060 )	(1,871 )	(10,489 )
Gain (loss) on divestiture of operations	(49,663 )	-	(349,868 )	179
Loss from discontinued operations	(63,275 )	(22,060 )	(351,739 )	(10,310 )
Net loss	(81,664 )	(671,307 )	(465,821 )	(608,476 )
Earnings attributable to noncontrolling interests:				
Continuing operations	(10,960 )	(9,574 )	(32,234 )	(26,272 )
Discontinued operations	(3,162 )	(4,732 )	(12,597 )	(14,075 )
	(14,122 )	(14,306 )	(44,831 )	(40,347 )
Loss attributable to Kindred	\$(95,786 )	\$(685,613 )	\$(510,652 )	\$(648,823 )
Amounts attributable to Kindred stockholders:				
Loss from continuing operations	\$(29,349 )	\$(658,821 )	\$(146,316 )	\$(624,438 )
Loss from discontinued operations	(66,437 )	(26,792 )	(364,336 )	(24,385 )
Net loss	\$(95,786 )	\$(685,613 )	\$(510,652 )	\$(648,823 )
Loss per common share:				

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Basic:

Loss from continuing operations	\$ (0.33 )	\$ (7.58 )	\$ (1.67 )	\$ (7.20 )
Discontinued operations:				
Loss from operations	(0.19 )	(0.31 )	(0.17 )	(0.28 )
Gain (loss) on divestiture of operations	(0.57 )	-	(4.00 )	-
Loss from discontinued operations	(0.76 )	(0.31 )	(4.17 )	(0.28 )
Net loss	\$ (1.09 )	\$ (7.89 )	\$ (5.84 )	\$ (7.48 )

Diluted:

Loss from continuing operations	\$ (0.33 )	\$ (7.58 )	\$ (1.67 )	\$ (7.20 )
Discontinued operations:				
Loss from operations	(0.19 )	(0.31 )	(0.17 )	(0.28 )
Gain (loss) on divestiture of operations	(0.57 )	-	(4.00 )	-
Loss from discontinued operations	(0.76 )	(0.31 )	(4.17 )	(0.28 )
Net loss	\$ (1.09 )	\$ (7.89 )	\$ (5.84 )	\$ (7.48 )

Shares used in computing loss per common share:

Basic	87,597	86,869	87,398	86,766
Diluted	87,597	86,869	87,398	86,766
Cash dividends declared and paid per common share	\$-	\$0.12	\$0.12	\$0.36

See accompanying notes.

KINDRED HEALTHCARE, INC.

## CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE LOSS

(Unaudited)

(In thousands)

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Net loss	\$ (81,664)	\$ (671,307)	\$ (465,821)	\$ (608,476)
Other comprehensive income (loss):				
Available-for-sale securities (Note 12):				
Change in unrealized investment gains	44	278	1,453	1,461
Reclassification of gains realized in net loss	(45 )	(1,333 )	(1,700 )	(1,202 )
Net change	(1 )	(1,055 )	(247 )	259
Interest rate swaps (Note 1):				
Change in unrealized gains (losses)	1,276	2,022	2,108	(3,761 )
Reclassification of (gains) losses realized in net loss, net of payments	(182 )	18	(505 )	411
Net change	1,094	2,040	1,603	(3,350 )
Income tax (expense) benefit related to items of other comprehensive income (loss)	-	(427 )	-	1,389
Other comprehensive income (loss)	1,093	558	1,356	(1,702 )
Comprehensive loss	(80,571)	(670,749)	(464,465)	(610,178)
Earnings attributable to noncontrolling interests	(14,122)	(14,306 )	(44,831 )	(40,347 )
Comprehensive loss attributable to Kindred	\$ (94,693)	\$ (685,055)	\$ (509,296)	\$ (650,525)

See accompanying notes.

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## KINDRED HEALTHCARE, INC.

## CONDENSED CONSOLIDATED BALANCE SHEET

(Unaudited)

(In thousands, except per share amounts)

	September 30, 2017	December 31, 2016
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 130,364	\$ 137,061
Insurance subsidiary investments	98,079	108,966
Accounts receivable less allowance for loss of \$103,997 \$71,070	September 30, 2017 and December 31, 2016	1,218,200
Inventories	21,491	22,438
Income taxes	4,983	10,067
Assets held for sale	79,051	289,450
Other	66,463	63,693
	1,618,631	1,803,753
Property and equipment	1,686,504	1,531,598
Accumulated depreciation	(956,644 )	(912,978 )
	729,860	618,620
Goodwill	2,424,831	2,427,074
Intangible assets less accumulated amortization of \$79,276 \$101,612	September 30, 2017 and December 31, 2016	612,277
Insurance subsidiary investments	184,417	204,929
Other	301,735	288,240
Total assets (a)	\$ 5,871,751	\$ 6,112,724
<b>LIABILITIES AND EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 176,353	\$ 203,925
Salaries, wages and other compensation	370,213	397,486
Due to third party payors	48,791	41,320
Professional liability risks	55,668	65,284
Accrued lease termination fees	109,113	5,224
Other accrued liabilities	264,957	264,512
Long-term debt due within one year	18,247	27,977
	1,043,342	1,005,728
Long-term debt	3,302,936	3,215,062
Professional liability risks	315,322	295,311
Deferred tax liabilities	182,065	201,808
Deferred credits and other liabilities	497,436	353,294

## Commitments and contingencies (Note 14)

## Equity:

## Stockholders' equity:

Common stock, \$0.25 par value; authorized 175,000 shares; issued 86,980 shares

September 30, 2017 and

85,166 shares	December 31, 2016	21,745	21,291
Capital in excess of par value		1,710,480	1,710,231
Accumulated other comprehensive income		2,929	1,573
Accumulated deficit		(1,431,196 )	(920,544 )
		303,958	812,551
Noncontrolling interests		226,692	228,970
Total equity		530,650	1,041,521
Total liabilities (a) and equity		\$ 5,871,751	\$ 6,112,724

(a) The Company's consolidated assets as of September 30, 2017 and December 31, 2016 include total assets of variable interest entities of \$404.2 million and \$394.1 million, respectively, which can only be used to settle the obligations of the variable interest entities. The Company's consolidated liabilities as of September 30, 2017 and December 31, 2016 include total liabilities of variable interest entities of \$41.8 million and \$38.9 million, respectively. See note 1 of the notes to unaudited condensed consolidated financial statements.

See accompanying notes.

## KINDRED HEALTHCARE, INC.

## CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(Unaudited)

(In thousands)

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2017	2016	2017	2016
<b>Cash flows from operating activities:</b>				
Net loss	\$ (81,664 )	\$ (671,307 )	\$ (465,821 )	\$ (608,476 )
Adjustments to reconcile net loss to net cash provided by operating activities:				
Depreciation expense	22,696	34,914	79,001	103,306
Amortization of intangible assets	2,889	5,468	11,909	18,251
Amortization of stock-based compensation costs	5,329	3,015	13,316	13,058
Amortization of deferred financing costs	4,363	3,987	12,847	11,262
Payment of capitalized lender fees related to debt amendment	-	(42 )	(5,403 )	(7,375 )
Provision for doubtful accounts	10,327	10,009	57,511	30,955
Deferred income taxes	(3,788 )	279,172	(19,608 )	308,470
Impairment charges	-	324,289	137,572	338,208
(Gain) loss on divestiture of discontinued operations	49,663	-	349,868	(179 )
Other	9,299	6,303	16,111	7,262
<b>Change in operating assets and liabilities:</b>				
Accounts receivable	(3,976 )	(42,832 )	(103,199 )	(143,953 )
Inventories and other assets	(6,999 )	11,871	(9,517 )	(3,522 )
Accounts payable	(3,903 )	11,995	(26,213 )	24,451
Income taxes	2,369	1,615	6,718	2,468
Due to third party payors	20,614	24,809	7,471	20,317
Other accrued liabilities	(18,738 )	33,101	(54,051 )	(73,268 )
Net cash provided by operating activities	8,481	36,367	8,512	41,235
<b>Cash flows from investing activities:</b>				
Routine capital expenditures	(16,463 )	(21,873 )	(45,800 )	(68,703 )
Development capital expenditures	(6,415 )	(8,386 )	(17,711 )	(27,112 )
Acquisitions, net of cash acquired	-	(49,329 )	(6,650 )	(77,040 )
Acquisition deposits	-	-	-	18,489
Sale of assets	5,494	3,739	5,494	4,962
Purchase of insurance subsidiary investments	(18,047 )	(22,427 )	(108,655 )	(75,422 )
Sale of insurance subsidiary investments	50,087	31,875	117,863	78,478
Net change in insurance subsidiary cash and cash equivalents	(10,053 )	(14,680 )	23,472	8,479
Net change in other investments	5,088	51	4,844	(33,347 )
Other	(81 )	(150 )	(35 )	(1,277 )
Net cash provided by (used in) investing activities	9,610	(81,180 )	(27,178 )	(172,493 )
<b>Cash flows from financing activities:</b>				
Proceeds from borrowings under revolving credit	426,700	489,200	1,214,300	1,267,200

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Repayment of borrowings under revolving credit	(427,300)	(388,100)	(1,120,600)	(1,215,800)
Proceeds from issuance of term loan, net of discount	-	-	-	198,100
Proceeds from other long-term debt	-	-	-	750
Repayment of term loan	(3,508 )	(3,508 )	(10,525 )	(10,019 )
Repayment of other long-term debt	(217 )	(276 )	(840 )	(826 )
Payment of deferred financing costs	(170 )	(50 )	(299 )	(342 )
Issuance of common stock in connection with employee benefit plans	-	-	32	-
Payment of dividend for mandatory redeemable preferred stock	(3,120 )	(2,904 )	(9,195 )	(8,558 )
Dividends paid	-	(10,224 )	(10,228 )	(30,517 )
Contributions made by noncontrolling interests	-	4,993	113	11,261
Distributions to noncontrolling interests	(10,071 )	(4,694 )	(48,372 )	(35,240 )
Purchase of noncontrolling interests	-	-	-	(1,000 )
Payroll tax payments for equity awards issuance	(88 )	(250 )	(2,417 )	(3,079 )
Net cash provided by (used in) financing activities	(17,774 )	84,187	11,969	171,930
Change in cash and cash equivalents	317	39,374	(6,697 )	40,672
Cash and cash equivalents at beginning of period	130,047	100,056	137,061	98,758
Cash and cash equivalents at end of period	\$ 130,364	\$ 139,430	\$ 130,364	\$ 139,430
Supplemental information:				
Interest payments	\$ 76,085	\$ 73,755	\$ 186,075	\$ 181,227
Income tax payments (refunds)	263	1,075	(2,054 )	2,184
Non-cash contributions made by noncontrolling interests	-	-	1,150	2,800
Non-cash investing activities (see Note 4):				
Net sale proceeds from the SNF Divestiture (as defined) placed in third party escrow	500,572	-	500,572	-
Payments from third party escrow funds to landlords related to the SNF Divestiture	(500,572)	-	(500,572 )	-

See accompanying notes.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 – BASIS OF PRESENTATION

Business

Kindred Healthcare, Inc. is a healthcare services company that through its subsidiaries operates a home health, hospice and community care business, transitional care (“TC”) hospitals, inpatient rehabilitation hospitals (“IRFs”), and a contract rehabilitation services business across the United States (collectively, the “Company” or “Kindred”). At September 30, 2017, the Company’s Kindred at Home division primarily provided home health, hospice, and community care services from 609 sites of service in 40 states. The Company’s hospital division operated 77 TC hospitals (certified as long-term acute care (“LTAC”) hospitals under the Medicare program) in 18 states. The Company’s Kindred Rehabilitation Services division operated 19 IRFs and 101 hospital-based acute rehabilitation units (“ARUs”) (certified as IRFs), and provided rehabilitation services primarily in hospitals and long-term care settings in 45 states.

Discontinued operations

The Company has completed several transactions related to the divestiture of unprofitable hospitals and nursing centers to improve its future operating results. The Company is also currently in the process of completing the SNF Divestiture (as defined and described more fully in Note 4). For accounting purposes, the operating results of these businesses and the gains or losses associated with these transactions were classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented in accordance with the authoritative guidance in effect through December 31, 2014. Effective January 1, 2015, the authoritative guidance modified the requirements for reporting discontinued operations. A disposal is now required to be reported in discontinued operations only if the disposal represents a strategic shift that has (or will have) a major effect on the Company’s operations and financial results. See Notes 4 and 5.

Recently issued accounting requirements

In August 2017, the Financial Accounting Standards Board (the “FASB”) issued authoritative guidance with the objective of improving the financial reporting of hedging relationships under United States generally accepted accounting principles (“GAAP”) to better portray economic results and to simplify the application of the current hedge accounting guidance. The new guidance is effective for annual and interim periods beginning after December 15, 2018 and early adoption is permitted. The adoption of this standard is not expected to have a material impact on the Company’s business, financial position, results of operations or liquidity.

In May 2017, the FASB issued authoritative guidance to provide clarity and reduce diversity in practice when accounting for changes to terms or conditions of a share-based payment award. The new guidance is effective for annual and interim periods beginning after December 15, 2017 and early adoption is permitted. The adoption of this standard is not expected to have a material impact on the Company’s business, financial position, results of operations or liquidity.

In January 2017, the FASB issued authoritative guidance that simplifies the measurement of goodwill impairment to a single-step test. The guidance removes step two of the goodwill impairment test, which required a hypothetical purchase price allocation. The measurement of goodwill impairment will now be the amount by which a reporting

unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. Under the revised guidance, failing step one will always result in goodwill impairment. The new guidance is effective for annual and interim periods beginning after December 15, 2019 and early adoption is permitted. The Company adopted the new guidance on January 1, 2017 on a prospective basis. If the Company fails step one of the goodwill impairment test under the new guidance, the results could materially impact the Company's financial position and results of operations but not its business or liquidity.

In January 2017, the FASB issued authoritative guidance that revises the definition of a business, which affects accounting for acquisitions, disposals, goodwill impairment, and consolidation. The guidance is intended to help entities evaluate whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The revision provides a more robust framework to use in determining when a set of assets and activities is a business. The new guidance is effective for annual and interim periods beginning after December 15, 2017 and early adoption is permitted. The adoption of this standard is not expected to have a material impact on the Company's business, financial position, results of operations or liquidity.

In November 2016, the FASB issued authoritative guidance that simplifies the disclosure of restricted cash within the statement of cash flows. The guidance is intended to reduce diversity when reporting restricted cash and requires entities to explain changes in the combined total of restricted and unrestricted balances in the statement of cash flows. The new guidance is effective for annual and interim periods beginning after December 15, 2017 and early adoption is permitted. The adoption of this standard is not expected to have a material impact on the Company's consolidated statement of cash flows.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 – BASIS OF PRESENTATION (Continued)

Recently issued accounting requirements (Continued)

In August 2016, the FASB issued authoritative guidance to eliminate diversity in practice related to the cash flow statement classification of eight specific cash flow issues, which include debt prepayment or extinguishment costs, maturity of a zero coupon bond, settlement of contingent consideration liabilities after a business combination, proceeds from insurance settlements and distribution from certain equity method investees. The new guidance is effective for annual and interim periods beginning after December 15, 2017 and early adoption is permitted. The Company is still evaluating this standard and will continue to assess it.

In June 2016, the FASB issued authoritative guidance for accounting for credit losses on financial instruments. The new guidance introduces an approach based on expected losses to estimate credit losses on certain types of financial instruments and modifies the impairment model for available-for-sale debt securities. The new guidance is effective for annual periods beginning after December 15, 2019 and early adoption is permitted beginning after December 15, 2018. The adoption of this standard is not expected to have a material impact on the Company's business, financial position, results of operations, and liquidity.

In February 2016, the FASB issued amended authoritative guidance on accounting for leases. The new provisions require that a lessee of operating leases recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. The lease liability will be equal to the present value of lease payments, with the right-of-use asset based upon the lease liability. The classification criteria for distinguishing between finance (or capital) leases and operating leases are substantially similar to the previous lease guidance, but with no explicit bright lines. As such, operating leases will result in straight-line rent expense similar to current practice. For short-term leases (term of 12 months or less), a lessee is permitted to make an accounting election not to recognize lease assets and lease liabilities, which would generally result in lease expense being recognized on a straight-line basis over the lease term. The guidance is effective for annual and interim periods beginning after December 15, 2018, and will require application of the new guidance at the beginning of the earliest comparable period presented. The Company will not elect early adoption and will apply the modified retrospective approach as required. The adoption of this standard is expected to have a material impact on the Company's financial position. The Company does not expect an impact on its business, results of operations or liquidity.

In January 2016, the FASB issued amended authoritative guidance which makes targeted improvements for financial instruments. The new provisions impact certain aspects of recognition, measurement, presentation and disclosure requirements of financial instruments. Specifically, the guidance will (1) require equity investments to be measured at fair value with changes in fair value recognized in net income, (2) simplify the impairment assessment of equity investments without readily determinable fair values, (3) eliminate the requirement to disclose the method and assumptions used to estimate fair value for financial instruments measured at amortized cost, and (4) require separate presentation of financial assets and financial liabilities by measurement category. The guidance is effective for annual and interim periods beginning after December 15, 2017, and early adoption is not permitted. The adoption of this standard is not expected to have a material impact on the Company's business, financial position, results of operations, or liquidity.

In May 2014, the FASB issued authoritative guidance which changes the requirements for recognizing revenue when entities enter into contracts with customers. Under the new provisions, an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects what it expects in exchange for the goods or services. It also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

In July 2015, the FASB finalized a one year deferral of the new revenue standard with an updated effective date for interim and annual periods beginning on or after December 15, 2017. Entities are not permitted to adopt the standard earlier than the original effective date, which was on or after December 15, 2016.

In March 2016, the FASB finalized its amendments to the guidance in the new revenue standard on assessing whether an entity is a principal or an agent in a revenue transaction. Under the new amendments, the FASB confirmed that a principal in an arrangement controls a good or service before it is transferred to a customer but revised the structure of indicators when an entity is the principal. The amendments have the same effective date and transition requirements as the new revenue standard.

In May 2016, the FASB finalized its amendments to the guidance in the new revenue standard on contracts with customers and specifically, collectability, non-cash consideration, presentation of sales taxes, and completed contracts. The amendments are intended to reduce the risk of diversity in practice and the cost and complexity of applying certain aspects of the revenue standard. The amendments have the same effective date and transition requirements as the new revenue standard, which is effective for interim and annual periods beginning on or after December 15, 2017, with early adoption permitted on or after December 15, 2016.

## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 1 – BASIS OF PRESENTATION (Continued)

## Recently issued accounting requirements (Continued)

The Company will not elect early adoption but will apply the modified retrospective approach upon the required effective date. Based upon the Company's assessment of the new guidance, it anticipates an opening balance sheet adjustment to reduce 2017 retained earnings in the range of \$7 million to \$10 million, which primarily relates to recognizing contractual adjustments to revenues earlier due primarily to variable considerations arising from its private payor portfolio. In addition, the Company anticipates a reclassification of bad debt expense to revenue contractual allowance in the range of \$9 million to \$12 million as a result of the provisions of the new standard in 2018. Management will continue to evaluate and review its estimates of the anticipated impact that the new guidance will have on its revenue recognition policies, procedures, financial position, results of operations, financial disclosures and control policies through December 31, 2017.

## Equity

The following table sets forth the changes in equity attributable to noncontrolling interests and equity attributable to Kindred stockholders for the nine months ended September 30, 2017 and 2016 (in thousands):

	Amounts attributable		
	to Kindred stockholders	Noncontrolling interests	Total equity
For the nine months ended September 30, 2017			
Balance at December 31, 2016	\$ 812,551	\$ 228,970	\$ 1,041,521
Comprehensive income (loss):			
Net income (loss)	(510,652 )	44,831	(465,821 )
Other comprehensive income	1,356	-	1,356
	(509,296 )	44,831	(464,465 )
Issuance of common stock in connection with employee benefit plans	32	-	32
Shares tendered by employees for statutory tax withholdings upon issuance of common stock	(2,417 )	-	(2,417 )
Amortization of stock-based compensation	13,316	-	13,316
Dividends paid	(10,228 )	-	(10,228 )
Distributions to noncontrolling interests	-	(48,372 )	(48,372 )
Contributions made by noncontrolling interests (cash and non-cash)	-	1,263	1,263
Balance at September 30, 2017	\$ 303,958	\$ 226,692	\$ 530,650
For the nine months ended September 30, 2016			
Balance at December 31, 2015	\$ 1,499,854	\$ 206,193	\$ 1,706,047
Comprehensive income (loss):			
Net income (loss)	(648,823 )	40,347	(608,476 )
Other comprehensive loss	(1,702 )	-	(1,702 )
	(650,525 )	40,347	(610,178 )

Shares tendered by employees for statutory tax withholdings upon issuance of common stock	(3,079 )	-	(3,079 )
Income tax benefit in connection with the issuance of common stock under employee benefit plans	434	-	434
Amortization of stock-based compensation	13,058	-	13,058
Dividends paid	(30,517 )	-	(30,517 )
Contributions made by noncontrolling interests (cash and non-cash)	-	14,061	14,061
Distributions to noncontrolling interests	-	(35,240 )	(35,240 )
Purchase of noncontrolling interests	(234 )	(2,158 )	(2,392 )
Balance at September 30, 2016	\$ 828,991	\$ 223,203	\$ 1,052,194
Property and equipment			

Beginning April 1, 2017, the Company changed the estimated useful life of certain information technology equipment and software based upon a detailed review of actual utilization. Following the acquisition of Gentiva (as defined in Note 6), the Company made significant investments in information technology and software. The actual usage and longevity of these assets supports longer lives than previously estimated. The change in estimate extended the expected useful life by one to two years depending on the asset category and has been accounted for prospectively. The impact from this change in accounting estimate was a decrease to loss from continuing operations before income taxes of approximately \$3.2 million (\$1.9 million net of income taxes) in the third quarter of 2017 and \$7.1 million (\$4.3 million net of income taxes) for the nine months ended September 30, 2017.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 – BASIS OF PRESENTATION (Continued)

#### Derivative financial instruments

In January 2016, the Company entered into three interest rate swap agreements to hedge its floating interest rate on an aggregate of \$325 million of debt outstanding under its Term Loan Facility (as defined in Note 13). The interest rate swaps have an effective date of January 11, 2016, and expire on January 9, 2021. The Company is required to make payments based upon a fixed interest rate of 1.862% and 1.855% calculated on the notional amount of \$175 million and \$150 million, respectively. In exchange, the Company will receive interest on \$325 million at a variable interest rate that is based upon the three-month London Interbank Offered Rate (“LIBOR”), subject to a minimum rate of 1.0%.

In March 2014, the Company entered into an interest rate swap agreement to hedge its floating interest rate on an aggregate of \$400 million of debt outstanding under its Term Loan Facility. On April 8, 2014, the Company completed a novation of a portion of its \$400 million swap agreement to two new counterparties, each in the amount of \$125 million. The original swap contract was not amended, terminated, or otherwise modified. The interest rate swap had an effective date of April 9, 2014, will expire on April 9, 2018, and continues to apply to the Term Loan Facility. The Company is required to make payments based upon a fixed interest rate of 1.867% calculated on the notional amount of \$400 million. In exchange, the Company will receive interest on \$400 million at a variable interest rate that is based upon the three-month LIBOR, subject to a minimum rate of 1.0%.

The interest rate swaps were assessed for hedge effectiveness for accounting purposes and the Company determined the interest rate swaps qualify for cash flow hedge accounting at September 30, 2017. The Company records the effective portion of the gain or loss on these derivative financial instruments in accumulated other comprehensive income (loss) as a component of stockholders’ equity and records the ineffective portion of the gain or loss on these derivative financial instruments as interest expense. For the three months and nine months ended September 30, 2017 and 2016, there was no ineffectiveness related to the interest rate swaps.

The aggregate fair value of the interest rate swaps recorded in other accrued liabilities was \$0.6 million and \$2.7 million at September 30, 2017 and December 31, 2016, respectively.

#### Variable interest entities

The Company follows the provisions of the authoritative guidance for determining whether an entity is a variable interest entity (“VIE”). In order to determine if the Company is a primary beneficiary of a VIE for financial reporting purposes, it must consider whether it has the power to direct activities of the VIE that most significantly impact the performance of the VIE and whether the Company has the obligation to absorb losses or the right to receive returns that would be significant to the VIE. The Company consolidates a VIE when it is the primary beneficiary.

Of the Company’s 19 operating IRFs, 17 are partnerships subject to an operating and management services agreement. Under GAAP, the Company determined that 14 of these 17 partnerships qualify as VIEs and concluded that the Company is the primary beneficiary in all but one partnership. The Company holds an ownership interest and acts as manager in each of the partnerships. Through the management services agreement, the Company is delegated necessary responsibilities to provide management services, administrative services and direction of the day-to-day

operations. Based upon the Company's assessment of the most significant activities of the IRFs, the manager has the ability to direct the majority of those activities in 13 of the partnerships.

The analysis upon which the consolidation determination rests can be complex, can involve uncertainties, and requires judgment on various matters, some of which could be subject to different interpretations.

KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 1 – BASIS OF PRESENTATION (Continued)

## Variable interest entities (Continued)

The carrying amounts and classifications of the assets and liabilities of the consolidated VIEs are as follows (in thousands):

	September 30, 2017	December 31, 2016
<b>Assets:</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 40,848	\$ 41,681
Accounts receivable, net	46,703	33,996
Inventories	1,633	1,641
Other	3,624	2,824
	92,808	80,142
Property and equipment, net	14,771	16,736
Goodwill	275,375	275,375
Intangible assets, net	21,211	21,839
Other	10	15
<b>Total assets</b>	<b>\$ 404,175</b>	<b>\$ 394,107</b>
<b>Liabilities:</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 24,354	\$ 23,345
Salaries, wages and other compensation	2,516	3,160
Other accrued liabilities	4,903	3,046
Long-term debt due within one year	1,037	1,571
	32,810	31,122
Long-term debt	149	455
Deferred credits and other liabilities	8,815	7,357
<b>Total liabilities</b>	<b>\$ 41,774</b>	<b>\$ 38,934</b>

## Other information

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions for quarterly reports on Form 10-Q of Regulation S-X and do not include all of the disclosures normally required by GAAP 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, 2016 filed with the Securities and Exchange Commission (the "SEC") on Form 10-K. The accompanying condensed consolidated balance sheet at December 31, 2016 was derived from audited consolidated financial statements, but does not include all disclosures required by GAAP.

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 statement of interim results and, except as otherwise disclosed, all such adjustments are of a normal and recurring nature.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with GAAP and include amounts based upon the estimates and judgments of management. Actual amounts may differ from those estimates.

#### Reclassifications

Certain prior period amounts have been reclassified to conform with the current period presentation.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 – ACQUISITIONS

The following is a summary of the Company's acquisition activities. The operating results of the acquired businesses have been included in the accompanying unaudited condensed consolidated financial statements of the Company from the respective acquisition dates. The purchase price of acquired businesses resulted from negotiations with each of the sellers that were based upon both the historical and expected future cash flows of the respective businesses. Each of these acquisitions was financed through operating cash flows and borrowings under the Company's ABL Facility (as defined in Note 13). Unaudited pro forma financial data related to the acquired businesses have not been presented because the acquisitions are not material individually to the Company's consolidated financial statements.

During the nine months ended September 30, 2017, the Company acquired three home health businesses for \$6.7 million in cash.

During the third quarter of 2016, the Company acquired home health operations from the Arkansas Department of Health, which included licenses to provide home health, hospice and personal care services throughout the state of Arkansas, for approximately \$39 million. In addition, the Company also acquired two certificates of need, one for home health and one for hospice, and an IRF Medicare license for \$4.3 million, in aggregate.

In June 2016, the Company acquired five LTAC hospitals (233 licensed beds) operated by Select Medical Holdings Corporation ("Select") and sold three of its LTAC hospitals (255 licensed beds) to Select. In the third quarter of 2016, the Company paid Select \$6 million in lieu of selling another LTAC hospital to Select. In connection with the facility swap with Select, the Company recorded a gain of \$0.9 million (\$0.5 million net of income taxes) during the nine months ended September 30, 2016.

In addition, during the nine months ended September 30, 2016, the Company acquired four home health and hospice businesses for \$26.3 million in cash. The Company also acquired a hospice business in exchange for \$9.0 million of outstanding accounts receivable owed to the Company.

NOTE 3 – IMPAIRMENT CHARGES

During the nine months ended September 30, 2017, the Company recorded asset impairment charges of \$134.6 million related to the previously acquired RehabCare trade name (\$97.4 million) and customer relationship intangible asset (\$37.2 million) due to the expected loss of affiliated contracts related to the SNF Divestiture (as defined in Note 4) and cancellation of non-affiliated contracts. The fair value of the trade name was measured using Level 3 inputs, such as projected revenues and royalty rate. The fair value of the customer relationship intangible asset was measured using Level 3 inputs, such as discounted projected future operating cash flows.

During the nine months ended September 30, 2017, the Company also recorded asset impairment charges of \$1.3 million related to a hospital certificate of need (\$0.7 million) and a Medicare certification for an IRF (\$0.6 million) after completing the annual indefinite-lived intangible assets impairment review at May 1, 2017. The fair value of the certificate of need was measured using Level 3 inputs, such as operating cash flows. The fair value of the Medicare certification was measured using a pending offer, a Level 3 input.

In addition, during the nine months ended September 30, 2017, the Company recorded an asset impairment charge of \$0.4 million related to a valuation adjustment for a building within the Kindred at Home division. The fair value of the building was measured using Level 3 inputs, primarily replacement cost.

On October 1, 2016, the Company completed the sale of 12 LTAC hospitals (the “Hospitals”) to a group of entities operating under the name “Curahealth”, which are affiliates of a private investment fund sponsored by Nautic Partners, LLC (the “Curahealth Disposal”). In connection with (1) the Curahealth Disposal, (2) the closure of three LTAC hospitals in the third quarter of 2016, (3) a reduction in revenues associated with revenue rate reductions announced by the Center of Medicare and Medicaid Services (“CMS”) on August 2, 2016, (4) continued increases in labor costs during 2016, and (5) a refinement of the impact of LTAC patient criteria that became effective for the majority of the Company’s LTAC hospitals on September 1, 2016 (collectively, the “Hospital Division Triggering Event”), the Company was required to assess the recoverability of the hospital division reporting unit goodwill in the third quarter of 2016.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 3 – IMPAIRMENT CHARGES (Continued)

The goodwill impairment test involved a two-step process. The first step was a comparison of the reporting unit's fair value to its carrying value. To determine the fair value of the hospital division reporting unit, the Company used a combination of an income approach and a market approach to calculate the fair value of the reporting unit. The discounted cash flow that served as the primary basis for the income approach was based upon the hospital division's financial forecast of revenue, gross profit margins, operating costs and cash flows. As a result of the Hospital Division Triggering Event, the Company concluded that the carrying value of the hospital division reporting unit exceeded its estimated fair value. The second step of the test was then performed to measure the impairment loss, a process which compared the implied fair value of goodwill to the implied fair value for the reporting unit. The Company determined that a goodwill impairment charge aggregating \$261.1 million was necessary during the third quarter of 2016. The Company also assessed the recoverability of the hospital division intangible assets and property and equipment and concluded a property and equipment impairment charge of \$3.2 million was necessary during the third quarter of 2016. The fair value of the assets was measured using Level 3 inputs such as operating cash flows, market data and replacement cost factoring in depreciation, economic obsolescence and inflation trends. The impairment charges did not impact the Company's cash flows or liquidity.

During the third quarter of 2016, the Hospitals met assets held for sale criteria and were subsequently sold to Curahealth on October 1, 2016. The Company recorded impairment charges in connection with the sale aggregating \$33.0 million, of which \$19.7 million was related to property and equipment, and \$13.3 million was related to goodwill and other intangible assets. The fair value of the assets was measured using a Level 3 input of the then pending offer. In addition, in the first quarter of 2016, the Company also recorded a property and equipment impairment charge of \$7.8 million under the held and used accounting model related to the planned Curahealth Disposal. The fair value of property and equipment in the first quarter of 2016 was measured using Level 3 inputs, primarily replacement costs.

During the nine months ended September 30, 2016, the Company also recorded an impairment charge of \$3.5 million related to certificates of need for two hospitals as part of the annual indefinite-lived intangible assets impairment review at May 1, 2016. The fair value of the certificates of need was measured using Level 3 inputs, such as operating cash flows.

In addition, during the nine months ended September 30, 2016, the Company recorded an asset impairment charge of \$2.6 million related to the sale of a hospital division medical office building. The fair value of the property was measured using a Level 3 input of the then pending offer.

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 hospital is considered the lowest level for which there are independent, identifiable cash flows. However, to the extent that groups of facilities are leased under a master lease agreement in which the operations of a facility and compliance with the lease terms are interdependent upon other facilities in the agreement (including the Company's ability to renew the lease or divest a particular property), the Company defines the group of facilities under a master lease agreement, or a renewal bundle in a master lease, 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, or a renewal bundle in a master lease, are aggregated for purposes of evaluating the carrying values of long-lived assets.

Each of the impairment charges discussed above reflects the amount by which the carrying value of the assets exceeded its estimated fair value at each impairment date.

All of the above mentioned charges are included in the impairment charges line on the statement of operations for all periods.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4 – DIVESTITURES

Skilled nursing facility business exit

On June 30, 2017, the Company entered into a definitive agreement with BM Eagle Holdings, LLC, a joint venture led by affiliates of BlueMountain Capital Management, LLC (“BlueMountain”), under which the Company agreed to sell its skilled nursing facility business for \$700 million in cash (the “SNF Divestiture”). The sale includes 89 nursing centers with 11,308 licensed beds and seven assisted living facilities with 380 licensed beds in 18 states. During the third quarter of 2017, the Company completed the sale of 54 of the skilled nursing facilities for \$519.4 million. The sale proceeds were deposited with an escrow agent and after paying closing costs and applying repair credits, net cash proceeds totaled \$501.6 million. The escrow agent directly paid \$500.6 million of the net cash proceeds to Ventas, Inc. (“Ventas”) and another landlord. The remaining net cash proceeds of \$1.0 million was directly paid to Kindred, which is reflected in the sale of assets in the investing activities in the accompanying unaudited condensed consolidated statement of cash flows. On October 1, 2017, the Company completed the sale of an additional 12 of the skilled nursing facilities and four of the assisted living facilities for \$107.5 million.

As previously disclosed, 36 of the skilled nursing facilities (the “Ventas Properties”) were or continue to be leased from Ventas and the Company has an option to acquire the real estate of the Ventas Properties for aggregate consideration of \$700 million. As the Company closes on the sale of the Ventas Properties, the Company will pay to Ventas the allocable portion of the \$700 million purchase price for the Ventas Properties and Ventas will convey or has conveyed the real estate for the applicable Ventas Property to BlueMountain or its designee. The Company, through an escrow agent, has paid \$488.1 million to Ventas for the Ventas Properties in connection with the closings that occurred during the third quarter of 2017. The Company, through an escrow agent, paid an additional \$82.5 million to Ventas for the Ventas Properties in connection with the closings that occurred on October 1, 2017.

The completion of the remainder of the sales is subject to customary conditions to closing, including the receipt of all licensure, regulatory and other approvals. The Company expects that the remainder of the sales will occur in phases as regulatory and other approvals are received. The Company expects that nearly all of the closings will be completed by year end.

In accordance with authoritative guidance for assets held for sale and discontinued operations accounting, the skilled nursing facility business is reported as assets held for sale and was moved to discontinued operations for all periods presented.

During the third quarter of 2017, the Company recorded \$51.3 million of pretax charges related to the SNF Divestiture, including a \$2.7 million lease termination accrual, \$23.8 million of transaction and other costs, a \$17.9 million loss on sale-leaseback transaction, and \$6.9 million of retention costs.

During the nine months ended September 30, 2017, the Company recorded \$346.3 million of pretax charges related to the SNF Divestiture, including a \$265.0 million lease termination accrual, \$42.2 million of transaction and other costs, a \$17.9 million loss on sale-leaseback transaction, and \$21.2 million of retention costs.

In connection with the SNF Divestiture, the Company entered into an interim management agreement in the third quarter of 2017 with certain affiliates of BlueMountain in the state of California whereby the Company would lease its license of certain operations to such affiliates until licensure approval is obtained. Because the Company has continuing involvement in the business through purveying certain rights of ownership of the assets while under the interim management agreement and license sublease, the Company does not meet the requirements for a sale-leaseback transaction as described in ASC 840-40, Leases - Sale-Leaseback Transactions. Under the failed-sale-leaseback accounting model, the Company is deemed under GAAP to still own certain real estate assets sold to BlueMountain, which the Company must continue to reflect in its consolidated balance sheet and depreciate over the assets' remaining useful life. The Company must also treat a portion of the pretax cash proceeds from the SNF Divestiture as though it were the result of a \$140.8 million other long-term liability financing obligation in its accompanying unaudited condensed consolidated balance sheet, and must also defer a \$17.9 million gain associated with some of these assets until continuing involvement ceases. The lease will terminate upon licensure approval, at which time the Company will cease to recognize the remaining other long-term liability financing obligation, as well as the remaining net book value of the real estate assets and will recognize the gain.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 5 – DISCONTINUED OPERATIONS

In accordance with the authoritative guidance for the impairment or disposal of long-lived assets, the divestitures of unprofitable businesses discussed in Note 1 have been accounted for as discontinued operations. Accordingly, the results of operations of these businesses for all periods presented and the gains or losses associated with these transactions have been classified as discontinued operations, net of income taxes, in the accompanying unaudited condensed consolidated statement of operations based upon the authoritative guidance which was in effect through December 31, 2014. Effective January 1, 2015, the authoritative guidance modified the requirements for reporting discontinued operations. A disposal is now required to be reported in discontinued operations only if the disposal represents a strategic shift that has (or will have) a major effect on the Company's operations and financial results.

In June 2017, the Company entered into a definitive agreement regarding the SNF Divestiture. In connection with the SNF Divestiture, the results of operations of the skilled nursing facility business, which previously were reported in the nursing center division, and the gains or losses associated with the SNF Divestiture, have been classified as discontinued operations for all periods presented. In addition, direct overhead and the profits from applicable RehabCare contracts servicing the Company's skilled nursing facility business were moved to discontinued operations for all periods presented. During the third quarter of 2017, the Company reclassified from discontinued operations to continuing operations for all periods presented historical profits from certain RehabCare contracts that were retained with new operators of divested skilled nursing facilities. The Company has reclassified certain retained businesses and expenses previously reported in the nursing center division to other business segments, including hospital-based sub-acute units and a skilled nursing facility to the hospital division and a small therapy business to the Kindred Hospital Rehabilitation Services operating segment for all periods presented. See Note 4.

During 2016, the nursing center division experienced a decline in financial performance as compared to projected results and in the third quarter of 2016, the Company determined it was more likely than not that it would dispose of its skilled nursing facility business. As a result, the Company tested the recoverability of its nursing center division intangible assets and property and equipment under the held and used accounting model. No goodwill existed on the nursing centers reporting unit's balance sheet at September 30, 2016. The Company determined that a property and equipment impairment charge aggregating \$21.7 million was necessary during the third quarter of 2016. The fair value of the assets was measured using Level 3 inputs, such as operating cash flows and replacement costs.

During the third quarter of 2016, the Company reviewed the long-lived assets related to the planned divestiture and pending offers for a nursing center held for sale and determined its property and equipment was impaired. As a result, the Company recorded an impairment charge of \$5.3 million. The fair value of the assets was measured based upon the then pending offers, a Level 3 input. The impairment charge did not impact the Company's cash flows or liquidity.



## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 5 – DISCONTINUED OPERATIONS (Continued)

The following table summarizes (in thousands) the SNF Divestiture liability activity (included in current liabilities) during the nine months ended September 30, 2017, which does not include non-cash charges of \$0.9 million related to other costs:

	Retention	Transaction and other costs	Lease termination costs	Total
Liability balance at December 31, 2016	\$ 3,920	\$ 420	\$ 12,777	\$ 17,117
Expense	21,154	41,310	264,999	327,463
Payments	(10,419 )	(30,626 )	(171,788 )	(212,833 )
Liability balance at September 30, 2017	\$ 14,655	\$ 11,104	\$ 105,988	\$ 131,747

A summary of discontinued operations follows (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Revenues	\$ 184,739	\$ 256,105	\$ 691,796	\$ 780,832
Salaries, wages and benefits	79,495	95,149	268,079	286,927
Supplies	8,488	10,708	29,654	32,457
Building rent	16,538	20,125	57,507	60,585
Equipment rent	1,644	1,903	5,845	5,895
Other operating expenses	57,871	72,156	204,005	216,026
General and administrative expenses	33,660	45,764	117,006	138,256
Other income	(179 )	(151 )	(495 )	(585 )
Impairment charges	-	27,013	1,268	27,013
Restructuring charges	-	-	-	4,010
Depreciation and amortization	777	7,387	10,631	21,810
Interest expense	5	12	17	36
Investment income	(16 )	(14 )	(53 )	(44 )
	198,283	280,052	693,464	792,386
Loss from operations before income taxes	(13,544 )	(23,947 )	(1,668 )	(11,554 )
Provision (benefit) for income taxes	68	(1,887 )	203	(1,065 )
Loss from operations	(13,612 )	(22,060 )	(1,871 )	(10,489 )
Gain (loss) on divestiture of operations	(49,663 )	-	(349,868 )	179
Loss from discontinued operations	(63,275 )	(22,060 )	(351,739 )	(10,310 )

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Earnings attributable to noncontrolling interests	(3,162 )	(4,732 )	(12,597 )	(14,075 )
Loss attributable to Kindred	\$(66,437 )	\$(26,792 )	\$(364,336 )	\$(24,385 )

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## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 5 – DISCONTINUED OPERATIONS (Continued)

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2017	2016	2017	2016
<b>Revenues:</b>				
Nursing center division	\$184,307	\$255,594	\$690,387	\$779,439
Hospital division	432	511	1,409	1,393
	\$184,739	\$256,105	\$691,796	\$780,832
<b>Segment adjusted operating income:</b>				
Nursing center division	\$4,909	\$31,899	\$71,622	\$106,275
Hospital division	495	580	1,925	1,476
	\$5,404	\$32,479	\$73,547	\$107,751
<b>Rent:</b>				
<b>Nursing center division:</b>				
Building rent	\$16,068	\$19,657	\$56,101	\$59,190
Equipment rent	1,644	1,903	5,845	5,895
	17,712	21,560	61,946	65,085
<b>Hospital division:</b>				
Building rent	470	468	1,406	1,395
Equipment rent	-	-	-	-
	470	468	1,406	1,395
<b>Totals:</b>				
Building rent	16,538	20,125	57,507	60,585
Equipment rent	1,644	1,903	5,845	5,895
	\$18,182	\$22,028	\$63,352	\$66,480
<b>Depreciation and amortization:</b>				
Nursing center division	\$777	\$7,387	\$10,631	\$21,810
Hospital division	-	-	-	-
	\$777	\$7,387	\$10,631	\$21,810

The following table sets forth a summary of assets held for sale related to the SNF Divestiture (in thousands):

September 30, December 31,

	2017	2016
Current assets:		
Property and equipment, net	\$ 58,456	\$ 259,966
Intangible assets, net	13,844	20,127
Other	6,751	9,357
	79,051	289,450
Current liabilities (included in other accrued liabilities)	(9,250 )	-
	\$ 69,801	\$ 289,450

#### NOTE 6 – RESTRUCTURING CHARGES

The Company has initiated various restructuring activities whereby it has incurred costs associated with reorganizing its operations, including the divestiture, swap, closure and consolidation of facilities and branches, reduced headcount and realigned operations in order to improve cost efficiencies in response to changes in the healthcare industry and to partially mitigate reductions in reimbursement rates from third party payors. The costs associated with these activities are reported as restructuring charges in the statement of operations and would have been recorded as general and administrative expense or rent expense if not classified as restructuring charges.

## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 6 – RESTRUCTURING CHARGES (Continued)

The following table sets forth the restructuring charges incurred by business segment (in thousands):

	Three months ended September 30, 2017		Nine months ended September 30, 2016	
<b>Kindred at Home:</b>				
Home health	\$ 1,024	\$ 1,240	\$ 7,869	\$ 1,976
Hospice	202	541	4,246	1,203
	1,226	1,781	12,115	3,179
Hospital division	13,867	78,476	17,318	78,743
<b>Kindred Rehabilitation Services:</b>				
Kindred Hospital Rehabilitation Services	-	128	-	128
RehabCare	-	586	-	586
	-	714	-	714
Support center	1,407	492	2,123	1,577
	\$ 16,500	\$ 81,463	\$ 31,556	\$ 84,213

## Restructuring Activities:

## LTAC Hospital Portfolio Repositioning 2017 Plan

During the third quarter of 2017, the Company approved phase two of the LTAC hospital portfolio repositioning plan that incorporated the closure and conversion of certain LTAC hospitals as part of its mitigation strategies in response to the new patient criteria for LTAC hospitals under the Pathway for SGR Reform Act of 2013 (the “LTAC Legislation”). The activities related to the LTAC hospital portfolio repositioning 2017 plan are expected to be substantially completed by the end of 2018.

	Three months ended September 30, 2017		Nine months ended September 30, 2016	
Lease termination costs	\$ 564	\$ -	\$ 564	\$ -
Severance	3,513	-	3,513	-
Asset write-offs	9,141	-	9,141	-
	\$ 13,218	\$ -	\$ 13,218	\$ -

The following table (in thousands) summarizes the Company’s LTAC hospital portfolio repositioning 2017 plan liability activity (included in current liabilities) during the nine months ended September 30, 2017, which does not

include non-cash charges of \$9.1 million related to asset write-offs:

	Severance
Liability balance at December 31, 2016	\$ -
Expense	3,513
Payments	(2,280 )
Liability balance at September 30, 2017	\$ 1,233

LTAC Hospital Portfolio Repositioning 2016 Plan

During the first quarter of 2016, the Company approved the LTAC hospital portfolio repositioning 2016 plan that incorporated the divestiture, swap or closure of certain LTAC hospitals as part of its mitigation strategies to prepare for new patient criteria for LTAC hospitals under the LTAC Legislation. The activities related to the LTAC hospital portfolio repositioning 2016 plan were substantially completed during 2016.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 6 – RESTRUCTURING CHARGES (Continued)

Restructuring Activities (Continued):

LTAC Hospital Portfolio Repositioning 2016 Plan (Continued)

The composition of the restructuring charges that the Company has incurred for these activities is as follows (in thousands):

	Three months ended September 30, 2017		Nine months ended September 30, 2016	
Lease termination costs	\$649	\$56,869	\$2,813	\$56,869
Facility closure costs and gain on disposal	-	955	232	(148 )
Asset write-offs	-	19,257	1,055	19,257
Severance	-	1,395	-	2,765
Transaction costs	-	492	-	1,577
	\$649	\$78,968	\$4,100	\$80,320

The following table (in thousands) summarizes the Company's LTAC hospital portfolio repositioning 2016 plan liability activity (included in accrued lease termination fees, and deferred credits and other liabilities) during the nine months ended September 30, 2017, which does not include non-cash charges of \$1.1 million related to asset write-offs:

	Lease termination costs
Liability balance at December 31, 2016	\$ 40,649
Expense	2,813
Payments	(8,608 )
Liability balance at September 30, 2017	\$ 34,854

## Kindred at Home 2017 Efficiency Initiative

During the first quarter of 2017, the Kindred at Home division approved and initiated a cost and operations efficiency initiative to address increases in labor costs associated with competitive labor markets and the integration of pay practices from acquisitions across the Kindred at Home portfolio. This initiative includes the consolidation and closure of under-performing branches and a reduction in force associated with the restructuring of divisional and regional support teams. These activities will be substantially completed during 2017.

The composition of the restructuring costs that the Company has incurred for these activities is as follows (in thousands):

	Three months ended September 30, 2017		Nine months ended September 30, 2016	
Lease termination costs	\$ 700	\$ -	\$ 1,470	\$ -
Asset write-offs	300	-	4,616	-
Severance	732	-	2,423	-
Gain on disposal	(718 )	-	(718 )	-
	\$ 1,014	\$ -	\$ 7,791	\$ -

The following table (in thousands) summarizes the related restructuring liability activity (included in current liabilities) during the nine months ended September 30, 2017, which does not include non-cash charges of \$4.6 million related to asset write-offs:

	Lease termination costs	Severance	Total
Liability balance at December 31, 2016	\$ -	\$ -	\$-
Expense	1,470	2,423	3,893
Payments	(301 )	(2,224 )	(2,525)
Other	-	39	39
Liability balance at September 30, 2017	\$ 1,169	\$ 238	\$ 1,407

## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 6 – RESTRUCTURING CHARGES (Continued)

## Restructuring Activities (Continued):

## Kindred at Home Branch Consolidations and Closures

During the first quarter of 2015, the Company approved and initiated branch consolidations and closures in specific markets to improve operations and cost efficiencies in the Kindred at Home division. The branch consolidations and closures included branches that served both the home health and hospice business segment operations. Gentiva Health Services, Inc. (“Gentiva”), a home health and hospice company acquired by the Company on February 2, 2015 (the “Gentiva Merger”), initiated similar branch consolidations and closures prior to the Gentiva Merger and these activities and acquired liabilities are included in the amounts below. These activities were substantially completed during 2016.

The composition of the restructuring costs that the Company has incurred for these consolidations and closures is as follows (in thousands):

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Lease termination costs	\$212	\$1,781	\$1,117	\$2,494
Branch closure and other costs	-	-	-	145
Asset write-offs	-	-	2,599	540
Severance	-	-	608	-
	\$212	\$1,781	\$4,324	\$3,179

The following table (in thousands) summarizes the related restructuring liability activity (included in current liabilities) during the nine months ended September 30, 2017, which does not include non-cash charges of \$2.6 million related to asset write-offs:

	Lease termination costs	Severance	Total
Liability balance at December 31, 2016	\$ 3,060	\$ 1,343	\$4,403
Expense	1,117	608	1,725
Payments	(3,049 )	(2,175 )	(5,224)
Other	(135 )	224	89
Liability balance at September 30, 2017	\$ 993	\$ -	\$993

## NOTE 7 – 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, Medicare Advantage, Medicaid Managed, and other third party payors. Revenues under third party agreements are subject to examination and retroactive adjustment. Provisions for estimated third party adjustments are provided in the period the related services are rendered. Differences between the amounts accrued and subsequent settlements are recorded in the periods the interim or final settlements are determined.

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Medicare	\$774,626	\$848,269	\$2,388,258	\$2,621,960
Medicaid	106,119	110,228	323,195	317,328
Medicare Advantage	121,119	122,167	360,286	367,158
Medicaid Managed	49,662	42,061	150,853	120,107
Other	446,443	465,031	1,395,272	1,423,646
	1,497,969	1,587,756	4,617,864	4,850,199
Eliminations	(20,828 )	(24,480 )	(67,023 )	(75,386 )
	\$1,477,141	\$1,563,276	\$4,550,841	\$4,774,813

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 – LOSS PER SHARE AND DIVIDENDS

Loss per common share is based upon the weighted average number of common shares outstanding during the respective periods. Because the Company reported a loss from continuing operations attributable to the Company for both the three months ended September 30, 2017 and 2016, and for both the nine months ended September 30, 2017 and 2016, the diluted calculation of earnings per common share excludes the dilutive impact of stock options and the Company's 172,500 tangible equity units (the "Units") of 1.4 million for both the third quarter of 2017 and for the nine months ended September 30, 2017 and 1.7 million for both the third quarter of 2016 and for the nine months ended September 30, 2016. The Company follows the provisions of the authoritative guidance for determining whether instruments granted in share-based payment transactions are participating securities, which requires that unvested restricted stock that entitles the holder to receive nonforfeitable dividends before vesting be included as a participating security in the basic and diluted earnings per common share calculation pursuant to the two-class method. However, because the Company reported a loss from continuing operations attributable to the Company, there was no allocation to participating unvested restricted stockholders for all periods presented.

During the nine months ended September 30, 2017, the Company paid a cash dividend of \$0.12 per common share on March 31, 2017. The Company's Board of Directors elected to discontinue paying dividends on the Company's common stock following the March 31, 2017 payment and instead redirected funds to repay debt and invest in growth.

During the nine months ended September 30, 2016, the Company paid a cash dividend of \$0.12 per common share on September 2, 2016 (to shareholders of record as of the close of business on August 18, 2016), June 10, 2016 and April 1, 2016.

The Company made installment payments on the Units of \$18.75 per Unit on September 1, 2017 (to holders of record as of close of business on August 15, 2017), June 1, 2017 and March 1, 2017. The Company made installment payments on the Units of \$18.75 per Unit on September 1, 2016 and March 1, 2016, and \$18.76 per Unit on June 1, 2016. Each Unit is composed of a prepaid stock purchase contract (a "Purchase Contract") and one share of 7.25% Mandatory Redeemable Preferred Stock, Series A (the "Mandatory Redeemable Preferred Stock") having a final preferred stock installment payment date of December 1, 2017 and an initial liquidation preference of \$201.58 per share of Mandatory Redeemable Preferred Stock. To the extent that any Unit has been separated into its constituent Purchase Contract and its constituent share of Mandatory Redeemable Preferred Stock, the installment payment is payable only on the constituent share of Mandatory Redeemable Preferred Stock.

NOTE 9 – BUSINESS SEGMENT DATA

The Company is organized into three operating divisions: the Kindred at Home division, the hospital division, and the Kindred Rehabilitation Services division. Based upon the authoritative guidance for business segments, the operating divisions represent five reportable operating segments, including (1) home health services, (2) hospice services, (3) hospitals, (4) Kindred Hospital Rehabilitation Services, and (5) RehabCare. These reportable operating segments are consistent with information used by the Company's President and Chief Executive Officer and its Chief Operating Officer to assess performance and allocate resources. The accounting policies of the operating segments are the same

as those described in the summary of significant accounting policies.

The Company has reclassified certain retained businesses and expenses previously reported in the nursing center division, including hospital-based sub-acute units and a skilled nursing facility to the hospital division and a small therapy business to the Kindred Hospital Rehabilitation Services operating segment for all periods presented.

During the third quarter of 2017, the Company recorded a favorable settlement of \$2.2 million related to certain RehabCare customer contracts for non-payment and related collection litigation (the "RehabCare Collection Litigation"). During the nine months ended September 30, 2017, the Company recorded a provision for doubtful accounts of \$23.1 million related to the RehabCare Collection Litigation.

For segment purposes, the Company defines segment adjusted operating income (loss) as earnings before interest, income taxes, depreciation, amortization, and total rent reported for each of the Company's operating segments, excluding litigation contingency expense, impairment charges, restructuring charges, transaction costs, and the allocation of support center overhead.

## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 9 – BUSINESS SEGMENT DATA (Continued)

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

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2017	2016	2017	2016
<b>Revenues:</b>				
<b>Kindred at Home:</b>				
Home health	\$453,684	\$449,958	\$1,363,691	\$1,318,549
Hospice	188,414	188,575	553,073	550,642
	642,098	638,533	1,916,764	1,869,191
Hospital division	503,138	588,943	1,600,593	1,888,447
<b>Kindred Rehabilitation Services:</b>				
Kindred Hospital Rehabilitation Services	173,638	170,308	530,192	508,448
RehabCare	179,095	189,972	570,315	584,113
	352,733	360,280	1,100,507	1,092,561
	1,497,969	1,587,756	4,617,864	4,850,199
<b>Eliminations:</b>				
Kindred Hospital Rehabilitation Services	(18,376 )	(22,330 )	(59,610 )	(69,515 )
RehabCare	(1,893 )	(1,632 )	(5,638 )	(4,136 )
Hospitals	(559 )	(518 )	(1,775 )	(1,735 )
	(20,828 )	(24,480 )	(67,023 )	(75,386 )
	\$1,477,141	\$1,563,276	\$4,550,841	\$4,774,813
<b>Loss from continuing operations:</b>				
<b>Segment adjusted operating income:</b>				
<b>Kindred at Home:</b>				
Home health	\$66,431	\$75,073	\$206,773	\$218,044
Hospice	34,761	31,326	95,126	87,521
	101,192	106,399	301,899	305,565
Hospital division	61,455	83,940	246,473	347,866
<b>Kindred Rehabilitation Services:</b>				
Kindred Hospital Rehabilitation Services	49,151	49,759	154,333	148,607
RehabCare	7,619	6,740	1,210	25,814
	56,770	56,499	155,543	174,421
Support center expenses	(60,323 )	(62,823 )	(182,909 )	(203,289 )
Litigation contingency expense	(4,000 )	-	(4,000 )	(2,840 )
Impairment charges	-	(297,276 )	(136,303 )	(311,195 )
Restructuring charges	(14,375 )	(22,813 )	(25,592 )	(24,850 )
Transaction costs	-	(2,982 )	-	(6,513 )
Building rent	(64,422 )	(66,946 )	(193,939 )	(199,956 )

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Equipment rent	(8,537 )	(9,911 )	(26,285 )	(31,280 )
Restructuring charges - rent	(2,125 )	(58,650 )	(5,964 )	(59,363 )
Depreciation and amortization	(24,808 )	(32,995 )	(80,279 )	(99,747 )
Interest, net	(60,441 )	(58,059 )	(177,833 )	(172,879 )
Loss from continuing operations before				
income taxes	(19,614 )	(365,617 )	(129,189 )	(284,060 )
Provision (benefit) for income taxes	(1,225 )	283,630	(15,107 )	314,106
	\$(18,389 )	\$(649,247 )	\$(114,082 )	\$(598,166 )

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## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 9 – BUSINESS SEGMENT DATA (Continued)

	Three months ended		Nine months ended	
	September 30, 2017	2016	September 30, 2017	2016
<b>Rent:</b>				
<b>Kindred at Home:</b>				
<b>Home health:</b>				
Building	\$7,993	\$8,188	\$24,218	\$24,725
Equipment	251	284	831	1,005
	8,244	8,472	25,049	25,730
<b>Hospice:</b>				
Building	4,139	4,264	12,513	12,794
Equipment	82	78	254	253
	4,221	4,342	12,767	13,047
<b>Hospital division:</b>				
Building	43,193	45,173	130,126	134,627
Equipment	7,193	8,521	22,147	26,994
	50,386	53,694	152,273	161,621
<b>Kindred Rehabilitation Services:</b>				
<b>Kindred Hospital Rehabilitation Services:</b>				
Building	8,559	8,448	25,463	25,329
Equipment	399	404	1,155	1,182
	8,958	8,852	26,618	26,511
<b>RehabCare:</b>				
Building	317	331	960	949
Equipment	585	594	1,816	1,748
	902	925	2,776	2,697
<b>Support center:</b>				
Building	221	542	659	1,532
Equipment	27	30	82	98
	248	572	741	1,630
<b>Totals:</b>				
Building	64,422	66,946	193,939	199,956
Equipment	8,537	9,911	26,285	31,280
	\$72,959	\$76,857	\$220,224	\$231,236
<b>Depreciation and amortization:</b>				
<b>Kindred at Home:</b>				

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Home health	\$2,662	\$3,803	\$8,281	\$11,916
Hospice	946	1,563	3,333	4,688
	3,608	5,366	11,614	16,604
Hospital division	10,637	12,789	31,868	39,334
Kindred Rehabilitation Services:				
Kindred Hospital Rehabilitation Services	3,808	3,576	11,206	10,629
RehabCare	338	2,011	3,779	5,983
	4,146	5,587	14,985	16,612
Support center	6,417	9,253	21,812	27,197
	\$24,808	\$32,995	\$80,279	\$99,747

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 9 – BUSINESS SEGMENT DATA (Continued)

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Capital expenditures, excluding acquisitions				
(including discontinued operations):				
Kindred at Home:				
Home health:				
Routine	\$1,105	\$1,300	\$3,209	\$5,009
Development	-	-	-	-
	1,105	1,300	3,209	5,009
Hospice:				
Routine	674	637	1,717	1,928
Development	-	-	-	-
	674	637	1,717	1,928
Hospital division:				
Routine	3,325	5,649	10,325	17,499
Development	-	-	-	-
	3,325	5,649	10,325	17,499
Kindred Rehabilitation Services:				
Kindred Hospital Rehabilitation Services:				
Routine	621	380	2,264	1,058
Development	14	4,973	498	15,344
	635	5,353	2,762	16,402
RehabCare:				
Routine	264	698	634	1,205
Development	-	-	-	-
	264	698	634	1,205
Support center:				
Routine:				
Information systems	8,511	7,031	21,620	24,744
Other	396	692	1,304	4,013
	8,907	7,723	22,924	28,757
Development	6,386	2,828	17,170	5,845
	15,293	10,551	40,094	34,602
Discontinued operations - nursing centers:				
Routine	1,567	5,486	4,727	13,247
Development	15	585	43	5,923

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	1,582	6,071	4,770	19,170
Totals:				
Routine	16,463	21,873	45,800	68,703
Development	6,415	8,386	17,711	27,112
	\$22,878	\$30,259	\$63,511	\$95,815

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 9 – BUSINESS SEGMENT DATA (Continued)

	September 30, 2017	December 31, 2016
Assets at end of period (including discontinued operations):		
Kindred at Home:		
Home health	\$ 1,551,317	\$ 1,540,370
Hospice	914,324	929,774
	2,465,641	2,470,144
Hospital division	1,274,200	1,232,541
Kindred Rehabilitation Services:		
Kindred Hospital Rehabilitation Services	824,780	815,804
RehabCare	185,062	329,516
	1,009,842	1,145,320
Support center	777,347	795,415
Discontinued operations - nursing centers	344,721	469,304
	\$ 5,871,751	\$ 6,112,724
Goodwill:		
Kindred at Home:		
Home health	\$ 917,239	\$ 919,482
Hospice	646,329	646,329
	1,563,568	1,565,811
Hospital division	361,310	361,310
Kindred Rehabilitation Services:		
Kindred Hospital Rehabilitation Services	499,953	499,953
RehabCare	-	-
	499,953	499,953
	\$ 2,424,831	\$ 2,427,074

## NOTE 10 – INCOME TAXES

At each balance sheet date, management assesses all available positive and negative evidence to determine whether a valuation allowance is needed against its deferred tax assets. The authoritative guidance requires evidence related to events that have actually happened to be weighted more significantly than evidence that is projected or expected to

happen. A significant piece of negative evidence according to this weighting standard is that there are cumulative losses in the two most recent years and the current year, which is the case for the Company at September 30, 2017 and December 31, 2016. The Company's outlook of taxable income for 2016 changed in the third quarter of 2016 after the Company recorded \$286.0 million of goodwill and property and equipment impairment charges and announced the planned SNF Divestiture and related expected loss on divestiture for tax purposes. Accordingly, a full valuation allowance was recorded at both September 30, 2017 and December 31, 2016. The amount of deferred tax asset considered realizable, however, could be adjusted if the weighting of the positive and negative evidence changes.

The Company has deferred tax liabilities related to tax amortization of acquired indefinite-lived intangible assets because these assets are not amortized for financial reporting purposes. The tax amortization in current and future years created a deferred tax liability which will reverse at the time of ultimate sale or book impairment. Due to the uncertain timing of this reversal, the temporary difference associated with indefinite-lived intangible assets cannot be considered a source of future taxable income for purposes of determining the valuation allowance. As such, this deferred tax liability cannot be used to offset the deferred tax asset related to the net deferred tax assets. The Company has a net deferred tax liability of \$182.1 million and \$201.8 million as of September 30, 2017 and December 31, 2016, respectively, representing indefinite-lived intangible assets.

The Company's income tax benefit for the nine months ended September 30, 2017 is primarily driven by the RehabCare trade name impairment charge of \$97.4 million recorded during the nine months ended September 30, 2017. The Company has a full valuation allowance on its net deferred tax assets with the exception of deferred tax liabilities related to indefinite-lived intangible assets. The impairment charge resulted in a reduction of those indefinite-lived intangible assets creating an income tax benefit. The income tax benefit for the nine months ended September 30, 2017 is limited to the forecasted income tax benefit for the full year of 2017.

## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 10 – INCOME TAXES (Continued)

The Company's effective income tax rate was 6.2% and 77.6% in the third quarter of 2017 and 2016, respectively, and 11.7% and 110.6% for the nine months ended September 30, 2017 and 2016, respectively. The reduction in the effective income tax rate in both periods of 2017 was attributable to the impact of recording the initial full deferred tax asset valuation allowance of \$366.5 million in the third quarter of 2016. The increase in the valuation allowance was \$7.4 million in the third quarter of 2017 and \$40.2 million for the nine months ended September 30, 2017, net of the tax benefit associated with the \$97.4 million RehabCare trade name impairment charge for the nine months ended September 30, 2017 and tax amortization related to indefinite-lived intangible assets in both periods.

## NOTE 11 – INSURANCE RISKS

The Company insures a substantial portion of its professional liability risks and workers compensation risks through its wholly owned limited purpose insurance subsidiary, Cornerstone Insurance Company ("Cornerstone"). Provisions for loss for these risks are based upon management's best available information including actuarially determined estimates. Effective with the Gentiva Merger, the Company cancelled all policies issued by the Gentiva wholly owned limited purpose insurance subsidiary and insures all post-merger risks through Cornerstone.

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 risks 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 expected ultimate claims costs vary from historical provisions for loss, future earnings will be charged or credited.

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

	Three months ended September 30, 2017		Nine months ended September 30, 2016	
<b>Professional liability:</b>				
Continuing operations	\$12,735	\$12,851	\$37,302	\$42,545
Discontinued operations	7,505	6,719	25,437	19,129
<b>Workers compensation:</b>				
Continuing operations	\$11,753	\$14,209	\$31,260	\$39,225
Discontinued operations	2,770	2,746	5,425	6,060

## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 11 – 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):

	September 30, 2017			December 31, 2016		
	Professional liability	Workers compensation	Total	Professional liability	Workers compensation	Total
<b>Assets:</b>						
<b>Current:</b>						
Insurance subsidiary investments	\$55,194	\$ 42,885	\$98,079	\$64,622	\$ 44,344	\$108,966
Reinsurance and other						
recoverables	7,697	1,623	9,320	7,912	1,488	9,400
Other	-	50	50	-	50	50
	62,891	44,558	107,449	72,534	45,882	118,416
<b>Non-current:</b>						
Insurance subsidiary investments	98,481	85,936	184,417	97,223	107,706	204,929
Reinsurance and other						
recoverables	115,224	107,551	222,775	111,596	101,984	213,580
Deposits	4,216	19,497	23,713	4,202	22,979	27,181
Other	92	-	92	-	-	-
	218,013	212,984	430,997	213,021	232,669	445,690
	\$280,904	\$ 257,542	\$538,446	\$285,555	\$ 278,551	\$564,106
<b>Liabilities:</b>						
<b>Allowance for insurance risks:</b>						
Current	\$55,668	\$ 46,401	\$102,069	\$65,284	\$ 48,237	\$113,521
Non-current	315,322	219,771	535,093	295,311	216,971	512,282
	\$370,990	\$ 266,172	\$637,162	\$360,595	\$ 265,208	\$625,803

Provisions for loss for professional liability risks retained by Cornerstone have been discounted based upon actuarial estimates of claim payment patterns using a discount rate of 1%. The discount rate is based upon the risk-free interest rate for the respective year. Amounts equal to the discounted loss provision are funded annually. The Company does not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated \$373.7 million at September 30, 2017 and \$363.2 million at December 31, 2016.

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

In the third quarter of 2017, as a result of improved underwriting results, the Company received a distribution of \$30 million (the “September Distribution”) from Cornerstone and has received distributions totaling \$38 million from Cornerstone for the nine months ended September 30, 2017. The September Distribution was used to repay a portion of the Company’s ABL Facility. These distributions were completed in accordance with applicable regulations and had no impact on earnings or cash flows from operations.

## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 12 – INSURANCE SUBSIDIARY INVESTMENTS

The Company maintains investments, consisting principally of cash and cash equivalents, debt securities, and certificates of deposit for the payment of claims and expenses related to professional liability and workers compensation risks. These investments have been categorized as available-for-sale and are reported at fair value. Due to a change in investment strategy, the Company liquidated all equities and reinvested the proceeds in debt securities during the second quarter of 2017.

The cost for equities, amortized cost for debt securities and estimated fair value of the Company's insurance subsidiary investments follows (in thousands):

	September 30, 2017				December 31, 2016			
	Cost	Unrealized gains	Unrealized losses	Fair value	Cost	Unrealized gains	Unrealized losses	Fair value
Cash and cash equivalents								
(a)	\$161,680	\$ -	\$ -	\$161,680	\$185,152	\$ -	\$ -	\$185,152
Debt securities:								
Corporate bonds	53,583	4	(74 )	53,513	55,239	37	(100 )	55,176
Debt securities issued								
by U.S. government								
agencies	20,013	-	(77 )	19,936	18,344	7	(63 )	18,288
U.S. Treasury notes	18,151	-	(50 )	18,101	24,763	6	(42 )	24,727
	91,747	4	(201 )	91,550	98,346	50	(205 )	98,191
Equities by industry:								
Consumer	-	-	-	-	2,596	66	(150 )	2,512
Technology	-	-	-	-	2,105	120	(23 )	2,202
Financial services	-	-	-	-	1,641	213	(24 )	1,830
Industrials	-	-	-	-	1,291	57	(19 )	1,329
Healthcare	-	-	-	-	1,332	-	(86 )	1,246
Other	-	-	-	-	6,530	109	(70 )	6,569
	-	-	-	-	15,495	565	(372 )	15,688
Certificates of deposit	9,264	3	(1 )	9,266	14,850	14	-	14,864
Term deposit	20,000	-	-	20,000	-	-	-	-
	\$282,691	\$ 7	\$ (202 )	\$282,496	\$313,843	\$ 629	\$ (577 )	\$313,895

(a) Includes \$15.5 million and \$14.8 million of money market funds at September 30, 2017 and December 31, 2016, respectively.

Since the Company's insurance subsidiary investments are restricted for a limited purpose, they are classified in the accompanying unaudited condensed consolidated balance sheet based upon the expected current and long-term cash requirements of Cornerstone.

The Company's investment policy governing insurance subsidiary investments precludes the investment portfolio managers from selling any security at a loss without prior authorization from the Company. The investment managers also limit the exposure to any one issue, issuer or type of investment. The Company intends, and has the ability, to hold insurance subsidiary investments for a long duration without the necessity of selling securities to fund the underwriting needs of Cornerstone. This ability to hold securities allows sufficient time for recovery of temporary declines in the par value of debt securities as of their stated maturity date.

The Company considered the severity and duration of its unrealized losses at September 30, 2017 for various investments held in its insurance subsidiary investment portfolio and determined that these unrealized losses were temporary and did not record any impairment losses related to these investments. The Company considered the severity and duration of its unrealized losses at September 30, 2016 and recognized pretax other-than-temporary-impairments of \$0.2 million during the nine months ended September 30, 2016 for various investments held in its insurance subsidiary investment portfolio. These investments were determined to be impaired after considering the duration of the declines in values and the likelihood of near term price recovery of each investment. Because the Company considered the remaining unrealized losses at September 30, 2016 to be temporary, the Company did not record any additional impairment losses related to these investments.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

#### NOTE 13 – LONG-TERM DEBT

##### Term Loan Facility

As used herein, “Term Loan Facility” means the Company’s \$1.36 billion term loan credit facility provided pursuant to the terms and provisions of that certain Sixth Amended and Restated Term Loan Credit Agreement dated as of March 14, 2017 (the “Term Loan Amendment Agreement”), among the Company, the lenders from time to time party thereto, and JPMorgan Chase Bank, N.A., as administrative agent and collateral agent. All obligations under the Term Loan Facility are fully and unconditionally guaranteed, subject to certain customary release provisions, by substantially all of the Company’s wholly owned, domestic material subsidiaries, as well as certain other subsidiaries as the Company may determine from time to time in its sole discretion.

The Term Loan Facility (1) matures on April 9, 2021, (2) contains financial maintenance covenants in the form of a maximum total leverage ratio, a minimum fixed charge coverage ratio and a maximum amount of annual capital expenditures, (3) imposes restrictions on the Company’s ability to incur debt and liens and make acquisitions, investments and payments on equity and junior debt, and (4) provides for interest rate margins of 3.50% for LIBOR borrowings (subject to a floor of 1.00%) and 2.50% for base rate borrowings.

On March 14, 2017, the Company entered into the Term Loan Amendment Agreement that amended and restated the Term Loan Facility to, among other things, (1) make adjustments to certain covenants and definitions to better accommodate the SNF Divestiture, (2) provide the Company with increased leverage covenant flexibility for an interim period, (3) increase the applicable margin on the outstanding borrowings from 3.25% to 3.50% for LIBOR borrowings and from 2.25% to 2.50% for base rate borrowings, (4) require a maximum leverage ratio of no more than 5.00 to 1.00 for use of the \$50 million annual dividend basket, and (5) provide for a prepayment premium of 1.00% in connection with any repricing transaction within six months of the closing date. In accordance with the authoritative guidance on debt, the Company accounted for the amendment as a debt modification.

##### ABL Facility

As used herein, “ABL Facility” means the Company’s \$900 million asset-based loan revolving credit facility provided pursuant to the terms and provisions of that certain Fourth Amended and Restated ABL Credit Agreement dated as of June 14, 2016 among the Company, the lenders party thereto from time to time, and JPMorgan Chase Bank, N.A., as administrative agent and collateral agent, as amended on September 27, 2017. All obligations under the ABL Facility are fully and unconditionally guaranteed, subject to certain customary release provisions, by substantially all of the Company’s wholly owned, domestic material subsidiaries, as well as certain other subsidiaries as the Company may determine from time to time in its sole discretion.

The ABL Facility (1) matures on April 9, 2019, (2) contains financial maintenance covenants in the form of a minimum fixed charge coverage ratio and a maximum amount of annual capital expenditures, (3) imposes restrictions on the Company’s ability to incur debt and liens and make acquisitions, investments and payments on equity and junior debt, (4) provides for interest rate margins of 2.00% to 2.50% for LIBOR borrowings and 1.00% to 1.50% for base rate borrowings (in each case depending on average daily excess availability), and (5) employs a borrowing base calculation to determine total available capacity thereunder.

On September 27, 2017, the Company entered into an amendment to the ABL Facility to update the provisions pertaining to letters of credit issued thereunder.

NOTE 14 – CONTINGENCIES

Management continually evaluates contingencies based upon the best available information. In addition, allowances for losses are provided currently for disputed items that have continuing significance, such as certain third party reimbursements and deductions that continue to be claimed 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 reimbursement programs. The Company is contesting certain issues raised in audits of prior year cost reports and the denial of payment by third parties to the Company's customers.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 14 – CONTINGENCIES (Continued)

Professional liability risks – The Company has provided for losses for professional liability risks based upon management’s best available information including actuarially determined estimates. Ultimate claims costs may differ from the provisions for loss. See Note 11.

Legal and regulatory proceedings – The Company is a party to various legal actions and regulatory and other governmental and internal audits and investigations in the ordinary course of business (including investigations resulting from the Company’s obligation to self-report suspected violations of law). The Company cannot predict the ultimate outcome of pending litigation and regulatory and other governmental and internal audits and investigations. The U.S. Department of Justice (the “DOJ”), CMS or other federal and state enforcement and regulatory agencies may conduct additional investigations related to the Company’s businesses in the future. These matters could potentially subject the Company to sanctions, damages, recoupments, fines, and other penalties (some of which may not be covered by insurance), which may, either individually or in the aggregate, have a material adverse effect on the Company’s business, financial position, results of operations, and liquidity. See Note 17.

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 related to employment-related matters, governmental regulations, environmental issues, and tax matters, as well as patient, third party payor, supplier, and contractual relationships. The Company also is subject to indemnity claims under contracts with its Kindred Rehabilitation Services division customers related to the provision of its services. Obligations under these indemnities generally are initiated by a breach of the terms of a contract or by a third party claim or event. These indemnifications could potentially subject the Company to damages and other payments which may, either individually or in the aggregate, have a material adverse effect on the Company’s business, financial position, results of operations, or liquidity.

Income taxes – The Company is subject to various federal and state income tax audits in the ordinary course of business. Such audits could result in increased tax payments, interest, and penalties.

NOTE 15 – FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

The Company follows the provisions of the authoritative guidance for fair value measurements, which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under GAAP.

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The guidance related to fair value measures establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance describes three levels of inputs that may be used to measure fair value:

- Level 1 Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury, other U.S. Government and agency asset backed debt securities that are highly liquid and are actively traded in over-the-counter markets.
- Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 15 – FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

The Company's assets and liabilities measured at fair value on a recurring and non-recurring basis and any associated losses are summarized below (in thousands):

	Fair value measurements			Assets/liabilities at fair value	Total losses
	Level 1	Level 2	Level 3		
<b>September 30, 2017</b>					
<b>Recurring:</b>					
<b>Assets:</b>					
<b>Available-for-sale debt securities:</b>					
Corporate bonds	\$-	\$53,513	\$-	\$ 53,513	\$-
Debt securities issued by U.S. government					
agencies	-	19,936	-	19,936	-
U.S. Treasury notes	18,101	-	-	18,101	-
	18,101	73,449	-	91,550	-
Money market funds	16,974	-	-	16,974	-
Term deposit	-	20,000	-	20,000	-
Certificates of deposit	-	9,266	-	9,266	-
Total available-for-sale investments	35,075	102,715	-	137,790	-
Deposits held in money market funds	300	4,216	-	4,516	-
	\$35,375	\$106,931	\$-	\$ 142,306	\$-
<b>Liabilities:</b>					
Contingent consideration liability	\$-	\$-	\$(3,335 )	\$(3,335 )	\$-
Interest rate swaps	-	(609 )	-	(609 )	-
	\$-	\$(609 )	\$(3,335 )	\$(3,944 )	\$-
<b>Non-recurring:</b>					
<b>Assets:</b>					
Property and equipment	\$-	\$-	\$1,100	\$ 1,100	\$(1,742 )
Intangible assets	-	-	500	500	(135,829)
	\$-	\$-	\$1,600	\$ 1,600	\$(137,571)
Liabilities	\$-	\$-	\$-	\$ -	\$-
<b>December 31, 2016</b>					
<b>Recurring:</b>					
<b>Assets:</b>					
<b>Available-for-sale debt securities:</b>					
Corporate bonds	\$-	\$55,176	\$-	\$ 55,176	\$-
Debt securities issued by U.S. government					
agencies	-	18,288	-	18,288	-
U.S. Treasury notes	24,727	-	-	24,727	-

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	24,727	73,464	-	98,191	-
Available-for-sale equity securities	15,688	-	-	15,688	-
Money market funds	16,472	-	-	16,472	-
Certificates of deposit	-	14,864	-	14,864	-
Total available-for-sale investments	56,887	88,328	-	145,215	-
Deposits held in money market funds	100	4,126	-	4,226	-
	\$56,987	\$92,454	\$-	\$ 149,441	\$-
<b>Liabilities:</b>					
Contingent consideration liability	\$-	\$-	\$(4,943 )	\$( 4,943 )	\$-
Interest rate swaps	-	(2,718 )	-	(2,718 )	-
	\$-	\$(2,718 )	\$(4,943 )	\$( 7,661 )	\$-
<b>Non-recurring:</b>					
<b>Assets:</b>					
Property and equipment	\$-	\$-	\$650,222	\$ 650,222	\$(31,029 )
Goodwill	-	-	361,310	361,310	(261,129)
Intangible assets - Hospitals	-	-	641	641	(3,559 )
Intangible assets - Kindred at Home	-	-	19,010	19,010	(3,534 )
Hospitals available for sale	-	-	-	-	(43,308 )
	\$-	\$-	\$1,031,183	\$ 1,031,183	\$(342,559)
Liabilities	\$-	\$-	\$-	\$ -	\$-

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 – FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

Recurring measurements

The Company's available-for-sale investments held by Cornerstone consist of debt securities, money market funds, certificates of deposit and a term deposit. These available-for-sale investments and Cornerstone's cash and cash equivalents of \$146.2 million as of September 30, 2017 and \$170.3 million as of December 31, 2016, classified as insurance subsidiary investments, are maintained for the payment of claims and expenses related to professional liability and workers compensation risks.

The Company also has available-for-sale investments totaling \$1.5 million as of September 30, 2017 and \$1.7 million as of December 31, 2016 related to a deferred compensation plan that is maintained for certain of the Company's current and former employees.

The fair value of actively traded debt and money market funds is based upon quoted market prices and is generally classified as Level 1. The fair value of inactively traded debt securities, certificates of deposit and the term deposit is based upon either quoted market prices of similar securities or observable inputs such as interest rates using either a market or income valuation approach and is generally classified as Level 2. The Company's investment advisors obtain and review pricing for each security. The Company is responsible for the determination of fair value and as such the Company reviews the pricing information from its advisors in determining reasonable estimates of fair value. Based upon the Company's internal review procedures, there were no adjustments to the prices during the three months or nine months ended September 30, 2017 or September 30, 2016.

The Company's deposits held in money market funds consist primarily of cash and cash equivalents held for the Company's insurance programs and for general corporate purposes.

The Company acquired a contingent consideration liability in the Gentiva Merger from a prior acquisition by Gentiva with an initial estimated fair value of \$7.9 million. The fair value is determined using a discounted cash flow approach utilizing Level 2 and Level 3 inputs which includes observable market discount rates, fixed payment schedules, and assumptions based on achieving certain predefined performance criteria. As of September 30, 2017, the fair value of the contingent consideration liability was \$3.3 million. The change in fair value in the third quarter of 2017 was related to accrued interest included in interest expense in the accompanying unaudited condensed consolidated statement of operations. A one percent change in the discount rate used to calculate the accretion of the present value of the contingent consideration liability would have an impact on the fair value of approximately \$0.1 million.

The fair value of the derivative liability associated with the interest rate swaps is estimated using industry-standard valuation models, which are Level 2 measurements. Such models project future cash flows and discount the future amounts to a present value using market-based observable inputs, including interest rate curves.

The following table presents the carrying amounts and estimated fair values of the Company's financial instruments. The carrying value is equal to fair value for financial instruments that are based upon quoted market prices or current market rates. The Company's long-term debt is based upon Level 2 inputs.

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(In thousands)	September 30, 2017		December 31, 2016	
	Carrying value	Fair value	Carrying value	Fair value
Cash and cash equivalents	\$ 130,364	\$ 130,364	\$ 137,061	\$ 137,061
Insurance subsidiary investments	282,496	282,496	313,895	313,895
Long-term debt, including amounts due within one year  (excluding capital lease obligations totaling \$0.4 million and  \$0.6 million at September 30, 2017 and December 31, 2016,  respectively)	3,320,813	3,287,484	3,242,459	3,220,291
Non-recurring measurements				

During the nine months ended September 30, 2017, the Company recorded asset impairment charges of \$134.6 million related to the previously acquired RehabCare trade name (\$97.4 million) and customer relationship intangible asset (\$37.2 million) due to the expected loss of affiliated contracts related to the SNF Divestiture and cancellation of non-affiliated contracts. The fair value of the trade name was measured using Level 3 inputs, such as projected revenues and royalty rate. The fair value of the customer relationship intangible asset was measured using Level 3 inputs, such as discounted projected future operating cash flows.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 15 – FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

Non-recurring measurements (Continued)

During the nine months ended September 30, 2017, the Company also recorded asset impairment charges of \$1.3 million related to a hospital certificate of need (\$0.7 million) and a Medicare certification for an IRF (\$0.6 million) as part of the annual indefinite-lived intangible assets impairment review at May 1, 2017. The fair value of the certificate of need was measured using Level 3 inputs, such as operating cash flows. The fair value of the Medicare certification was measured using a pending offer, a Level 3 input.

In addition, during the nine months ended September 30, 2017, the Company recorded an asset impairment charge of \$0.4 million related to a valuation adjustment for a building within the Kindred at Home division. The fair value of the building was measured using Level 3 inputs, primarily replacement cost.

During the nine months ended September 30, 2017, the Company recorded an asset impairment charge of \$1.3 million related to the SNF Divestiture and is recorded in discontinued operations. The fair value of property and equipment was measured using Level 3 inputs, primarily replacement costs.

During the third quarter of 2016, the Company recorded a goodwill impairment charge of \$261.1 million and a property and equipment impairment charge of \$3.2 million related to the Hospital Division Triggering Event. The fair value of the assets was measured using Level 3 inputs such as operating cash flows, market data and replacement cost factoring in depreciation, economic obsolescence and inflation trends.

During the third quarter of 2016, the Company recorded impairment charges aggregating \$33.0 million, comprised of \$19.7 million related to property and equipment, and \$13.3 million related to goodwill and other intangible assets. The fair value of the assets was measured using a Level 3 input of the pending offer from Curahealth. In addition, during the nine months ended September 30, 2016, the Company recorded asset impairment charges of \$7.8 million related to the Curahealth Disposal. The fair value of property and equipment was measured using Level 3 inputs, primarily replacement costs.

During the third quarter of 2016, the Company reviewed the long-lived assets related to the decline in financial performance of its nursing center division. After determining it was more likely than not that the Company would dispose of its skilled nursing facility business, the Company determined that its property and equipment was impaired. As a result, the Company recorded an impairment charge of \$21.7 million and is recorded in discontinued operations. The fair value of the assets was measured using Level 3 inputs, such as operating cash flows and replacement costs.

During the third quarter of 2016, the Company reviewed the long-lived assets related to the planned divestiture and pending offers for a nursing center held for sale and determined its property and equipment was impaired. As a result, the Company recorded an impairment charge of \$5.3 million and is recorded in discontinued operations. The fair value of the assets was measured based upon pending offers, a Level 3 input.

During the nine months ended September 30, 2016, the Company recorded an asset impairment charge of \$2.6 million related to the sale of a medical office building. The fair value of the property was measured using a Level 3 input of

the then pending offer.

During the nine months ended September 30, 2016, the Company also recorded an impairment charge of \$3.5 million related to certificates of need for two hospitals as part of the annual indefinite-lived intangible assets impairment review at May 1, 2016. The fair value of the certificates of need was measured using Level 3 inputs, such as operating cash flows.

Each of the impairment charges discussed above reflects the amount by which the carrying value of the assets exceeded its estimated fair value at each impairment date.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 16 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION

The accompanying condensed consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X, Rule 3-10, “Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered.” The Company’s \$750 million aggregate principal amount of 8.00% Senior Notes due 2020 (the “Notes due 2020”), \$500 million aggregate principal amount of 6.375% senior notes due 2022 (the “Notes due 2022”) and \$600 million aggregate principal amount of 8.75% Senior Notes due 2023 (the “Notes due 2023”) are fully and unconditionally guaranteed by substantially all of the Company’s domestic 100% owned subsidiaries. The equity method has been used with respect to the parent company’s investment in subsidiaries.

The following unaudited condensed consolidating financial data present the financial position of the parent company/issuer, the guarantor subsidiaries and the non-guarantor subsidiaries as of September 30, 2017 and December 31, 2016, and the respective results of operations and cash flows for the three months and nine months ended September 30, 2017 and September 30, 2016.

KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 16 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

## Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)

(In thousands)	Three months ended September 30, 2017				
	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Revenues	\$-	\$ 1,308,785	\$ 193,957	\$ (25,601 )	\$ 1,477,141
Salaries, wages and benefits	-	760,010	70,548	-	830,558
Supplies	-	63,899	9,445	-	73,344
Building rent	-	51,529	12,893	-	64,422
Equipment rent	-	7,375	1,162	-	8,537
Other operating expenses	-	142,003	13,946	-	155,949
General and administrative expenses	-	236,067	48,368	(25,601 )	258,834
Other (income) expense	-	321	(959 )	-	(638 )
Litigation contingency expense	-	4,000	-	-	4,000
Restructuring charges	-	15,914	586	-	16,500
Depreciation and amortization	-	22,641	2,167	-	24,808
Management fees	-	(2,655 )	2,655	-	-
Intercompany interest (income) expense from					
affiliates	(64,290)	59,147	5,143	-	-
Interest expense (income)	61,502	(368 )	12	-	61,146
Investment income	-	(58 )	(647 )	-	(705 )
Equity in net loss of consolidating affiliates	98,574	-	-	(98,574 )	-
	95,786	1,359,825	165,319	(124,175 )	1,496,755
Income (loss) from continuing operations before					
income taxes	(95,786)	(51,040 )	28,638	98,574	(19,614 )
Provision (benefit) for income taxes	-	(5,091 )	3,866	-	(1,225 )
Income (loss) from continuing operations	(95,786)	(45,949 )	24,772	98,574	(18,389 )
Discontinued operations, net of income taxes:					
Income (loss) from operations	-	(16,769 )	3,157	-	(13,612 )
Loss on divestiture of operations	-	(49,663 )	-	-	(49,663 )
Income (loss) from discontinued operations	-	(66,432 )	3,157	-	(63,275 )
Net income (loss)	(95,786)	(112,381 )	27,929	98,574	(81,664 )
Earnings attributable to noncontrolling interests:					

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Continuing operations	-	-	(10,960 )	-	(10,960 )
Discontinued operations	-	-	(3,162 )	-	(3,162 )
	-	-	(14,122 )	-	(14,122 )
Income (loss) attributable to					
Kindred	\$(95,786)	\$(112,381 )	\$ 13,807	\$ 98,574	\$(95,786 )
Comprehensive income (loss)	\$(94,693)	\$(112,381 )	\$ 27,928	\$ 98,575	\$(80,571 )
Comprehensive income (loss) attributable to					
Kindred	\$(94,693)	\$(112,381 )	\$ 13,806	\$ 98,575	\$(94,693 )

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KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 16 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

## Condensed Consolidating Statement of Operations and Comprehensive Income (Loss) (Continued)

(In thousands)	Three months ended September 30, 2016				
	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Revenues	\$-	\$ 1,396,922	\$ 191,882	\$ (25,528 )	\$ 1,563,276
Salaries, wages and benefits	-	805,372	62,239	-	867,611
Supplies	-	74,813	10,656	-	85,469
Building rent	-	53,247	13,699	-	66,946
Equipment rent	-	8,494	1,417	-	9,911
Other operating expenses	-	152,868	14,585	-	167,453
General and administrative expenses	-	224,458	63,121	(25,528 )	262,051
Other (income) expense	-	350	(691 )	-	(341 )
Impairment charges	-	175,604	121,672	-	297,276
Restructuring charges	-	80,268	1,195	-	81,463
Depreciation and amortization	-	30,881	2,114	-	32,995
Management fees	-	(2,277 )	2,277	-	-
Intercompany interest (income) expense from					
affiliates	(56,169 )	44,525	11,644	-	-
Interest expense (income)	59,859	(23 )	20	-	59,856
Investment income	-	(83 )	(1,714 )	-	(1,797 )
Equity in net loss of consolidating affiliates	683,376	-	-	(683,376 )	-
	687,066	1,648,497	302,234	(708,904 )	1,928,893
Loss from continuing operations before					
income taxes	(687,066)	(251,575 )	(110,352 )	683,376	(365,617 )
Provision (benefit) for income taxes	(1,453 )	284,480	603	-	283,630
Loss from continuing operations	(685,613)	(536,055 )	(110,955 )	683,376	(649,247 )
Income (loss) from discontinued operations,					
net of income taxes	-	(26,852 )	4,792	-	(22,060 )
Net loss	(685,613)	(562,907 )	(106,163 )	683,376	(671,307 )
Earnings attributable to noncontrolling interests:					
Continuing operations	-	-	(9,574 )	-	(9,574 )
Discontinued operations	-	-	(4,732 )	-	(4,732 )

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	-	-	(14,306 )	-	(14,306 )
Loss attributable to Kindred	\$(685,613)	\$(562,907 )	\$(120,469 )	\$ 683,376	\$(685,613 )
Comprehensive loss	\$(685,055)	\$(562,907 )	\$(106,849 )	\$ 684,062	\$(670,749 )
Comprehensive loss attributable to Kindred	\$(685,055)	\$(562,907 )	\$(121,155 )	\$ 684,062	\$(685,055 )

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## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 16 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

## Condensed Consolidating Statement of Operations and Comprehensive Income (Loss) (Continued)

(In thousands)	Nine months ended September 30, 2017				
	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Revenues	\$-	\$4,042,394	\$ 585,251	\$ (76,804 )	\$4,550,841
Salaries, wages and benefits	-	2,309,712	194,362	-	2,504,074
Supplies	-	201,339	29,890	-	231,229
Building rent	-	153,688	40,251	-	193,939
Equipment rent	-	22,463	3,822	-	26,285
Other operating expenses	-	455,028	41,906	-	496,934
General and administrative expenses	-	696,849	180,448	(76,804 )	800,493
Other income	-	(839 )	(2,056 )	-	(2,895 )
Litigation contingency expense	-	4,000	-	-	4,000
Impairment charges	-	136,303	-	-	136,303
Restructuring charges	-	30,970	586	-	31,556
Depreciation and amortization	-	73,048	7,231	-	80,279
Management fees	-	(8,160 )	8,160	-	-
Intercompany interest (income) expense from					
affiliates	(185,148)	162,275	22,873	-	-
Interest expense (income)	181,890	(657 )	42	-	181,275
Investment income	-	(213 )	(3,229 )	-	(3,442 )
Equity in net loss of consolidating affiliates	513,910	-	-	(513,910 )	-
	510,652	4,235,806	524,286	(590,714 )	4,680,030
Income (loss) from continuing operations before					
income taxes	(510,652)	(193,412 )	60,965	513,910	(129,189 )
Provision (benefit) for income taxes	-	(19,800 )	4,693	-	(15,107 )
Income (loss) from continuing operations	(510,652)	(173,612 )	56,272	513,910	(114,082 )
Discontinued operations, net of income taxes:					
Income (loss) from operations	-	(14,430 )	12,559	-	(1,871 )
Loss on divestiture of operations	-	(349,868 )	-	-	(349,868 )
Income (loss) from discontinued operations	-	(364,298 )	12,559	-	(351,739 )
Net income (loss)	(510,652)	(537,910 )	68,831	513,910	(465,821 )

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Earnings attributable to noncontrolling interests:					
Continuing operations	-	-	(32,234 )	-	(32,234 )
Discontinued operations	-	-	(12,597 )	-	(12,597 )
	-	-	(44,831 )	-	(44,831 )
Income (loss) attributable to					
Kindred	\$(510,652)	\$(537,910 )	\$ 24,000	\$ 513,910	\$(510,652 )
Comprehensive income (loss)	\$(509,296)	\$(537,910 )	\$ 68,584	\$ 514,157	\$(464,465 )
Comprehensive income (loss) attributable to					
Kindred	\$(509,296)	\$(537,910 )	\$ 23,753	\$ 514,157	\$(509,296 )

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## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 16 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

## Condensed Consolidating Statement of Operations and Comprehensive Income (Loss) (Continued)

(In thousands)	Nine months ended September 30, 2016				Consolidated
	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	
Revenues	\$-	\$4,271,040	\$ 580,358	\$ (76,585 )	\$4,774,813
Salaries, wages and benefits	-	2,361,057	184,974	-	2,546,031
Supplies	-	230,968	32,711	-	263,679
Building rent	-	158,593	41,363	-	199,956
Equipment rent	-	26,919	4,361	-	31,280
Other operating expenses	-	455,057	45,730	-	500,787
General and administrative expenses	-	737,436	188,094	(76,585 )	848,945
Other income	-	(220 )	(2,459 )	-	(2,679 )
Litigation contingency expense	-	2,840	-	-	2,840
Impairment charges	-	186,951	124,244	-	311,195
Restructuring charges	-	83,018	1,195	-	84,213
Depreciation and amortization	-	92,971	6,776	-	99,747
Management fees	-	(7,003 )	7,003	-	-
Intercompany interest (income) expense from					
affiliates	(166,673)	131,532	35,141	-	-
Interest expense (income)	175,372	(53 )	79	-	175,398
Investment income	-	(276 )	(2,243 )	-	(2,519 )
Equity in net loss of consolidating affiliates	643,548	-	-	(643,548 )	-
	652,247	4,459,790	666,969	(720,133 )	5,058,873
Loss from continuing operations before					
income taxes	(652,247)	(188,750 )	(86,611 )	643,548	(284,060 )
Provision (benefit) for income taxes	(3,424 )	316,205	1,325	-	314,106
Loss from continuing operations	(648,823)	(504,955 )	(87,936 )	643,548	(598,166 )
Discontinued operations, net of income taxes:					
Income (loss) from operations	-	(24,644 )	14,155	-	(10,489 )
Gain on divestiture of operations	-	179	-	-	179
Income (loss) from discontinued operations	-	(24,465 )	14,155	-	(10,310 )
Net loss	(648,823)	(529,420 )	(73,781 )	643,548	(608,476 )

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Earnings attributable to noncontrolling interests:					
Continuing operations	-	-	(26,272 )	-	(26,272 )
Discontinued operations	-	-	(14,075 )	-	(14,075 )
	-	-	(40,347 )	-	(40,347 )
Loss attributable to Kindred	\$(648,823)	\$(529,420 )	\$(114,128 )	\$643,548	\$(648,823 )
Comprehensive loss	\$(650,525)	\$(529,420 )	\$(73,613 )	\$643,380	\$(610,178 )
Comprehensive loss attributable to Kindred	\$(650,525)	\$(529,420 )	\$(113,960 )	\$643,380	\$(650,525 )

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## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 16 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

## Condensed Consolidating Balance Sheet

(In thousands)	As of September 30, 2017			Consolidating and eliminating adjustments	Consolidated
	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries		
<b>ASSETS</b>					
Current assets:					
Cash and cash equivalents	\$-	\$29,061	\$ 101,303	\$-	\$ 130,364
Insurance subsidiary investments	-	-	98,079	-	98,079
Accounts receivable, net	-	1,079,976	138,224	-	1,218,200
Inventories	-	17,456	4,035	-	21,491
Income taxes	-	3,476	1,507	-	4,983
Assets held for sale	-	78,324	727	-	79,051
Other	-	51,126	15,337	-	66,463
	-	1,259,419	359,212	-	1,618,631
Property and equipment, net	-	675,343	54,517	-	729,860
Goodwill	-	1,974,760	450,071	-	2,424,831
Intangible assets, net	-	566,557	45,720	-	612,277
Insurance subsidiary investments	-	-	184,417	-	184,417
Intercompany	4,917,830	-	-	(4,917,830 )	-
Deferred tax assets	-	-	7,311	(7,311 )	-
Other	6,803	133,771	161,161	-	301,735
	\$4,924,633	\$4,609,850	\$ 1,262,409	\$(4,925,141 )	\$ 5,871,751
<b>LIABILITIES AND EQUITY</b>					
Current liabilities:					
Accounts payable	\$-	\$122,828	\$ 53,525	\$-	\$ 176,353
Salaries, wages and other					
compensation	-	315,144	55,069	-	370,213
Due to third party payors	-	48,739	52	-	48,791
Professional liability risks	-	3,437	52,231	-	55,668
Accrued lease termination fees	-	109,113	-	-	109,113
Other accrued liabilities	54,079	188,123	22,755	-	264,957
Long-term debt due within one					
year	17,210	-	1,037	-	18,247
	71,289	787,384	184,669	-	1,043,342

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Long-term debt	3,302,787	-	149	-	3,302,936
Intercompany/deficiency in earnings of					
consolidated subsidiaries	1,246,599	4,352,955	564,875	(6,164,429 )	-
Professional liability risks	-	90,716	224,606	-	315,322
Deferred tax liabilities	-	189,376	-	(7,311 )	182,065
Deferred credits and other liabilities	-	357,877	139,559	-	497,436
Commitments and contingencies					
Equity (deficit):					
Stockholders' equity (deficit)	303,958	(1,168,458 )	(78,141 )	1,246,599	303,958
Noncontrolling interests	-	-	226,692	-	226,692
	303,958	(1,168,458 )	148,551	1,246,599	530,650
	\$4,924,633	\$4,609,850	\$ 1,262,409	\$(4,925,141 )	\$ 5,871,751

## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 16 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

## Condensed Consolidating Balance Sheet (Continued)

(In thousands)	As of December 31, 2016			Consolidating and eliminating adjustments	Consolidated
	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries		
<b>ASSETS</b>					
Current assets:					
Cash and cash equivalents	\$-	\$25,767	\$ 111,294	\$-	\$ 137,061
Insurance subsidiary investments	-	-	108,966	-	108,966
Accounts receivable, net	-	1,022,850	149,228	-	1,172,078
Inventories	-	18,290	4,148	-	22,438
Income taxes	-	9,023	1,044	-	10,067
Assets held for sale	-	278,689	10,761	-	289,450
Other	-	56,054	7,639	-	63,693
	-	1,410,673	393,080	-	1,803,753
Property and equipment, net	-	557,761	60,859	-	618,620
Goodwill	-	1,977,003	450,071	-	2,427,074
Intangible assets, net	-	723,760	46,348	-	770,108
Insurance subsidiary investments	-	-	204,929	-	204,929
Intercompany	4,850,517	-	-	(4,850,517 )	-
Deferred tax assets	-	-	7,224	(7,224 )	-
Other	10,123	116,305	161,812	-	288,240
	\$4,860,640	\$4,785,502	\$ 1,324,323	\$(4,857,741 )	\$ 6,112,724
<b>LIABILITIES AND EQUITY</b>					
Current liabilities:					
Accounts payable	\$-	\$ 112,286	\$ 91,639	\$-	\$ 203,925
Salaries, wages and other					
compensation	-	339,600	57,886	-	397,486
Due to third party payors	-	41,320	-	-	41,320
Professional liability risks	-	3,401	61,883	-	65,284
Accrued lease termination fees	-	5,224	-	-	5,224
Other accrued liabilities	74,634	170,476	19,402	-	264,512
Long-term debt due within one					
year	26,406	-	1,571	-	27,977
	101,040	672,307	232,381	-	1,005,728

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Long-term debt	3,214,607	-	455	-	3,215,062
Intercompany/deficiency in earnings of					
consolidated subsidiaries	732,442	4,281,685	568,832	(5,582,959 )	-
Professional liability risks	-	78,124	217,187	-	295,311
Deferred tax liabilities	-	209,032	-	(7,224 )	201,808
Deferred credits and other liabilities	-	219,701	133,593	-	353,294
Commitments and contingencies					
Equity (deficit):					
Stockholders' equity (deficit)	812,551	(675,347 )	(57,095 )	732,442	812,551
Noncontrolling interests	-	-	228,970	-	228,970
	812,551	(675,347 )	171,875	732,442	1,041,521
	\$4,860,640	\$4,785,502	\$ 1,324,323	\$(4,857,741 )	\$ 6,112,724

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 16 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

Condensed Consolidating Statement of Cash Flows

(In thousands)	Three months ended September 30, 2017				
	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Net cash provided by (used in) operating activities	\$(12,276 )	\$(16,014 )	\$ 36,771	\$ -	\$ 8,481
Cash flows from investing activities:					
Routine capital expenditures	-	(15,972 )	(491 )	-	(16,463 )
Development capital expenditures	-	(6,415 )	-	-	(6,415 )
Sale of assets	-	5,494	-	-	5,494
Purchase of insurance subsidiary investments	-	-	(18,047 )	-	(18,047 )
Sale of insurance subsidiary investments	-	-	50,087	-	50,087
Net change in insurance subsidiary cash and					
cash equivalents	-	-	(10,053 )	-	(10,053 )
Net change in other investments	-	5,088	-	-	5,088
Return of contributed surplus from					
Cornerstone	-	30,000	-	(30,000 )	-
Other	-	(81 )	-	-	(81 )
Net cash provided by investing activities	-	18,114	21,496	(30,000 )	9,610
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	426,700	-	-	-	426,700
Repayment of borrowings under revolving credit	(427,300)	-	-	-	(427,300 )
Repayment of term loan	(3,508 )	-	-	-	(3,508 )
Payment of other long-term debt	-	-	(217 )	-	(217 )
Payment of deferred financing costs	(170 )	-	-	-	(170 )
Payment of dividend for Mandatory Redeemable					
Preferred Stock	(3,120 )	-	-	-	(3,120 )
Distributions to noncontrolling interests	-	-	(10,071 )	-	(10,071 )
Payroll tax payments for equity awards issuance	-	(88 )	-	-	(88 )
	-	-	(30,000 )	30,000	-

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Return of contributed surplus from

Cornerstone

Net change in intercompany accounts	19,674	(3,490 )	(16,184 )	-	-
Net cash provided by (used in) financing					
activities	12,276	(3,578 )	(56,472 )	30,000	(17,774 )
Change in cash and cash equivalents	-	(1,478 )	1,795	-	317
Cash and cash equivalents at beginning of period	-	30,539	99,508	-	130,047
Cash and cash equivalents at end of period	\$-	\$ 29,061	\$ 101,303	\$ -	\$ 130,364

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KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 16 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

## Condensed Consolidating Statement of Cash Flows (Continued)

(In thousands)	Three months ended September 30, 2016			Consolidating and eliminating adjustments	Consolidated
	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries		
Net cash provided by (used in) operating activities	\$(16,518 )	\$ 31,382	\$ 21,503	\$ -	\$ 36,367
Cash flows from investing activities:					
Routine capital expenditures	-	(19,562 )	(2,311 )	-	(21,873 )
Development capital expenditures	-	(3,413 )	(4,973 )	-	(8,386 )
Acquisitions, net of cash acquired	-	(49,329 )	-	-	(49,329 )
Sale of assets	-	3,739	-	-	3,739
Purchase of insurance subsidiary investments	-	-	(22,427 )	-	(22,427 )
Sale of insurance subsidiary investments	-	-	31,875	-	31,875
Net change in insurance subsidiary cash and cash equivalents					
	-	-	(14,680 )	-	(14,680 )
Net change in other investments	-	(63 )	114	-	51
Other	-	(150 )	-	-	(150 )
Net cash used in investing activities	-	(68,778 )	(12,402 )	-	(81,180 )
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	489,200	-	-	-	489,200
Repayment of borrowings under revolving credit	(388,100)	-	-	-	(388,100 )
Repayment of term loan	(3,508 )	-	-	-	(3,508 )
Repayment of other long-term debt	-	-	(276 )	-	(276 )
Payment of deferred financing costs	(50 )	-	-	-	(50 )
Payment of dividend for Mandatory Redeemable Preferred Stock					
	(2,904 )	-	-	-	(2,904 )
Dividends paid	(10,224 )	-	-	-	(10,224 )
Contributions made by noncontrolling interests	-	-	4,993	-	4,993
Distributions to noncontrolling interests	-	-	(4,694 )	-	(4,694 )
	-	(250 )	-	-	(250 )

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Payroll tax payments for equity awards issuance					
Net change in intercompany accounts	(67,896 )	46,232	21,664	-	-
Net cash provided by financing activities	16,518	45,982	21,687	-	84,187
Change in cash and cash equivalents	-	8,586	30,788	-	39,374
Cash and cash equivalents at beginning of period	-	24,037	76,019	-	100,056
Cash and cash equivalent at end of period	\$-	\$ 32,623	\$ 106,807	\$	\$ 139,430



## KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 16 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

## Condensed Consolidating Statement of Cash Flows (Continued)

(In thousands)	Nine months ended September 30, 2017				Consolidated
	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	
Net cash provided by (used in) operating activities	\$ (9,488 )	\$ (39,244 )	\$ 57,244	\$ -	\$ 8,512
Cash flows from investing activities:					
Routine capital expenditures	-	(43,741 )	(2,059 )	-	(45,800 )
Development capital expenditures	-	(17,711 )	-	-	(17,711 )
Acquisitions, net of cash acquired	-	(6,650 )	-	-	(6,650 )
Sale of assets	-	5,494	-	-	5,494
Purchase of insurance subsidiary investments	-	-	(108,655 )	-	(108,655 )
Sale of insurance subsidiary investments	-	-	117,863	-	117,863
Net change in insurance subsidiary cash and cash equivalents					
	-	-	23,472	-	23,472
Net change in other investments	-	4,844	-	-	4,844
Return of contributed surplus from					
Cornerstone	-	38,000	-	(38,000 )	-
Other	-	(35 )	-	-	(35 )
Net cash provided by (used in) investing activities	-	(19,799 )	30,621	(38,000 )	(27,178 )
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	1,214,300	-	-	-	1,214,300
Repayment of borrowings under revolving credit	(1,120,600)	-	-	-	(1,120,600 )
Repayment of term loan	(10,525 )	-	-	-	(10,525 )
Payment of other long-term debt	-	-	(840 )	-	(840 )
Payment of deferred financing costs	(299 )	-	-	-	(299 )
Issuance of common stock in connection with	32	-	-	-	32

employee benefit plans					
Payment of dividend for Mandatory Redeemable					
Preferred Stock	(9,195 )	-	-	-	(9,195 )
Dividends paid	(10,228 )	-	-	-	(10,228 )
Contributions made by noncontrolling interests	-	-	113	-	113
Distributions to noncontrolling interests	-	-	(48,372 )	-	(48,372 )
Payroll tax payments for equity awards issuance	-	(2,417 )	-	-	(2,417 )
Return of contributed surplus from Cornerstone	-	-	(38,000 )	38,000	-
Net change in intercompany accounts	(53,997 )	64,754	(10,757 )	-	-
Net cash provided by (used in) financing activities	9,488	62,337	(97,856 )	38,000	11,969
Change in cash and cash equivalents	-	3,294	(9,991 )	-	(6,697 )
Cash and cash equivalents at beginning of period	-	25,767	111,294	-	137,061
Cash and cash equivalents at end of period	\$-	\$ 29,061	\$ 101,303	\$ -	\$ 130,364



KINDRED HEALTHCARE, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## NOTE 16 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

## Condensed Consolidating Statement of Cash Flows (Continued)

(In thousands)	Nine months ended September 30, 2016				Consolidated
	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	
Net cash provided by (used in) operating activities	\$(21,938 )	\$ 16,329	\$ 46,844	\$ -	\$ 41,235
Cash flows from investing activities:					
Routine capital expenditures	-	(63,476 )	(5,227 )	-	(68,703 )
Development capital expenditures	-	(11,768 )	(15,344 )	-	(27,112 )
Acquisitions, net of cash acquired	-	(77,040 )	-	-	(77,040 )
Acquisition deposits	-	18,489	-	-	18,489
Sale of assets	-	4,962	-	-	4,962
Purchase of insurance subsidiary investments	-	-	(75,422 )	-	(75,422 )
Sale of insurance subsidiary investments	-	-	78,478	-	78,478
Net change in insurance subsidiary cash and cash equivalents	-	-	8,479	-	8,479
Net change in other investments	-	(34,546 )	1,199	-	(33,347 )
Other	-	(1,277 )	-	-	(1,277 )
Net cash used in investing activities	-	(164,656 )	(7,837 )	-	(172,493 )
Cash flows from financing activities:					
Proceeds from borrowings under revolving credit	1,267,200	-	-	-	1,267,200
Repayment of borrowings under revolving credit	(1,215,800)	-	-	-	(1,215,800 )
Proceeds from issuance of term loan, net of discount	198,100	-	-	-	198,100
Proceeds from other long-term debt	-	-	750	-	750
Repayment of term loan	(10,019 )	-	-	-	(10,019 )
Repayment of other long-term debt	-	-	(826 )	-	(826 )
Payment of deferred financing costs	(342 )	-	-	-	(342 )
Payment of dividend for Mandatory Redeemable Preferred Stock	(8,558 )	-	-	-	(8,558 )

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Dividends paid	(30,517 )	-	-	-	(30,517 )
Contributions made by noncontrolling interests	-	-	11,261	-	11,261
Distributions to noncontrolling interests	-	-	(35,240 )	-	(35,240 )
Purchase of noncontrolling interests	-	-	(1,000 )	-	(1,000 )
Payroll tax payments for equity awards issuance	-	(3,079 )	-	-	(3,079 )
Net change in intercompany accounts	(178,126 )	165,797	12,329	-	-
Net cash provided by (used in) financing activities	21,938	162,718	(12,726 )	-	171,930
Change in cash and cash equivalents	-	14,391	26,281	-	40,672
Cash and cash equivalents at beginning of period	-	18,232	80,526	-	98,758
Cash and cash equivalents at end of period	\$-	\$ 32,623	\$ 106,807	\$ -	\$ 139,430

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 17 – LEGAL AND REGULATORY PROCEEDINGS

The Company provides services in a highly regulated industry and is subject to various legal actions and regulatory and other governmental and internal audits and investigations in the ordinary course of business (including investigations resulting from the Company's obligation to self-report suspected violations of law). These matters could (1) require the Company to pay substantial damages, fines, penalties or amounts in judgments or settlements, which individually or in the aggregate could exceed amounts, if any, that may be recovered under the Company's insurance policies where coverage applies and is available; (2) cause the Company to incur substantial expenses; (3) require significant time and attention from the Company's management; (4) subject the Company to sanctions, including possible exclusions from the Medicare and Medicaid programs; and (5) cause the Company to close or sell one or more facilities or otherwise modify the way the Company conducts business. The ultimate resolution of these matters, whether as a result of litigation or settlement, could have a material adverse effect on the Company's business, financial position, results of operations, and liquidity.

In accordance with authoritative accounting guidance related to loss contingencies, the Company records an accrued liability for litigation and regulatory matters that are both probable and reasonably estimable. Additional losses in excess of amounts accrued may be reasonably possible. The Company reviews loss contingencies that are reasonably possible and determines whether an estimate of the possible loss or range of loss, individually or in aggregate, can be disclosed in the Company's consolidated financial statements. These estimates are based upon currently available information for those legal and regulatory proceedings in which the Company is involved, taking into account the Company's best estimate of losses for those matters for which such estimate can be made. The Company's estimates involve significant judgment and a variety of assumptions, given that (1) these legal and regulatory proceedings may be in early stages; (2) discovery may not be completed; (3) damages sought in these legal and regulatory proceedings can be unsubstantiated or indeterminate; (4) the matters often involve legal uncertainties or evolving areas of law; (5) there are often significant facts in dispute; and/or (6) there is a wide range of possible outcomes. Accordingly, the Company's estimated loss or range of loss may change from time to time, and actual losses may be more or less than the current estimate. At this time, except as otherwise specifically noted, no estimate of the possible loss or range of loss, individually or in the aggregate, in excess of the amounts accrued, if any, can be made regarding the matters described below.

Set forth below are descriptions of the Company's significant legal proceedings.

Medicare and Medicaid payment reviews, audits, and investigations—As a result of the Company's participation in the Medicare and Medicaid programs, the Company faces and is currently subject to various governmental and internal reviews, audits, and investigations to verify the Company's compliance with these programs and applicable laws and regulations. The Company is routinely subject to audits under various government programs, such as the CMS Recovery Audit Contractor program, in which third party firms engaged by CMS conduct extensive reviews of claims data and medical and other records to identify potential improper payments to healthcare providers under the Medicare program. In addition, the Company, like other healthcare providers, is subject to ongoing investigations by the U.S. Department of Health and Human Services Office of Inspector General (the "OIG"), the DOJ and state attorneys general into the billing of services provided to Medicare and Medicaid patients, including whether such services were properly documented and billed, whether services provided were medically necessary, and general compliance with conditions of participation in the Medicare and Medicaid programs. Private pay sources such as third party insurance and

managed care entities also often reserve the right to conduct audits. The Company's costs to respond to and defend any such reviews, audits, and investigations are significant and are likely to increase in the current enforcement environment. These audits and investigations may require the Company to refund or retroactively adjust amounts that have been paid under the relevant government program or by other payors. Further, an adverse review, audit, or investigation also could result in other adverse consequences, particularly if the underlying conduct is found to be pervasive or systemic. These consequences include (1) state or federal agencies imposing fines, penalties, and other sanctions on the Company; (2) loss of the Company's right to participate in the Medicare or Medicaid programs or one or more third party payor networks; (3) indemnity claims asserted by customers and others for which the Company provides services; and (4) damage to the Company's reputation in various markets, which could adversely affect the Company's ability to attract patients, residents and employees.

Whistleblower lawsuits—The Company is also subject to qui tam or “whistleblower” lawsuits under the federal False Claims Act and comparable state laws for allegedly submitting fraudulent bills for services to the Medicare and Medicaid programs. These lawsuits can result in monetary damages, fines, attorneys' fees, and the award of bounties to private qui tam plaintiffs who successfully bring these lawsuits and to the respective government programs. The Company also could be subject to civil penalties (including the loss of the Company's licenses to operate one or more facilities or healthcare activities), criminal penalties (for violations of certain laws and regulations), and exclusion of one or more facilities or healthcare activities from participation in the Medicare, Medicaid, and other federal and state healthcare programs. The lawsuits are in various stages of adjudication or investigation and involve a wide variety of claims and potential outcomes.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 17 – LEGAL AND REGULATORY PROCEEDINGS (Continued)

Employment-related lawsuits—The Company’s operations are subject to a variety of federal and state employment-related laws and regulations, including but not limited to the U.S. Fair Labor Standards Act (“FLSA”), Equal Employment Opportunity laws, and enforcement policies of the Equal Employment Opportunity Commission, the Office of Civil Rights and state attorneys general, federal and state wage and hour laws, and a variety of laws enacted by the federal and state governments that govern these and other employment-related matters. Accordingly, the Company is currently subject to employee-related claims, class actions and other lawsuits and proceedings in connection with the Company’s operations, including but not limited to those related to alleged wrongful discharge, illegal discrimination, and violations of equal employment and federal and state wage and hour laws. Because labor represents such a large portion of the Company’s operating costs, noncompliance with these evolving federal and state laws and regulations could subject the Company to significant back pay awards, fines, and additional lawsuits and proceedings. These claims, lawsuits, and proceedings are in various stages of adjudication or investigation and involve a wide variety of claims and potential outcomes.

A purported wage and hour class action lawsuit is currently pending against the Company in federal district court for the Northern District of California. This lawsuit pertains to alleged errors made by the Company with respect to minimum wage and overtime payments resulting from a piece-rate payment system. The Company recorded a \$2.0 million loss provision in the first quarter of 2017 and an additional \$3.0 million loss provision in the third quarter of 2017 related to this lawsuit, for a total loss reserve of \$5.0 million related to this lawsuit. At this time, no estimate of the possible loss or range of loss in excess of the amount accrued can be made regarding this lawsuit. The Company disputes the allegations made in this lawsuit and will defend this action and any related claims vigorously.

Minimum staffing lawsuits—Various states in which the Company operates have established minimum staffing requirements or may establish minimum staffing requirements in the future. While the Company seeks to comply with all applicable staffing requirements, the regulations in this area are complex and the Company may experience compliance issues from time to time. Failure to comply with such minimum staffing requirements may result in one or more facilities failing to meet the conditions of participation under relevant federal and state healthcare programs and the imposition of significant fines, damages, or other sanctions.

Shareholder actions—The Company is also subject to lawsuits and other shareholder actions brought from time to time. A shareholder derivative action (the “Complaint”) is currently pending against certain of the Company’s current and former officers and directors in circuit court for Jefferson County, Kentucky. The Complaint also names the Company as a nominal defendant. The Complaint alleges that the named current and former officers and directors breached their respective duties of good faith, loyalty, and candor, and other general fiduciary duties owed to the Company and its shareholders by, among other things, failing to exercise reasonable and prudent supervision over the management, policies, and controls of the Company in order to detect practices that existed at RehabCare resulting in the Company having to enter into two separate settlement agreements with the DOJ. The Company has tentatively settled this lawsuit and is awaiting final court approval of such settlement. The Company recorded a loss reserve of \$1.0 million in the third quarter of 2017 related to this matter. The Company disputes the allegations made in the Complaint and will defend this action and any related claims vigorously.

Ordinary course matters—In addition to the matters described above, the Company is subject to investigations, claims, and lawsuits in the ordinary course of business, including investigations resulting from the Company's obligation to self-report suspected violations of law and professional liability claims, particularly in the Company's hospital and nursing center operations. In many of these claims, plaintiffs' attorneys are seeking significant fines and compensatory and punitive damages in addition to attorneys' fees. The Company maintains professional and general liability insurance in amounts and coverage that management believes are sufficient for the Company's operations. However, the Company's insurance may not cover all claims against the Company or the full extent of its liability.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 18 – SUBSEQUENT EVENT

In October 2017, in connection with the review of the Company's insurance programs as a result of the SNF Divestiture, the Company restructured the funding mechanisms and certain other elements of its insurance programs (the "October Insurance Restructuring"). With respect to its workers compensation program, approximately \$115 million of restricted cash collateral deposits were replaced with letters of credit and approximately \$21 million of other cash deposits were released. In addition, certain funding mechanisms associated with the Company's professional liability insurance and reinsurance agreements were modified such that approximately \$106 million of cash deposits maintained at Cornerstone and \$4 million of other cash deposits were released to the parent company. In both cases, no changes were made to the financial risk transfer aspects of the Company's insurance arrangements with third parties. Also in October 2017, as a result of further improvement in Cornerstone's underwriting results, the Company received an additional distribution of \$5 million from Cornerstone (the "October Distribution"). In aggregate, the approximately \$281 million generated from the October Insurance Restructuring, the September Distribution and the October Distribution was used to repay in its entirety the Company's ABL Facility balance and to increase cash reserves.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Cautionary Statement

This Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). These forward-looking statements include, but are not limited to, all statements regarding the SNF Divestiture and the expected timing of the SNF Divestiture, including the receipt of all required regulatory approvals and the satisfaction of the closing conditions for the SNF Divestiture, as well as the Company's ability to realize the anticipated benefits, sale proceeds, cost savings and strategic gains from the SNF Divestiture, all statements regarding the Company's expected future financial position, results of operations, cash flows, dividends, financing plans, business strategy, budgets, capital expenditures, competitive positions, growth opportunities, plans and objectives of management, government investigations, regulatory matters, and statements containing words such as "anticipate," "approximate," "believe," "plan," "estimate," "expect," "project," "could," "would," "should," "will," "intend," "hope," "may," "potential," "u similar expressions. Statements in this report concerning the Company's business outlook or future economic performance, anticipated profitability, revenues, expenses, dividends or other financial items, and product or services line growth, and expected outcome of government investigations and other regulatory matters, together with other statements that are not historical facts, are forward-looking statements that are estimates reflecting the best judgment of the Company based upon currently available information.

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, performance, or plans to differ materially from any future results, performance or plans 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.

In addition to the factors set forth above, other factors that may affect the Company's plans, results, or stock price include, without limitation:

- the impact of healthcare reform, which will initiate significant changes to the United States healthcare system, including potential material changes to the delivery of healthcare services and the reimbursement paid for such services by the government or other third party payors, including reforms resulting from the Patient Protection and Affordable Care Act and the Healthcare Education and Reconciliation Act (collectively, the "ACA") or future deficit reduction measures adopted at the federal or state level. Healthcare reform is impacting each of the Company's businesses in some manner. Potential future efforts in the U.S. Congress to repeal, amend, modify, or retract funding for various aspects of the ACA create additional uncertainty about the ultimate impact of the ACA on the Company and the healthcare industry. Due to the substantial regulatory changes that will need to be implemented by CMS and others, and the numerous processes required to implement these reforms, the Company cannot predict which healthcare initiatives will be implemented at the federal or state level, the timing of any such reforms, or the effect such reforms or any other future legislation or regulation will have on the Company's business, financial position, results of operations, and liquidity,

the Company's ability to adjust to the new patient criteria for LTAC hospitals under the LTAC Legislation, which reduces the population of patients eligible for reimbursement under the Medicare prospective payment system for LTAC hospitals ("LTAC PPS") and changes the basis upon which the Company is paid for other patients, changes in the reimbursement rates or the methods or timing of payment from third party payors, including commercial payors and the Medicare and Medicaid programs, changes arising from and related to LTAC PPS, including potential changes in the Medicare payment rules, and changes in Medicare and Medicaid reimbursement for the Company's home health and hospice operations, TC hospitals, and IRFs, and the expiration of the Medicare Part B therapy cap exception process,

- the Company's significant level of indebtedness, including the Company's ability to meet its substantial debt service requirements, and its impact on the Company's funding costs, operating flexibility, and ability to fund ongoing operations, development capital expenditures, or other strategic acquisitions with additional borrowings,
- the Company's ability to comply with the terms of its corporate integrity agreement with the OIG,
- the Company's ability to complete the SNF Divestiture, and realize the anticipated benefits, sale proceeds, cost savings and strategic gains from the SNF Divestiture,

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

Cautionary Statement (Continued)

the potential for diversion of management time and use of resources in seeking to complete the SNF Divestiture, the effects of additional legislative changes and government regulations, interpretation of regulations, and changes in the nature and enforcement of regulations governing the healthcare industry, the ability of the Company's hospitals and other healthcare services to adjust to medical necessity reviews, the Company's ability to successfully pursue its development activities, including through acquisitions, and successfully integrate new operations, including the realization of anticipated revenues, economies of scale, cost savings, and productivity gains associated with such operations, as and when planned, including the potential impact of unanticipated issues, expenses, and liabilities associated with those activities, the Company's obligations under various laws to self-report suspected violations of law to various government agencies (including any associated obligation to refund overpayments to government payors, fines, and other sanctions), the failure of the Company's facilities and other operations to meet applicable licensure and certification requirements, the consolidation or cost containment efforts of managed care organizations, other third party payors, conveners, and referral sources, the Company's ability to control costs, particularly labor and employee benefit costs, increased operating costs due to shortages in qualified nurses, therapists, and other healthcare personnel, the Company's ability to successfully reduce (by divestiture of operations or otherwise) its exposure to professional liability and other claims, the costs of defending and insuring against alleged professional liability and other claims and investigations (including those related to pending investigations and whistleblower and wage and hour class action lawsuits against the Company) and the Company's ability to predict the estimated costs and reserves related to such claims and investigations, including the impact of differences in actuarial assumptions and estimates compared to eventual outcomes, the Company's ability to comply with its rental and debt agreements, including payment of amounts owed thereunder and compliance with the covenants contained therein, including under the Company's master lease agreements with Ventas, the Company's inability to maintain the security and functionality of its information systems, or to defend against or otherwise prevent a cybersecurity attack or breach, the condition of the financial markets, including volatility and weakness in the equity, capital, and credit markets, which could limit the availability and terms of debt and equity financing sources to fund the requirements of the Company's businesses, or which could negatively impact the Company's investment portfolio, national, regional, and industry-specific economic, financial, business, and political conditions, including their effect on the availability and cost of labor, credit, materials, and other services, the Company's ability to attract and retain key executives and other healthcare personnel, the Company's ability to successfully dispose of unprofitable facilities, events or circumstances that could result in the impairment of an asset or other charges, changes in GAAP or practices, and changes in tax accounting or tax laws (or authoritative interpretations relating to any of these matters), including a new lease accounting standard that will significantly increase balance sheet assets and liabilities on and after January 1, 2019, and the Company's ability to 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.

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

General

The accompanying unaudited condensed consolidated financial statements, including the notes thereto, should be read in conjunction with the following discussion and analysis.

The Company is a healthcare services company that through its subsidiaries operates a home health, hospice and community care business, TC hospitals, IRFs, and a contract rehabilitation services business across the United States. At September 30, 2017, the Company's Kindred at Home division primarily provided home health, hospice, and community care services from 609 sites of service in 40 states. The Company's hospital division operated 77 TC hospitals (5,797 licensed beds) in 18 states. The Company's Kindred Rehabilitation Services division operated 19 IRFs (995 licensed beds) and 101 hospital-based ARUs, and provided rehabilitation services primarily in hospitals and long-term care settings in 45 states.

Skilled nursing facility business exit

On June 30, 2017, the Company entered into a definitive agreement with BlueMountain under which the Company agreed to sell its skilled nursing facility business for \$700 million in cash (previously defined as the SNF Divestiture). The sale includes 89 nursing centers with 11,308 licensed beds and seven assisted living facilities with 380 licensed beds in 18 states. During the third quarter of 2017, the Company completed the sale of 54 of the skilled nursing facilities for \$519 million. The sale proceeds were deposited with an escrow agent and after paying closing costs and applying repair credits, net cash proceeds totaled \$502 million. The escrow agent directly paid \$501 million of the net cash proceeds to Ventas and another landlord. The remaining net cash proceeds of \$1 million was directly paid to Kindred, which is reflected in the sale of assets in the investing activities in the accompanying unaudited condensed consolidated statement of cash flows. On October 1, 2017, the Company completed the sale of an additional 12 of the skilled nursing facilities and four of the assisted living facilities for \$108 million. See notes 4 and 5 of the notes to unaudited condensed consolidated financial statements.

Gentiva Merger

On October 9, 2014, the Company entered into an agreement and plan of merger with Gentiva, providing for the Gentiva Merger. On February 2, 2015, the Company consummated the Gentiva Merger, with Gentiva continuing as the surviving company and the Company's wholly owned subsidiary.

Operating results in the third quarter of 2016 included transaction and integration costs totaling \$1 million and a lease termination charge of \$0.3 million related to the Gentiva Merger. Operating results for the nine months ended September 30, 2016 included transaction and integration costs totaling \$4 million, retention and severance costs totaling \$1 million, and a lease termination charge of \$0.3 million related to the Gentiva Merger.

Discontinued operations

The Company has completed several strategic divestitures to improve its future operating results. For accounting purposes, the operating results of these businesses and the gains or losses associated with these transactions were classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented in accordance with the authoritative guidance in effect through December 31, 2014. Effective January 1, 2015, the authoritative guidance modified the requirements for reporting discontinued operations. A

disposal is now required to be reported in discontinued operations only if the disposal represents a strategic shift that has (or will have) a major effect on the Company's operations and financial results. In connection with the SNF Divestiture, the results of operations of the skilled nursing facility business, which previously were reported in the nursing center division, and the gains or losses associated with the SNF Divestiture, have been classified as discontinued operations for all periods presented. In addition, direct overhead and the profits from applicable RehabCare contracts servicing the Company's skilled nursing facility business were moved to discontinued operations for all periods presented. During the third quarter of 2017, the Company reclassified from discontinued operations to continuing operations for all periods presented historical profits from certain RehabCare contracts that were retained with new operators of divested skilled nursing facilities. The Company has reclassified certain retained businesses and expenses previously reported in the nursing center division to other business segments, including hospital-based sub-acute units and a skilled nursing facility to the hospital division and a small therapy business to the Kindred Hospital Rehabilitation Services operating segment for all periods presented. See notes 4 and 5 of the notes to unaudited condensed consolidated financial statements.

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

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 GAAP. 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.

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, skilled nursing and hospital customers, individual patients, and other customers. Estimated provisions for doubtful accounts are recorded to the extent it is probable that a portion or all of a particular account will not be collected.

In evaluating the collectibility of accounts receivable, the Company considers a number of factors, including the age of the accounts, changes in collection patterns, the composition of patient accounts by payor type, the status of ongoing disputes with third party payors, and general industry conditions. Actual collections of accounts receivable in subsequent periods may require changes in the estimated provision for loss. Changes in these estimates are charged or credited to the results of operations in the period of the change. During the third quarter of 2017, the Company recorded a favorable settlement of \$2 million related to the RehabCare Collection Litigation. During the nine months ended September 30, 2017, the Company recorded a provision for doubtful accounts of \$23 million related to the RehabCare Collection Litigation.

The provision for doubtful accounts totaled \$3 million and \$4 million in the third quarter of 2017 and 2016, respectively, and \$40 million and \$14 million for the nine months ended September 30, 2017 and 2016, respectively. The increase for the nine months ended September 30, 2017 was primarily attributable to the previously mentioned RehabCare Collection Litigation.

Accounting for income taxes

The provision (benefit) for income taxes is based upon the Company's estimate of annual taxable income or loss for each respective accounting period. The Company recognizes an asset or liability for the deferred tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements. These temporary differences will result in taxable or deductible amounts in future years when the reported amounts of the assets are recovered or liabilities are settled. The Company also recognizes as deferred tax assets the future tax benefits from net operating losses and capital loss carryforwards.

At each balance sheet date, management assesses all available positive and negative evidence to determine whether a valuation allowance is needed against its deferred tax assets. The authoritative guidance requires evidence related to

events that have actually happened to be weighted more significantly than evidence that is projected or expected to happen. A significant piece of negative evidence according to this weighting standard is that there are cumulative losses in the two most recent years and the current year, which is the case for the Company at September 30, 2017 and December 31, 2016. The Company's outlook of taxable income for 2016 changed in the third quarter of 2016 after the Company recorded \$286 million of goodwill and property and equipment impairment charges and announced the planned SNF Divestiture and related expected loss on divestiture for tax purposes. Accordingly, a full valuation allowance was recorded at both September 30, 2017 and December 31, 2016. The amount of deferred tax asset considered realizable, however, could be adjusted if the weighting of the positive and negative evidence changes.

The Company has deferred tax liabilities related to tax amortization of acquired indefinite-lived intangible assets because these assets are not amortized for financial reporting purposes. The tax amortization in current and future years created a deferred tax liability which will reverse at the time of ultimate sale or book impairment. Due to the uncertain timing of this reversal, the temporary difference associated with indefinite-lived intangible assets cannot be considered a source of future taxable income for purposes of determining the valuation allowance. As such, this deferred tax liability cannot be used to offset the deferred tax asset related to the net deferred tax assets. The Company has a net deferred tax liability of \$182 million and \$202 million as of September 30, 2017 and December 31, 2016, respectively, representing indefinite-lived intangible assets.

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

Critical Accounting Policies (Continued)

Accounting for income taxes (Continued)

The Company's income tax benefit for the nine months ended September 30, 2017 is primarily driven by the RehabCare trade name impairment charge of \$98 million recorded during the nine months ended September 30, 2017. The Company has a full valuation allowance on its net deferred tax assets with the exception of deferred tax liabilities related to indefinite-lived intangible assets. The impairment charge resulted in a reduction of those indefinite-lived intangible assets creating an income tax benefit. The income tax benefit for the nine months ended September 30, 2017 is limited to the forecasted income tax benefit for the full year of 2017.

The Company's effective income tax rate was 6.2% and 77.6% in the third quarter of 2017 and 2016, respectively, and 11.7% and 110.6% for the nine months ended September 30, 2017 and 2016, respectively. The reduction in the effective income tax rate in both periods of 2017 was attributable to the impact of recording the initial full deferred tax asset valuation allowance of \$366 million in the third quarter of 2016. The increase in the valuation allowance was \$7 million in the third quarter of 2017 and \$40 million for the nine months ended September 30, 2017, net of the tax benefit associated with the \$98 million RehabCare trade name impairment charge for the nine months ended September 30, 2017 and tax amortization related to indefinite-lived intangible assets in both periods.

Valuation of long-lived assets, goodwill, and intangible assets

Long-lived assets and intangible assets with finite lives

The Company reviews the carrying value of certain long-lived assets and finite lived 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 that 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 for hospitals or IRFs, skilled nursing rehabilitation services reporting unit, hospital rehabilitation services reporting unit, or sites of service within the Kindred at Home division are considered the lowest level for which there are independent, identifiable cash flows. However, to the extent that groups of facilities are leased under a master lease agreement in which the operations of a facility and compliance with the lease terms are interdependent upon other facilities in the agreement (including the Company's ability to renew the lease or divest a particular property), the Company defines the group of facilities under a master lease agreement, or a renewal bundle in a master lease, 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, or a renewal bundle in a master lease, are aggregated for purposes of evaluating the carrying values of long-lived assets.

The Company's intangible assets with finite lives, such as customer relationship assets, trade names, leasehold interests, and non-compete agreements, are amortized in accordance with the authoritative guidance for goodwill and other intangible assets, primarily using the straight-line method over their estimated useful lives ranging from two to 15 years.

During the nine months ended September 30, 2017, the Company recorded an asset impairment charge of \$37 million related to a customer relationship intangible asset due to the expected loss of affiliated contracts related to the SNF Divestiture and cancellation of non-affiliated contracts. The fair value of the customer relationship intangible asset was measured using Level 3 inputs, such as discounted projected future operating cash flows.

In addition, during the nine months ended September 30, 2017, the Company recorded an asset impairment charge of \$0.4 million related to a valuation adjustment for a building within the Kindred at Home division. The fair value of the building was measured using Level 3 inputs, primarily replacement cost.

During the third quarter of 2016, the Company recorded an asset impairment charge of \$20 million related to the property and equipment of the Hospitals sold to Curahealth. The fair value of the properties was measured using Level 3 inputs of the then pending offers.

During the third quarter of 2016, the Company recorded a property and equipment impairment charge of \$3 million related to the Hospital Division Triggering Event. The fair value of the assets was measured using Level 3 inputs such as operating cash flows, market data and replacement cost factoring in depreciation, economic obsolescence and inflation trends.

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

Critical Accounting Policies (Continued)

Valuation of long-lived assets, goodwill, and intangible assets (Continued)

Long-lived assets and intangible assets with finite lives (Continued)

During the nine months ended September 30, 2016, the Company recorded an asset impairment charge of \$3 million related to the sale of a medical office building. The fair value of the property was measured using a Level 3 input of the then pending offer.

During the nine months ended September 30, 2016, the Company also recorded asset impairment charges of \$8 million related to the Curahealth Disposal. The fair value of property and equipment was measured using Level 3 inputs, primarily replacement costs.

Each of the impairment charges discussed above reflects the amount by which the carrying value of the assets exceeded its estimated fair value at each impairment date.

Goodwill

In accordance with the authoritative guidance for goodwill and other intangible assets, the Company is required to perform an impairment test for goodwill and indefinite-lived intangible assets at least annually or more frequently if adverse events or changes in circumstances indicate that the asset may be impaired. The Company performs its annual goodwill impairment test on October 1 each fiscal year for each of its reporting units.

A reporting unit is either an operating segment or one level below the operating segment, referred to as a component. When the components within the Company's operating segments have similar economic characteristics, the Company aggregates the components of its operating segments into one reporting unit. Accordingly, the Company has determined that its reporting units are home health, hospice, community care, hospitals, hospital rehabilitation services, inpatient rehabilitation hospitals, and RehabCare. The community care reporting unit is included in the home health operating segment of the Kindred at Home division. The hospital rehabilitation services and inpatient rehabilitation hospitals reporting units are both included in the Kindred Hospital Rehabilitation Services operating segment of the Kindred Rehabilitation Services division. The carrying value of goodwill for each of the Company's reporting units at September 30, 2017 and December 31, 2016 follows (in thousands):

	September 30, 2017	December 31, 2016
<b>Kindred at Home:</b>		
Home health	\$ 746,613	\$ 746,019
Hospice	646,329	646,329
Community care	170,626	173,463
	1,563,568	1,565,811
Hospitals	361,310	361,310
<b>Kindred Rehabilitation Services:</b>		
Kindred Hospital Rehabilitation Service contracts	173,618	173,618
IRFs	326,335	326,335

RehabCare	-	-
	499,953	499,953
	\$ 2,424,831	\$ 2,427,074

The goodwill impairment test involved a two-step process at October 1, 2016. The first step is a comparison of each reporting unit's fair value to its carrying value. If the carrying value of the reporting unit is greater than its fair value, there is an indication that impairment may exist and the second step must be performed to measure the amount of impairment loss, if any. Based upon the results of the step one impairment test for goodwill for each of the Company's reporting units at October 1, 2016, no goodwill impairment charges were recorded in connection with the Company's annual impairment test.

Since quoted market prices for the Company's reporting units are not available, the Company applies judgment in determining the fair value of these reporting units for purposes of performing the goodwill impairment test. The Company relies on widely accepted valuation techniques, including discounted cash flow and market multiple analyses approaches, which capture both the future income potential of the reporting unit and the market behaviors and actions of market participants in the industry that includes the reporting unit. These types of analyses require the Company to make assumptions and estimates regarding future cash flows, industry-specific economic factors and the profitability of future business strategies. The discounted cash flow approach uses a projection of estimated operating results and cash flows that are discounted using a weighted average cost of capital. Under the discounted cash flow approach, the projection uses management's best estimates of economic and market conditions over the projected period for each

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

Critical Accounting Policies (Continued)

Valuation of long-lived assets, goodwill, and intangible assets (Continued)

Goodwill (Continued)

reporting unit including growth rates in the number of admissions, patient days, reimbursement rates, operating costs, rent expense, and capital expenditures. Other significant estimates and assumptions include terminal value growth rates, changes in working capital requirements, and weighted average cost of capital. The market multiple analysis estimates fair value by applying cash flow multiples to the reporting unit's operating results. The multiples are derived from comparable publicly traded companies with similar operating and investment characteristics to the reporting units.

During the third quarter of 2016, the Company recorded a goodwill impairment charge of \$13 million related to the Curahealth Disposal. The fair value of the properties was measured using a Level 3 input of the then pending offer.

During the third quarter of 2016, the Company recorded a goodwill impairment charge of \$261 million related to the Hospital Division Triggering Event.

Each of these impairment charges reflects the amount by which the carrying value of the hospital reporting unit goodwill exceeded the estimated fair value.

As part of the October 1, 2016 annual impairment test, it was determined the hospice reporting unit carrying value was within 3% of its fair value. Adverse changes in the operating environment and related key assumptions used to determine the fair value of the Company's reporting units and indefinite-lived intangible assets or declines in the value of the Company's common stock may result in future impairment charges for a portion or all of these assets. Specifically, if the rate of growth of government and commercial revenues earned by the Company's reporting units were to be less than projected, if healthcare reforms were to negatively impact the Company's business, if weighted average cost of capital increases, or if recent increases in labor costs materially exceed the Company's projections in its reporting units or business segments, an impairment charge of a portion or all of these assets may be required. An impairment charge could have a material adverse effect on the Company's business, financial position and results of operations, but would not be expected to have an impact on the Company's cash flows or liquidity.

In January 2017, the FASB issued authoritative guidance that simplifies the measurement of goodwill impairment to a single-step test. The guidance removes step two of the goodwill impairment test, which required a hypothetical purchase price allocation. The measurement of goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. Under the revised guidance, failing step one will always result in goodwill impairment. The Company adopted the new guidance on January 1, 2017 on a prospective basis.

Indefinite-lived intangible assets

The Company's indefinite-lived intangible assets consist of trade names, Medicare certifications, and certificates of need. The fair values of the Company's indefinite-lived intangible assets are derived from current market data, including comparable sales or royalty rates, and projections at a facility, geographical location level or reporting unit

which include management's best estimates of economic and market conditions over the projected period. Significant assumptions include growth rates in the number of admissions, patient days, reimbursement rates, operating costs, total rent expense, capital expenditures, terminal value growth rates, changes in working capital requirements, weighted average cost of capital, and opportunity costs.

During the nine months ended September 30, 2017, the Company recorded an asset impairment charge of \$98 million related to the previously acquired RehabCare trade name due to the expected loss of affiliated contracts related to the SNF Divestiture and cancellation of non-affiliated contracts. The fair value of the trade name was measured using Level 3 inputs, such as projected revenues and royalty rate.

The annual impairment tests for certain of the Company's indefinite-lived intangible assets are performed as of May 1 and October 1. During the nine months ended September 30, 2017, the Company recorded asset impairment charges of \$1 million related to a hospital certificate of need (\$0.7 million) and a Medicare certification for an IRF (\$0.6 million) as part of the annual indefinite-lived intangible assets impairment review at May 1, 2017. The fair value of the certificate of need was measured using Level 3 inputs, such as operating cash flows. The fair value of the Medicare certification was measured using a pending offer, a Level 3 input.

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

Critical Accounting Policies (Continued)

Valuation of long-lived assets, goodwill, and intangible assets (Continued)

Indefinite-lived intangible assets (Continued)

As part of the annual indefinite-lived impairment review at October 1, 2016, an impairment charge of \$4 million was recorded related to previously acquired home health and hospice Medicare certifications, certificates of need and a trade name. The fair values of the assets were measured using Level 3 inputs, such as projected revenues and operating cash flows. As part of the impairment review on May 1, 2016, an impairment charge of \$3 million was recorded related to certificates of need for two hospitals which had declines in operating cash flows. The fair value of the certificates of need was measured using Level 3 inputs, such as operating cash flows.

Each of the impairment charges discussed above reflects the amount by which the carrying value of the assets exceeded its estimated fair value at each impairment date.

Medicare certifications in the Company's home health, hospice and IRF reporting units aggregating approximately \$129 million were within 1% of their fair value at October 1, 2016 after the annual impairment test. The majority of the \$129 million Medicare certification value is related to the Gentiva Merger and the Company's acquisition of 11 IRFs in January 2015 from Centerre Healthcare Corporation, which were each appraised during 2015.

Results of Operations – Continuing Operations

For segment purposes, the Company defines segment adjusted operating income as earnings before interest, income taxes, depreciation, amortization, and total rent reported for each of the Company's operating segments, excluding litigation contingency expense, impairment charges, restructuring charges, transaction costs, and the allocation of support center overhead.

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

## Results of Operations – Continuing Operations (Continued)

A summary of the Company's operating data follows (unaudited):

(In thousands)	Three months ended		Nine months ended	
	September 30, 2017	2016	September 30, 2017	2016
<b>Revenues:</b>				
<b>Kindred at Home:</b>				
Home health	\$453,684	\$449,958	\$1,363,691	\$1,318,549
Hospice	188,414	188,575	553,073	550,642
	642,098	638,533	1,916,764	1,869,191
Hospital division	503,138	588,943	1,600,593	1,888,447
<b>Kindred Rehabilitation Services:</b>				
Kindred Hospital Rehabilitation Services	173,638	170,308	530,192	508,448
RehabCare	179,095	189,972	570,315	584,113
	352,733	360,280	1,100,507	1,092,561
	1,497,969	1,587,756	4,617,864	4,850,199
<b>Eliminations:</b>				
Kindred Hospital Rehabilitation Services	(18,376 )	(22,330 )	(59,610 )	(69,515 )
RehabCare	(1,893 )	(1,632 )	(5,638 )	(4,136 )
Hospitals	(559 )	(518 )	(1,775 )	(1,735 )
	(20,828 )	(24,480 )	(67,023 )	(75,386 )
	\$1,477,141	\$1,563,276	\$4,550,841	\$4,774,813
<b>Loss from continuing operations:</b>				
<b>Segment adjusted operating income:</b>				
<b>Kindred at Home:</b>				
Home health	\$66,431	\$75,073	\$206,773	\$218,044
Hospice	34,761	31,326	95,126	87,521
	101,192	106,399	301,899	305,565
Hospital division	61,455	83,940	246,473	347,866
<b>Kindred Rehabilitation Services:</b>				
Kindred Hospital Rehabilitation Services	49,151	49,759	154,333	148,607
RehabCare	7,619	6,740	1,210	25,814
	56,770	56,499	155,543	174,421
Support center expenses	(60,323 )	(62,823 )	(182,909 )	(203,289 )
Litigation contingency expense	(4,000 )	-	(4,000 )	(2,840 )
Impairment charges	-	(297,276 )	(136,303 )	(311,195 )
Restructuring charges	(14,375 )	(22,813 )	(25,592 )	(24,850 )
Transaction costs	-	(2,982 )	-	(6,513 )
Building rent	(64,422 )	(66,946 )	(193,939 )	(199,956 )
Equipment rent	(8,537 )	(9,911 )	(26,285 )	(31,280 )
Restructuring charges - rent	(2,125 )	(58,650 )	(5,964 )	(59,363 )

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Depreciation and amortization	(24,808 )	(32,995 )	(80,279 )	(99,747 )
Interest, net	(60,441 )	(58,059 )	(177,833 )	(172,879 )
Loss from continuing operations before income taxes	(19,614 )	(365,617 )	(129,189 )	(284,060 )
Provision (benefit) for income taxes	(1,225 )	283,630	(15,107 )	314,106
	\$(18,389 )	\$(649,247 )	\$(114,082 )	\$(598,166 )

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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)

## Operating data:

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
<b>Kindred at Home:</b>				
Home health:				
Sites of service (at end of period)	376	395		
Revenue mix %:				
Medicare	74.0	78.1	75.5	79.1
Medicaid	1.7	2.5	1.7	2.2
Commercial and other	12.7	8.6	11.8	8.4
Commercial paid at episodic rates	11.6	10.8	11.0	10.3
Episodic revenues (\$ 000s)	\$320,279	\$332,562	\$981,580	\$990,576
Total admissions	87,156	86,761	270,684	262,541
Same-store total admissions	86,312	85,511	268,534	258,827
Total episodic admissions	67,790	69,219	210,717	210,857
Same-store total episodic admissions	67,191	68,285	209,309	208,018
Medicare episodic admissions	56,772	59,823	177,751	182,564
Total episodes	111,488	113,256	340,031	340,421
Episodes per admission	1.64	1.64	1.61	1.61
Revenue per episode	\$2,873	\$2,936	\$2,887	\$2,910
Hospice:				
Sites of service (at end of period)	178	185		
Admissions	12,236	12,916	38,446	39,299
Same-store admissions	11,997	12,541	37,692	38,045
Average length of stay	97	98	96	93
Patient days	1,239,094	1,277,125	3,647,774	3,699,617
Average daily census	13,468	13,882	13,362	13,502
Revenue per patient day	\$152	\$148	\$152	\$149
Community Care and other revenues (included in				
home health business segment) (\$ 000s)	\$79,720	\$75,978	\$228,037	\$210,512

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

## Results of Operations – Continuing Operations (Continued)

## Operating data (Continued):

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
<b>Hospitals (excluding sub-acute units and skilled nursing facility):</b>				
End of period data:				
Number of transitional care hospitals	77	94		
Number of licensed beds	5,797	6,890		
Revenue mix %:				
Medicare	50.6	54.6	51.3	56.0
Medicaid	4.3	4.0	4.4	4.1
Medicare Advantage	12.3	12.1	12.3	11.9
Medicaid Managed	10.1	7.3	9.4	6.4
Commercial insurance and other	22.7	22.0	22.6	21.6
Patient criteria data:				
Revenues:				
Compliant patients	89.1	%	87.7	%
Site neutral	10.9	%	12.3	%
Revenues per patient day:				
Compliant patients	\$1,799		\$1,807	
Site neutral	1,067		1,052	
Total	1,674		1,661	
Admissions:				
Medicare	6,073	7,861	20,345	25,033
Medicaid	362	375	1,097	1,224
Medicare Advantage	1,197	1,327	3,790	4,162
Medicaid Managed	861	861	2,615	2,362
Commercial insurance and other	1,483	1,727	4,705	5,405
	9,976	12,151	32,552	38,186
Patient days:				
Medicare	158,083	202,482	519,737	650,499
Medicaid	13,429	16,781	40,096	57,324
Medicare Advantage	38,338	43,241	119,913	136,698
Medicaid Managed	31,249	28,534	96,597	81,142
Commercial insurance and other	49,895	59,856	158,399	185,634
	290,994	350,894	934,742	1,111,297
Average length of stay:				
Medicare	26.0	25.8	25.5	26.0
Medicaid	37.1	44.7	36.6	46.8
Medicare Advantage	32.0	32.6	31.6	32.8
Medicaid Managed	36.3	33.1	36.9	34.4
Commercial insurance and other	33.6	34.7	33.7	34.3

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Weighted average	29.2	28.9	28.7	29.1
Revenues per admission:				
Medicare	\$40,577	\$39,945	\$39,124	\$41,445
Medicaid	57,365	61,338	62,391	62,716
Medicare Advantage	50,301	52,363	50,219	52,826
Medicaid Managed	57,172	48,631	55,970	49,831
Commercial insurance and other	74,435	73,515	74,737	74,099
Weighted average	48,818	47,348	47,701	48,508
Revenues per patient day:				
Medicare	\$1,559	\$1,551	\$1,532	\$1,595
Medicaid	1,546	1,371	1,707	1,339
Medicare Advantage	1,571	1,607	1,587	1,608
Medicaid Managed	1,575	1,467	1,515	1,451
Commercial insurance and other	2,212	2,121	2,220	2,158
Weighted average	1,674	1,640	1,661	1,667
Medicare case mix index (discharged patients only)	1.180	1.172	1.176	1.172
Average daily census	3,163	3,814	3,424	4,056
Occupancy %	59.9	61.6	63.9	65.4

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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)

Operating data (Continued):

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Same-hospital data:				
End of period data:				
Number of transitional care hospitals	77	77		
Number of licensed beds	5,797	5,797		
Revenue mix %:				
Medicare	50.6	53.9	50.9	55.8
Medicaid	4.3	3.6	4.6	3.8
Medicare Advantage	12.4	12.3	12.1	11.7
Medicaid Managed	10.1	7.9	9.6	6.8
Commercial insurance and other	22.6	22.3	22.8	21.9
Patient criteria data:				
Revenues:				
Compliant patients	89.1	%	87.8	%
Site neutral	10.9	%	12.2	%
Revenues per patient day:				
Compliant patients	\$1,799		\$1,813	
Site neutral	1,067		1,058	
Total	1,673		1,668	
Admissions:				
Medicare	6,018	6,758	19,471	21,228
Medicaid	361	333	1,089	1,058
Medicare Advantage	1,190	1,140	3,614	3,419
Medicaid Managed	851	783	2,546	2,106
Commercial insurance and other	1,468	1,415	4,482	4,382
	9,888	10,429	31,202	32,193
Patient days:				
Medicare	156,412	173,863	497,189	551,367
Medicaid	13,433	11,631	40,193	39,317
Medicare Advantage	38,098	38,245	114,423	114,880
Medicaid Managed	30,816	26,552	94,771	73,620
Commercial insurance and other	49,402	51,043	152,532	154,782
	288,161	301,334	899,108	933,966
Average length of stay:				
Medicare	26.0	25.7	25.5	26.0
Medicaid	37.2	34.9	36.9	37.2
Medicare Advantage	32.0	33.5	31.7	33.6
Medicaid Managed	36.2	33.9	37.2	35.0
Commercial insurance and other	33.7	36.1	34.0	35.3

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Weighted average	29.1	28.9	28.8	29.0
Revenues per admission:				
Medicare	\$40,513	\$40,020	\$39,228	\$41,725
Medicaid	57,689	54,880	62,842	56,715
Medicare Advantage	50,241	54,398	50,365	54,586
Medicaid Managed	57,158	50,360	56,488	51,498
Commercial insurance and other	74,312	79,176	76,130	79,418
Weighted average	48,761	48,155	48,052	49,354
Revenues per patient day:				
Medicare	\$1,559	\$1,556	\$1,536	\$1,606
Medicaid	1,550	1,571	1,703	1,526
Medicare Advantage	1,569	1,621	1,591	1,625
Medicaid Managed	1,578	1,485	1,518	1,473
Commercial insurance and other	2,208	2,195	2,237	2,248
Weighted average	1,673	1,667	1,668	1,701
Average daily census	3,132	3,275	3,293	3,409

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

## Results of Operations – Continuing Operations (Continued)

## Operating data (Continued):

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2017	2016	2017	2016
Kindred Rehabilitation Services:				
Kindred Hospital Rehabilitation Services:				
Freestanding IRFs:				
End of period data:				
Number of IRFs	19	19		
Number of licensed beds	995	969		
Discharges (a)	4,755	4,644	14,296	13,738
Same-hospital discharges (a)	4,477	4,546	13,387	13,376
Occupancy % (a)	68.8	68.8	70.1	70.0
Average length of stay (a)	12.7	12.7	12.8	12.9
Revenue per discharge (a)	\$20,329	\$19,599	\$20,348	\$19,547
Contract services:				
Sites of service (at end of period):				
Inpatient rehabilitation units (ARUs)	101	104		
LTAC hospitals	110	120		
Sub-acute units	6	7		
Outpatient units	123	139		
	340	370		
Revenue per site	\$222,504	\$210,810	\$678,138	\$638,025
RehabCare:				
Sites of service (at end of period)	1,624	1,754		
Revenue per site	\$110,281	\$108,308	\$337,969	\$331,862

(a)Excludes non-consolidating IRF.

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

Results of Operations – Continuing Operations (Continued)

Kindred at Home

Home health

Revenues increased 1% to \$454 million in the third quarter of 2017 compared to \$450 million for the same period in 2016, and increased 3% to \$1.4 billion for the nine months ended September 30, 2017 compared to \$1.3 billion for the same period in 2016, primarily the result of a 1% increase in same-store admissions in the third quarter of 2017 and a 4% increase in same-store admissions for the nine months ended September 30, 2017, both compared to the same period a year ago. Hurricanes Irma and Harvey (the “Hurricanes”) negatively impacted revenues by \$3 million for both the third quarter of 2017 and for the nine months ended September 30, 2017.

Segment adjusted operating income margins declined to 14.6% in the third quarter of 2017 compared to 16.7% in the third quarter of 2016 and declined to 15.2% for the nine months ended September 30, 2017 compared to 16.5% for the same period in 2016. The declines in segment adjusted operating income margins for both periods were primarily attributable to a \$3 million impact primarily from business interruption and incremental labor costs related to the Hurricanes, and an increase in managed care and commercial patient revenue mix that pays lower average rates than Medicare.

Direct labor cost per visit decreased 4% in the third quarter of 2017 compared to the same period in 2016, and was relatively unchanged for the nine months ended September 30, 2017 compared to the same period in 2016. The decline in direct labor cost per visit in the third quarter of 2017 was primarily a result of the integration of pay practices that was completed in the first half of 2017. Employee benefit costs increased 5% in both the third quarter of 2017 and for the nine months ended September 30, 2017 compared to the same respective periods in 2016, primarily as a result of an increase in health insurance expense in both periods.

Hospice

Revenues were relatively unchanged at \$189 million in the third quarter of 2017 compared to the same period in 2016 as a 3% increase in revenue per patient day was offset by a 3% decline in patient days. Revenues increased slightly to \$553 million for the nine months ended September 30, 2017 compared to \$551 million for the same period in 2016, primarily as a result of 2% growth in revenue per patient day. The Hurricanes negatively impacted revenues by \$2 million for both the third quarter of 2017 and for the nine months ended September 30, 2017.

Segment adjusted operating income margins increased to 18.4% in the third quarter of 2017 compared to 16.6% in the same period in 2016 and increased to 17.2% for the nine months ended September 30, 2017 compared to 15.9% for the same period of 2016. The increases in both periods were primarily attributable to operating efficiencies and the closure of unprofitable branches, partially offset by a \$2 million impact primarily from business interruption and incremental labor costs related to the Hurricanes.

Direct labor cost per patient day decreased 1% in both the third quarter of 2017 and for the nine months ended September 30, 2017 compared to the same periods in 2016, primarily as a result of the integration of pay practices partially offset by an increase in average wage rates in both periods. Employee benefit costs were relatively unchanged in the third quarter of 2017 and declined 1% for the nine months ended September 30, 2017 compared to

the same periods in 2016, primarily as a result of a reduction in health insurance expense.

#### Hospital division

Revenues declined 15% to \$503 million in the third quarter of 2017 compared to \$589 million for the same period in 2016, and declined 15% to \$1.6 billion for the nine months ended September 30, 2017 compared to \$1.9 billion for the same period in 2016, primarily as a result of the sale or closure of 21 LTAC hospitals beginning in the second half of 2016 (which eliminated \$69 million and \$203 million of revenues in the third quarter of 2017 and for the nine months ended September 30, 2017, respectively), the hospital division entering LTAC patient criteria on September 1, 2016 for the majority of the Company's LTAC hospitals, lower same-hospital volumes and, to a lesser extent, \$3 million related to the Hurricanes. Same-hospital admissions declined 5% in the third quarter of 2017 and declined 3% for the nine months ended September 30, 2017, compared to the same periods in 2016.

Segment adjusted operating income margins declined to 12.2% in the third quarter of 2017 compared to 14.3% for the same period in 2016, and declined to 15.4% for the nine months ended September 30, 2017 compared to 18.4% for the same period in 2016, primarily as a result of LTAC patient criteria for both periods, lower same-hospital volumes and a \$10 million impact primarily from business interruption and incremental labor costs related to the Hurricanes.

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

Results of Operations – Continuing Operations (Continued)

Hospital division (Continued)

Average hourly wage rates increased 6% and 4% in the third quarter of 2017 and for the nine months ended September 30, 2017, respectively, compared to the same periods in 2016, primarily as a result of pay rate increases and hurricane related premium pay. Employee benefit costs declined 10% and 12% in the third quarter of 2017 and for the nine months ended September 30, 2017, respectively, compared to the same periods in 2016, primarily as a result of the sale or closure of 21 LTAC hospitals beginning in the second half of 2016.

Professional liability costs were \$10 million in both the third quarter of 2017 and 2016, and \$29 million and \$34 million for the nine months ended September 30, 2017 and 2016, respectively. The decline for the nine months ended September 30, 2017 was primarily attributable to a decrease in the frequency and severity of claims.

Kindred Rehabilitation Services

Kindred Hospital Rehabilitation Services

Revenues increased 2% to \$173 million in the third quarter of 2017 compared to \$170 million for the same period in 2016, and increased 4% to \$530 million for the nine months ended September 30, 2017 compared to \$508 million for the same period in 2016. The increases in both periods were primarily attributable to an increase in revenue per discharge and the maturing operations of two freestanding IRFs that opened during 2016. The Hurricanes had an immaterial impact on revenue during the third quarter of 2017.

Segment adjusted operating income margins declined to 28.3% in the third quarter of 2017 compared to 29.2% for the same period in 2016, and declined to 29.1% for the nine months ended September 30, 2017 compared to 29.2% for the same period in 2016. The declines for both periods were primarily a result of an 8% decline in contract sites of service resulting primarily from the closure of eight company-operated LTAC hospitals beginning in the second half of 2016 and, to a lesser extent, higher labor costs. The Hurricanes negatively impacted segment adjusted operating income by \$1 million for both the third quarter of 2017 and for the nine months ended September 30, 2017.

Employee benefit costs increased 5% and 6% in the third quarter of 2017 and for the nine months ended September 30, 2017, respectively, compared to the same periods in 2016, primarily as a result of an increase in health insurance expense in both periods and the two freestanding IRFs that opened during 2016.

RehabCare

Revenues declined 6% to \$179 million in the third quarter of 2017 compared to \$190 million for the same period in 2016, and declined 2% to \$570 million for the nine months ended September 30, 2017 compared to \$584 million for the same period in 2016. The decline in revenues for both periods was primarily attributable to a net loss of customer contract sites of service. The number of RehabCare sites of service at September 30, 2017 was 1,624 compared to 1,754 at September 30, 2016. The net loss of customer contract sites of service was primarily attributable to the strategic termination of unprofitable customer contract sites and competition.

Segment adjusted operating income included a \$2 million favorable settlement in the third quarter of 2017 and a charge of \$23 million for the nine months ended September 30, 2017 related to the RehabCare Collection Litigation. Excluding these charges, segment adjusted operating income margins declined to 3.0% in the third quarter of 2017 compared to 3.5% in the third quarter of 2016, and declined to 4.3% for the nine months ended September 30, 2017 compared to 4.4% for the nine months ended September 30, 2016, both primarily due to the net loss of customer contract sites of service and, to a lesser extent, wage rate pressure.

Employee benefit costs declined 3% and 2% in the third quarter of 2017 and for the nine months ended September 30, 2017, respectively, compared to the same periods in 2016, primarily as a result of the net loss of customer contract sites of service.

#### Support center expenses

Segment adjusted operating income for the Company's operating divisions excludes allocations of support center overhead. These costs aggregated \$60 million and \$63 million in the third quarter of 2017 and 2016, respectively and \$183 million and \$203 million for the nine months ended September 30, 2017 and 2016, respectively. The decline in support center overhead was primarily attributable to cost reduction initiatives executed in both the fourth quarter of 2016 and the first quarter of 2017, lower incentive compensation costs and lower legal fees. As a percentage of consolidated revenues, support center overhead totaled 4.1% and 4.0% in the third quarter of 2017 and 2016, respectively, and 4.0% and 4.3% for the nine months ended September 30, 2017 and 2016, respectively.

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

Results of Operations – Continuing Operations (Continued)

Restructuring Costs

The Company has initiated various restructuring activities whereby it has incurred costs associated with reorganizing its operations, including the divestiture, swap, closure and consolidation of facilities and branches, reduced headcount and realigned operations in order to improve cost efficiencies in response to changes in the healthcare industry and to partially mitigate reductions in reimbursement rates from third party payors. The costs associated with these activities are reported as restructuring charges in the statement of operations and would have been recorded as general and administrative expense or rent expense if not classified as restructuring charges.

LTAC Hospital Portfolio Repositioning 2017 Plan

During the third quarter of 2017, the Company approved phase two of the LTAC hospital portfolio repositioning plan that incorporated the closure and conversion of certain LTAC hospitals as part of its mitigation strategies in response to the new patient criteria for LTAC hospitals under the LTAC Legislation. The activities related to the LTAC hospital portfolio repositioning 2017 plan are expected to be substantially completed by the end of 2018. The additional costs cannot be reasonably estimated at this time.

Restructuring charges that the Company incurred related to the LTAC hospital portfolio repositioning 2017 plan consisted of \$9 million for asset write-offs, \$3 million for severance, and \$1 million for lease termination costs in both the third quarter of 2017 and for the nine months ended September 30, 2017.

LTAC Hospital Portfolio Repositioning 2016 Plan

During the first quarter of 2016, the Company approved the LTAC hospital portfolio repositioning 2016 plan that incorporated the divestiture, swap or closure of certain LTAC hospitals as part of its mitigation strategies to prepare for new patient criteria for LTAC hospitals under the LTAC Legislation. The activities related to the LTAC hospital portfolio repositioning 2016 plan were substantially completed during 2016.

Restructuring charges that the Company incurred related to the LTAC hospital portfolio repositioning 2016 plan consisted of \$1 million for lease termination costs in the third quarter of 2017 compared to \$57 million for lease termination costs, \$19 million for asset write-offs, \$1 million for facility closure costs and gain on disposal, \$1 million for severance and \$0.5 million for transaction costs in the third quarter of 2016. Lease termination costs were \$3 million and asset write-offs were \$1 million for the nine months ended September 30, 2017 as compared to \$57 million for lease termination costs, \$19 million for asset write-offs, \$2 million for severance and \$2 million for transaction costs for the nine months September 30, 2016.

Kindred at Home 2017 Efficiency Initiative

During the first quarter of 2017, the Kindred at Home division approved and initiated a cost and operations efficiency initiative to address increases in labor costs associated with competitive labor markets and the integration of pay practices from acquisitions across the Kindred at Home portfolio. This initiative includes the consolidation and closure of under-performing branches and a reduction in force associated with the restructuring of divisional and regional support teams. These activities will be substantially completed during 2017. The additional costs cannot be

reasonably estimated at this time.

Restructuring charges related to these initiatives consisted of \$1 million for lease termination costs, \$1 million for severance and \$1 million for gain on disposal in the third quarter of 2017, and \$2 million for lease termination costs, \$4 million for asset write-offs, \$3 million for severance and \$1 million for gain on disposal for the nine months ended September 30, 2017.

#### Kindred at Home Branch Consolidations and Closures

During the first quarter of 2015, the Company approved and initiated branch consolidations and closures in specific markets to improve operations and cost efficiencies in the Kindred at Home division. The branch consolidations and closures included branches that served both the home health and hospice business segment operations. Gentiva initiated similar branch consolidations and closures prior to the Gentiva Merger and these activities and acquired liabilities are included herein. These activities were substantially completed during 2016.

Restructuring charges related to these consolidations and closures consisted of \$1 million for lease termination costs, \$3 million for asset write-offs, and \$0.6 million for severance for the nine months ended September 30, 2017. These charges were \$2 million for lease termination costs in the third quarter of 2016 and \$2 million for lease termination costs, \$0.5 million for asset write-offs and \$0.1 million for branch closure and other costs for the nine months ended September 30, 2016.

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

Results of Operations – Continuing Operations (Continued)

Transaction costs

Operating results in the third quarter of 2016 included transaction and integration costs totaling \$1 million related to the Gentiva Merger and \$2 million of transaction costs associated with other acquisition activities. Operating results for the nine months ended September 30, 2016 included transaction and integration costs totaling \$4 million, and retention and severance costs totaling \$1 million related to the Gentiva Merger, and \$2 million of transaction costs associated with other acquisition activities. These transaction, retention, and severance costs were included in general and administrative expenses.

Other expenses

Total rent expense declined 5% to \$73 million in the third quarter of 2017 compared to \$77 million in the third quarter 2016. Total rent expense declined 5% to \$220 million for the nine months ended September 30, 2017 compared to \$231 million for the same period in 2016. The declines in both periods were primarily attributable to the sale or closure of 21 LTAC hospitals beginning in the second half of 2016.

Depreciation and amortization expense declined 25% to \$24 million in the third quarter of 2017 compared to \$33 million in third quarter of 2016. Depreciation and amortization expense declined 20% to \$80 million for the nine months ended September 30, 2017 compared to \$100 million for the nine months ended September 30, 2016. The declines in both periods were primarily attributable to a change in estimate in the depreciable life of certain information technology equipment and software which reduced depreciation expense by \$3 million and \$7 million in the third quarter of 2017 and for the nine months ended September 30, 2017, respectively, as well as the sale or closure of 21 LTAC hospitals beginning in the second half of 2016.

Interest expense increased 2% to \$61 million in the third quarter of 2017 compared to \$60 million in the third quarter of 2016, and increased 3% to \$181 million for the nine months ended September 30, 2017 compared to \$175 million for the nine months ended September 30, 2016, primarily as a result of increased long-term borrowings and, to a lesser extent, an interest rate increase of 25 basis points related to the Term Loan Amendment Agreement entered into in March 2017.

Consolidated results

Loss from continuing operations before income taxes aggregated \$20 million in the third quarter of 2017 compared to \$366 million in the third quarter of 2016. Loss from continuing operations before income taxes aggregated \$129 million for the nine months ended September 30, 2017 compared to \$284 million for the nine months ended September 30, 2016. Loss from continuing operations attributable to the Company aggregated \$29 million in the third quarter of 2017 compared to \$659 million for the same period in 2016. Loss from continuing operations attributable to the Company aggregated \$146 million for the nine months September 30, 2017 compared to \$624 million for the nine months ended September 30, 2016. A favorable settlement related to the RehabCare Collection Litigation, litigation contingency expense, and restructuring charges negatively impacted consolidated pretax operating results by \$18 million (\$19 million net of income taxes, including the deferred tax asset valuation allowance adjustment of \$7 million) in the third quarter of 2017. Transaction and integration costs, research and development, restructuring charges, and impairment charges negatively impacted consolidated pretax operating results by \$384 million (\$663

million net of income taxes, including a deferred tax asset valuation allowance of \$366 million) in the third quarter of 2016. Impairment charges, the RehabCare Collection Litigation, litigation contingency expense, restructuring charges, and business interruption settlements negatively impacted consolidated pretax operating results by \$193 million (\$158 million net of income taxes, including the deferred tax asset valuation allowance adjustment of \$40 million) for the nine months ended September 30, 2017. Impairment charges, transaction and integration costs, litigation contingency expense, business interruption settlements, research and development, restructuring charges, and debt amendment costs negatively impacted consolidated pretax operating results by \$409 million (\$681 million net of income taxes, including a deferred tax asset valuation allowance of \$366 million) for the nine months ended September 30, 2016.

#### Results of Operations – Discontinued Operations

Loss from discontinued operations aggregated \$14 million in the third quarter of 2017 compared to \$22 million for the same period in 2016. Loss from discontinued operations aggregated \$2 million for the nine months ended September 30, 2017 compared to \$10 million for the same period in 2016. The Company recorded a net loss on divestiture of operations of \$50 million in the third quarter of 2017, primarily related to the SNF Divestiture, including a \$3 million lease termination accrual, \$24 million of transaction and other costs, an \$18 million loss on sale-leaseback transaction, and \$7 million of retention costs. The Company recorded a net loss on divestiture of operations of \$350 million for the nine months ended September 30, 2017, primarily related to the SNF Divestiture, including a \$265 million lease termination accrual, \$42 million of transaction and other costs, an \$18 million loss on sale-leaseback transaction, and \$21 million of retention costs, compared to a net gain on divestiture of operations of \$0.2 million for the same period in 2016.

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

Results of Operations – Discontinued Operations (Continued)

Nursing centers

Revenues declined 28% to \$184 million in the third quarter of 2017 compared to \$255 million in the same period in 2016 and declined 11% to \$690 million for the nine months ended September 30, 2017 compared to \$779 million for the nine months ended September 30, 2016. The declines in revenues were primarily as a result of the sale of 54 skilled nursing facilities to new operators during the third quarter of 2017 in conjunction with the SNF Divestiture. These 54 skilled nursing facilities contributed revenues of \$105 million and \$166 million in the third quarter of 2017 and 2016, respectively, and \$435 million and \$500 million for the nine months ended September 30, 2017 and 2016, respectively.

Segment adjusted operating income margins declined to 2.7% in the third quarter of 2017 compared to 12.5% for the same period in 2016, and declined to 10.4% for the nine months ended September 30, 2017 compared to 13.6% for the nine months ended September 30, 2016. The declines in both periods were primarily as a result of the previously mentioned sale of 54 skilled nursing facilities to new operators during the third quarter of 2017 in conjunction with the SNF Divestiture.

Average hourly wage rates increased 6% in the third quarter of 2017 and 5% for the nine months ended September 30, 2017 compared to the respective prior year periods, primarily as a result of pay rate increases and higher contract labor costs. Employee benefit costs declined 14% and 10% in the third quarter of 2017 and for the nine months ended September 30, 2017 compared to the same periods in 2016, primarily as a result of the SNF Divestiture for both periods.

Professional liability costs were \$8 million and \$7 million in the third quarter of 2017 and 2016, respectively, and \$26 million and \$20 million for the nine months ended September 30, 2017 and 2016, respectively, primarily attributable to increases in the frequency and severity of claims.

Liquidity

Operating cash flows

Cash flows provided by operations (including discontinued operations) was \$8 million for the nine months ended September 30, 2017 compared to \$41 million for the nine months ended September 30, 2016. Operating cash flows for the nine months ended September 30, 2017 were negatively impacted by \$56 million for severance, retention, transaction, litigation, debt refinancing, and lease termination payments, and business interruption settlements. Operating cash flows for the nine months ended September 30, 2017 also were negatively impacted by LTAC patient criteria, approximately \$20 million from temporary billing delays and a \$16 million decline in operating results both associated with the Hurricanes, and to a lesser extent, growth in managed care and commercial payor mix, which generally requires a longer accounts receivable collection cycle than Medicare. Operating cash flows for the nine months ended September 30, 2016 were negatively impacted by \$161 million for severance, retention, transaction, litigation, debt refinancing, and lease termination payments, and business interruption settlements. In January 2016, the Company entered into a settlement agreement with the United States of America, acting through the DOJ and on behalf of the OIG, to resolve a then-pending DOJ investigation concerning the operations of RehabCare. Under the settlement agreement, the Company paid \$126 million to the United States during the nine months ended September

30, 2016.

The Company utilizes its ABL Facility to meet working capital needs and finance its acquisition and development activities. As a result, the Company typically carries minimal amounts of cash on its consolidated balance sheet. Based upon the Company's expected operating cash flows and the availability of borrowings under the ABL Facility (\$517 million at September 30, 2017), management believes that the Company has the necessary financial resources to satisfy its expected short-term and long-term liquidity needs.

The Company expects to realize net value of approximately \$210 million from the SNF Divestiture, subject to post-closing adjustments, and after the \$700 million payment to Ventas, estimated transaction costs of approximately \$35 million and estimated severance costs of approximately \$35 million. This amount includes approximately \$75 million in retained net working capital, the majority of which will be liquidated over late 2017 and early 2018, approximately \$145 million of cash tax benefit over time from the creation of an approximately \$390 million net operating loss carryforward associated with the SNF Divestiture, and approximately \$60 million of value associated with a retained skilled nursing facility, hospital-based sub-acute units and other retained assets. The Company's deferred tax assets are subjected to a full valuation allowance under the authoritative guidance and the cash tax benefit is subject to the Company generating taxable income over the carryforward period.

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

Liquidity (Continued)

Operating cash flows (Continued)

In connection with the SNF Divestiture, the Company entered into an interim management agreement in the third quarter of 2017 with certain affiliates of BlueMountain in the state of California whereby the Company would lease its license of certain operations to such affiliates until licensure approval is obtained. Because the Company has continuing involvement in the business through purveying certain rights of ownership of the assets while under the interim management agreement and license sublease, the Company does not meet the requirements for a sale-leaseback transaction as described in ASC 840-40, Leases - Sale-Leaseback Transactions. Under the failed-sale-leaseback accounting model, the Company is deemed under GAAP to still own certain real estate assets sold to BlueMountain, which the Company must continue to reflect in its consolidated balance sheet and depreciate over the assets' remaining useful life. The Company must also treat a portion of the pretax cash proceeds from the SNF Divestiture as though it were the result of a \$141 million other long-term liability financing obligation in its accompanying unaudited condensed consolidated balance sheet, and must also defer a \$18 million gain associated with some of these assets until continuing involvement ceases. The lease will terminate upon licensure approval, at which time the Company will cease to recognize the remaining other long-term liability financing obligation, as well as the remaining net book value of the real estate assets and will recognize the gain.

Dividends and other payments

During the nine months ended September 30, 2017, the Company paid a cash dividend of \$0.12 per common share on March 31, 2017. The Company's Board of Directors elected to discontinue paying dividends on the Company's common stock following the March 31, 2017 payment and instead redirected funds to repay debt and invest in growth.

During the nine months ended September 30, 2016, the Company paid a cash dividend of \$0.12 per common share on September 2, 2016 (to shareholders of record as of the close of business on August 18, 2016), June 10, 2016 and April 1, 2016.

The Company made installment payments on the Units of \$18.75 per Unit on September 1, 2017 (to holders of record as of the close of business on August 15, 2017), June 1, 2017 and March 1, 2017. The Company made installment payments on the Units of \$18.75 per Unit on September 1, 2016 and March 1, 2016, and of \$18.76 on June 1, 2016. Each Unit is composed of a Purchase Contract and one share of Mandatory Redeemable Preferred Stock having a final preferred stock installment payment date of December 1, 2017 and an initial liquidation preference of \$201.58 per share of Mandatory Redeemable Preferred Stock. To the extent that any Unit has been separated into its constituent Purchase Contract and its constituent share of Mandatory Redeemable Preferred Stock, the installment payment is payable only on the constituent share of Mandatory Redeemable Preferred Stock. The cash funding of installment payments on the Units will require the use of approximately \$13 million in 2017, of which \$10 million was paid during the nine months ended September 30, 2017.

Term Loan Amendment Agreement

On March 14, 2017, the Company entered into the Term Loan Amendment Agreement that amended and restated the Term Loan Facility to, among other things, (1) make adjustments to certain covenants and definitions to better accommodate the SNF Divestiture, (2) provide the Company with increased leverage covenant flexibility for an

interim period, (3) increase the applicable margin on the outstanding borrowings from 3.25% to 3.50% for LIBOR borrowings and from 2.25% to 2.50% for base rate borrowings, (4) require a maximum leverage ratio of no more than 5.00 to 1.00 for use of the \$50 million annual dividend basket, and (5) provide for a prepayment premium of 1.00% in connection with any repricing transaction within six months of the closing date. In accordance with the authoritative guidance on debt, the Company accounted for the amendment as a debt modification.

#### ABL Facility

On September 27, 2017, the Company entered into an amendment to the ABL Facility to update the provisions pertaining to letters of credit issued thereunder.

#### Interest rate swaps

In January 2016, the Company entered into three interest rate swap agreements to hedge its floating interest rate on an aggregate of \$325 million of debt outstanding under its Term Loan Facility. The interest rate swaps have an effective date of January 11, 2016, and expire on January 9, 2021. The Company is required to make payments based upon a fixed interest rate of 1.862% and 1.855% calculated on the notional amount of \$175 million and \$150 million, respectively. In exchange, the Company will receive interest on \$325 million at a variable interest rate that is based upon the three-month LIBOR, subject to a minimum rate of 1.0%.

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

Liquidity (Continued)

Interest rate swaps (Continued)

In March 2014, the Company entered into an interest rate swap agreement to hedge its floating interest rate on an aggregate of \$400 million of debt outstanding under its Term Loan Facility. On April 8, 2014, the Company completed a novation of a portion of its \$400 million swap agreement to two new counterparties, each in the amount of \$125 million. The original swap contract was not amended, terminated, or otherwise modified. The interest rate swap had an effective date of April 9, 2014, will expire on April 9, 2018, and continues to apply to the Term Loan Facility. The Company is required to make payments based upon a fixed interest rate of 1.867% calculated on the notional amount of \$400 million. In exchange, the Company will receive interest on \$400 million at a variable interest rate that is based upon the three-month LIBOR, subject to a minimum rate of 1.0%.

The interest rate swaps were assessed for hedge effectiveness for accounting purposes and the Company determined the interest rate swaps qualify for cash flow hedge accounting at September 30, 2017. The Company records the effective portion of the gain or loss on these derivative financial instruments in accumulated other comprehensive income (loss) as a component of stockholders' equity and records the ineffective portion of the gain or loss on these derivative financial instruments as interest expense. For the three months and nine months ended September 30, 2017 and 2016, there was no ineffectiveness related to the interest rate swaps.

The aggregate fair value of the interest rate swaps recorded in other accrued liabilities was \$1 million and \$3 million at September 30, 2017 and December 31, 2016, respectively.

Other financing activities

In the third quarter of 2017, as a result of improved underwriting results, the Company received the September Distribution from Cornerstone and has received distributions totaling \$38 million from Cornerstone for the nine months ended September 30, 2017. The September Distribution was used to repay a portion of the Company's ABL Facility. These distributions were completed in accordance with applicable regulations and had no impact on earnings or cash flows from operations.

In October 2017, in connection with the review of the Company's insurance programs as a result of the SNF Divestiture, the Company completed the October Insurance Restructuring. With respect to its workers compensation program, approximately \$115 million of restricted cash collateral deposits were replaced with letters of credit and approximately \$21 million of other cash deposits were released. In addition, certain funding mechanisms associated with the Company's professional liability insurance and reinsurance agreements were modified such that approximately \$106 million of cash deposits maintained at Cornerstone and \$4 million of other cash deposits were released to the parent company. In both cases, no changes were made to the financial risk transfer aspects of the Company's insurance arrangements with third parties. Also in October 2017, as a result of further improvement in Cornerstone's underwriting results, the Company received the October Distribution. In aggregate, the approximately \$281 million generated from the October Insurance Restructuring, the September Distribution and the October Distribution was used to repay in its entirety the Company's ABL Facility balance and to increase cash reserves. The Company expects that there will be additional cash savings from these activities over the duration of the fourth quarter that will offset approximately \$11 million of estimated costs in the same period associated with the October Insurance Restructuring.

## Capital Resources

### Capital expenditures and acquisitions

Excluding acquisitions, routine capital expenditures (expenditures necessary to maintain existing facilities that generally do not increase capacity or add services) totaled \$46 million and \$69 million for the nine months ended September 30, 2017 and 2016, respectively. Kindred Hospital Rehabilitation Services development capital expenditures (primarily new IRF development) totaled \$0.5 million and \$15 million for the nine months ended September 30, 2017 and 2016, respectively. Support center development capital expenditures totaled \$17 million and \$6 million for the nine months ended September 30, 2017 and 2016, respectively. Nursing center development capital expenditures totaled \$6 million for the nine months ended September 30, 2016. Excluding acquisitions, the Company anticipates that routine capital spending for 2017 should approximate \$65 million to \$70 million and development capital spending should approximate \$30 million to \$35 million. Management expects that substantially all of these expenditures will be financed through internal sources or borrowings under the ABL Facility. Management believes that its capital expenditure program is adequate to improve and equip existing facilities. At September 30, 2017, the estimated cost to complete and equip construction in progress approximated \$26 million.

Acquisition expenditures totaled \$7 million and \$77 million for the nine months ended September 30, 2017 and 2016, respectively, which were financed with operating cash flows and the ABL Facility, and also for the nine months ended September 30, 2016, an acquisition deposit of \$18 million. See note 2 of the notes to unaudited condensed consolidated financial statements.

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

Other Information

Effects of inflation and changing prices

The Company derives a substantial portion of its revenues from patients covered by the Medicare and Medicaid programs. The Company has been, and could be in the future, materially adversely affected by the continuing efforts of governmental and private third party payors to contain healthcare costs.

The Company cannot provide assurance that reimbursement payments under governmental and private third party payor programs, including Medicare supplemental insurance policies, will remain at levels comparable to present levels or will be sufficient to cover the costs allocable to patients eligible for reimbursement pursuant to these programs. Medicare reimbursement in LTAC hospitals, IRFs, home health, and hospice is subject to fixed payments under the Medicare prospective payment systems. In accordance with Medicare laws, CMS makes annual adjustments to Medicare payment rates in many prospective payment systems under what is commonly known as a "market basket update." Each year, the Medicare Payment Advisory Commission ("MedPAC"), a commission chartered by Congress to advise it on Medicare payment issues, makes payment policy recommendations to Congress for a variety of Medicare payment systems. Congress is not obligated to adopt MedPAC recommendations, and, based upon outcomes in previous years, there can be no assurance that Congress will adopt MedPAC's recommendations in a given year. Medicaid reimbursement rates in many states in which the Company operates are based upon fixed payment systems. Generally, these rates are adjusted annually for inflation. However, these adjustments do not reflect the actual increase in the costs of providing healthcare services. In addition, Medicaid reimbursement can be impacted negatively by state budgetary pressures, which may lead to reduced reimbursement or delays in receiving payments. There can be no assurance that the facilities operated by the Company, or the provision of goods and services offered by the Company, will meet the requirements for participation in such programs.

The Patient Protection and Affordable Care Act and the Healthcare Education and Reconciliation Act

Various healthcare reform provisions became law upon enactment of the Patient Protection and Affordable Care Act and the Healthcare Education and Reconciliation Act (previously defined as the ACA). The reforms contained in the ACA have affected each of the Company's businesses in some manner and are directed in large part at increased quality and cost reductions. Several of the reforms are very significant and could ultimately change the nature of the Company's services, the methods of payment for the Company's services, and the underlying regulatory environment. These reforms include the possible modifications to the conditions of qualification for payment, bundling of payments to cover both acute and post-acute care, and the imposition of enrollment limitations on new providers.

The ACA also provides for: (1) reductions to the annual market basket payment updates for LTAC hospitals, IRFs, home health agencies, and hospice providers that could result in lower reimbursement than in the preceding year; (2) additional annual "productivity adjustment" reductions to the annual market basket payment update as determined by CMS for LTAC hospitals and IRFs (beginning in federal fiscal year 2012), home health agencies (beginning in federal fiscal year 2015) and hospice providers (beginning in federal fiscal year 2013); (3) a quality reporting system for hospitals (including LTAC hospitals and IRFs) beginning in federal fiscal year 2014; and (4) reductions in Medicare payments to hospitals (including LTAC hospitals and IRFs) beginning in federal fiscal year 2014 for failure to meet certain quality reporting standards or to comply with standards in new value-based purchasing demonstration project programs.

Further, the ACA mandates changes to home health and hospice benefits under Medicare. For home health, the ACA mandates creation of a value-based purchasing program, development of quality measures, a decrease in home health reimbursement beginning with federal fiscal year 2014 that will be phased-in over a four-year period, a reduction in the outlier cap, and reinstates a 3% add-on payment for home health services delivered to residents in rural areas on or after April 1, 2010 and before January 1, 2016.

In addition, the ACA requires the Secretary of the United States Department of Health and Human Services (“HHS”) to test different models for delivery of care, some of which would involve home health services. It also requires the Secretary of HHS to establish a national pilot program for integrated care for patients with certain conditions, bundling payment for acute hospital care, physician services, outpatient hospital services (including emergency department services), and post-acute care services, which would include home health. The ACA further directed the Secretary of HHS to rebase payments for home health, which resulted in a decrease in home health reimbursement that began in 2014 and is being phased-in over a four-year period. The Secretary of HHS is also required to conduct a study to evaluate costs and quality of care among efficient home health agencies regarding access to care and treating Medicare beneficiaries with varying severity levels of illness and provide a report to Congress.

Potential efforts in the U.S. Congress to repeal, amend, modify, or retract funding for various aspects of the ACA create additional uncertainty about the ultimate impact of the ACA on the Company and the healthcare industry.

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

Other Information (Continued)

Effects of inflation and changing prices (Continued)

The Patient Protection and Affordable Care Act and the Healthcare Education and Reconciliation Act (Continued)

The healthcare reforms and changes resulting from the ACA (including any repeal, amendment, modification or retraction thereof), as well as other similar healthcare reforms, including any potential change in the nature of services the Company provides, the methods or amount of payment the Company receives for such services, and the underlying regulatory environment, could have a material adverse effect on the Company's business, financial position, results of operations, and liquidity.

Congress, MedPAC, and CMS will continue to address reimbursement rates for a variety of healthcare settings. The Company cannot predict the adjustments to Medicare payment rates that Congress or CMS may make in the future. Any downward adjustment to rates for the types of services the Company provides could have a material adverse effect on the Company's business, financial position, results of operations, and liquidity.

Congress continues to discuss additional deficit reduction measures, leading to a high degree of uncertainty regarding potential reforms to governmental healthcare programs, including Medicare and Medicaid. These discussions, along with other continuing efforts to reform governmental healthcare programs, could result in major changes in healthcare delivery and reimbursement systems on a national and state level, including changes directly impacting the government and private reimbursement systems for each of the Company's businesses. Healthcare reform, future healthcare legislation, or other changes in the administration or interpretation of governmental healthcare programs, whether resulting from deficit reduction measures or otherwise, could have a material adverse effect on the Company's business, financial position, results of operations, and liquidity.

The Company believes that its operating margins also will continue to be under pressure as the growth in operating expenses, particularly professional liability, labor, and employee benefits costs, exceeds any potential 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.

LTAC Legislation

The LTAC Legislation creates new Medicare criteria and payment rules for LTAC hospitals. Medicare payments to LTAC hospitals are now based upon one of two methods: (1) LTAC PPS, or (2) a site-neutral formula based upon the lesser of what a short-term acute care hospital would be paid, or estimated cost. CMS classifies LTAC hospitals as a distinct provider type, separate from short-term acute care hospitals. Only providers certified as LTAC hospitals may be paid under the LTAC PPS system. CMS regulations classify LTAC hospital patients into diagnostic categories called Medicare Severity Diagnosis Related Groups ("MS-LTC-DRGs"). LTAC PPS is based upon discharged-based MS-LTC-DRGs similar to the prospective payment system used to pay general short-term acute care hospitals ("IPPS").

Under the new criteria set forth in the LTAC Legislation, LTAC hospitals treating patients with at least a three-day prior stay in an acute care hospital intensive care unit and patients on prolonged mechanical ventilation admitted from an acute care hospital will continue to receive payment under LTAC PPS. Other patients will continue to have access to LTAC care, whether they are admitted to LTAC hospitals from acute care hospitals or directly from other settings

or the community, and in such cases, LTAC hospitals will be paid at a site-neutral rate for these patients, based on the lesser of per diem Medicare rates paid for patients with the same diagnoses under IPPS or an estimate of cost. The Company expects that the majority of these site-neutral payments will be materially less than the payments provided under LTAC PPS.

The effective date of the new patient criteria was October 1, 2015, and tied to each individual LTAC hospital's cost reporting period, followed by a two-year phase-in period. During the phase-in period, payment for patients receiving the site-neutral rate is based 50% on LTAC PPS and 50% on the site-neutral rate. CMS estimates an overall net reduction in Medicare revenue of 4.6% for hospitals receiving this 50/50 blended reimbursement. The majority of the Company's TC hospitals (which are certified as LTAC hospitals under the Medicare program) have a cost reporting period starting on September 1 of each year, and thus the phase-in of new patient criteria did not begin for a majority of the Company's TC hospitals until September 1, 2016, and full implementation of the new criteria will not begin until September 1, 2018.

The new patient criteria imposed by the LTAC Legislation reduces the population of patients eligible for reimbursement under LTAC PPS and changes the basis upon which the Company is paid for other patients. In addition, the LTAC Legislation is subject to additional governmental regulations and the interpretation and enforcement of those regulations. The LTAC Legislation, the implementation of new patient criteria, changes in referral patterns, and other associated elements has had, and will continue to have, an adverse effect on the Company's business, financial position, results of operations, and liquidity.

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)

LTAC Legislation (Continued)

Beginning in 2020, the LTAC Legislation requires that at least 50% of a hospital's patients must be paid under the new LTAC payment system to maintain Medicare certification as a LTAC hospital. The failure of one or more of the Company's TC hospitals to maintain its Medicare certification as a LTAC hospital could have a material adverse effect on the Company's business, financial position, results of operations, and liquidity.

The Medicare Access and CHIP Reauthorization Act of 2015

The Medicare Access and CHIP Reauthorization Act of 2015 ("MACRA") was signed into law on April 16, 2015. Among other items, MACRA: (1) permanently replaces the sustainable growth rate formula previously used to determine updates to Medicare physician reimbursement, replacing these updates with quality and value measurements and participation in alternate payment models; (2) extends the Medicare Part B outpatient therapy cap exception process until December 31, 2017; (3) extends the 3% add-on payment for home health services delivered to residents in rural areas until December 31, 2017; and (4) sets payment updates for post-acute providers at 1% after other adjustments required by the ACA for 2018.

For additional information regarding Medicare and Medicaid reimbursement and other government regulations impacting the Company, see the Company's Annual Report on Form 10-K for 2016 as filed with the SEC.

Kindred at Home

Home health. On November 1, 2017, CMS issued final regulations regarding Medicare payment rates for home health agencies effective January 1, 2018. Included in the final regulations is a net 0.4% reduction, consisting of a market basket update of 1.0% as required by MACRA, less (1) a 0.9% reduction adjustment to account for industry wide case mix growth, and (2) an additional 0.5% reduction for the elimination of the rural add-on provision.

CMS elected to not create a new payment methodology at this time known as the home health grouping model ("HHGM") as it previously indicated in the proposed regulations it issued in July 2017 (the "Proposed Home Health Regulations"). Under the Proposed Home Health Regulations, beginning in 2019, Medicare payments for home health services would have been based upon HHGM, utilizing a 30-day (rather than a 60-day) episode of care, comorbidities (rather than therapy service-use thresholds), and other criteria to set payments. CMS continues to review the HHGM as well as other alternative home health payment models.

On October 31, 2016, CMS issued final regulations regarding Medicare payment rates for home health agencies effective January 1, 2017. These final regulations implement a net 0.7% reduction, consisting of a market basket update of 2.8%, less (1) a 0.3% productivity reduction, (2) a 2.3% rebasing adjustment mandated under the ACA, and (3) an additional 0.9% reduction adjustment to account for industry wide case mix growth.

On October 29, 2015, CMS issued final regulations regarding Medicare payment rates for home health agencies effective January 1, 2016. These final regulations implement a net 1.4% reduction consisting of a 2.3% market basket

inflation increase, less (1) a 0.4% productivity reduction, (2) a 2.4% rebasing adjustment mandated under the ACA, and (3) a 0.9% reduction to account for industry wide case mix growth. The regulations also implement a value-based purchasing demonstration model to be tested in nine states (Massachusetts, Maryland, North Carolina, Florida, Washington, Arizona, Iowa, Nebraska and Tennessee) through payment year 2022.

Hospice. On August 1, 2017, CMS issued final regulations for Medicare reimbursement for hospice providers effective October 1, 2017. These final regulations implement a net market basket increase to the standard federal payment rate of 1.0%, as required by MACRA.

On July 29, 2016, CMS issued final regulations for Medicare reimbursement for hospice providers effective October 1, 2016. Included in these final regulations are: (1) a market basket increase of 2.7%; (2) a multifactor productivity reduction of 0.3%; and (3) an additional 0.3% reduction as mandated in the ACA.

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)

Kindred at Home (Continued)

On July 31, 2015, CMS issued final regulations for Medicare reimbursement for hospice providers for the federal fiscal year beginning October 1, 2015. These final regulations implement a net market basket increase of 1.6% consisting of: (1) a market basket inflation increase of 2.4%, less (2) offsets to the standard payment conversion factor mandated by the ACA of: (a) a 0.5% adjustment to account for the effect of a productivity adjustment, and (b) 0.3% as required by statute. In addition, there is a 0.2% increase resulting from the blend of wage index values under the updated core based statistical areas and a 0.7% reduction for the final year of the phase-out of the wage index budget neutrality adjustment. The regulation also implements, effective January 1, 2016: (1) the creation of two different payment rates for routine home care, a higher base payment for the first 60 days and a reduced payment for days 61 and beyond; and (2) a new service intensity add-on which would pay an additional amount during the last seven days of life when a patient has direct care provided by a registered nurse or social worker.

Hospital division

On August 2, 2017, CMS issued final regulations regarding Medicare reimbursement for LTAC hospitals for the federal fiscal year beginning October 1, 2017. Included in the final regulations are: (1) a net market basket increase to the standard federal payment rate of 1.0%, as required by MACRA; (2) a wage level budget neutrality factor of 1.0006434 applied to the standard federal payment rate; (3) an additional budget neutrality adjustment for impact of changes in short stay outliers; (4) adjustments to area wage indexes; and (5) an increase in the high cost outlier threshold per discharge to \$27,382. This final rule also extends the moratorium on the full implementation of the 25% rule until October 1, 2018.

On August 2, 2016, CMS issued final regulations regarding Medicare reimbursement for LTAC hospitals for the federal fiscal year beginning October 1, 2016. Included in the final regulations are: (1) a market basket increase to the standard federal payment rate of 2.8%; (2) offsets to the standard federal payment rate by the ACA of: (a) 0.3% to account for the effect of a productivity adjustment, and (b) 0.75% as required by the statute; (3) a wage level budget neutrality factor of 0.999593 applied to the adjusted standard federal payment rate; (4) adjustments to area wage indexes; and (5) an increase in the high cost outlier threshold per discharge to \$21,943. The final rule also implements a new regulation to consolidate existing 25% rule requirements.

On July 31, 2015, CMS issued final regulations regarding Medicare reimbursement for LTAC hospitals for the federal fiscal year beginning October 1, 2015. Included in the final regulations are: (1) a market basket increase to the standard federal payment rate of 2.4%; (2) offsets to the standard federal payment rate mandated by the ACA of: (a) 0.5% to account for the effect of a productivity adjustment, and (b) 0.2% as required by statute; (3) a wage level budget neutrality factor of 1.000513 applied to the adjusted standard federal payment rate; (4) adjustments to area wage indexes; and (5) an increase in the high cost outlier threshold per discharge to \$16,423.

Kindred Rehabilitation Services

Inpatient rehabilitation hospitals. On July 31, 2017, CMS issued final regulations regarding Medicare reimbursement for IRFs for the federal fiscal year beginning October 1, 2017. These final regulations implement a net market basket increase to the standard payment conversion factor of 1.0%, as required by MACRA, less a 0.1% reduction related to recalibrating the outlier threshold.

On July 29, 2016, CMS issued final regulations regarding Medicare reimbursement for IRFs for the federal fiscal year beginning October 1, 2016. Included in these final regulations are: (1) a market basket increase of 2.7%; (2) a productivity reduction of 0.3%; (3) an additional reduction of 0.75% as required by the ACA; and (4) a decrease in the high cost outlier threshold per discharge to \$7,984.

On July 31, 2015, CMS issued final regulations regarding Medicare reimbursement for IRFs for the federal fiscal year beginning October 1, 2015. Included in these final regulations are: (1) a market basket increase of 2.4%; (2) a productivity reduction of 0.5%; (3) an additional reduction of 0.2% as required by the ACA; and (4) a decrease in the high cost outlier threshold per discharge to \$8,658.

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)

	2016 Quarters				2017 Quarters		
	First	Second	Third	Fourth	First	Second	Third
Revenues	\$1,603,272	\$1,608,265	\$1,563,276	\$1,514,365	\$1,538,682	\$1,535,018	\$1,477,141
Salaries, wages and benefits	835,580	842,840	867,611	846,232	839,813	833,703	830,558
Supplies	89,059	89,151	85,469	79,386	80,101	77,784	73,344
Building rent	65,985	67,025	66,946	64,350	64,656	64,861	64,422
Equipment rent	10,158	11,211	9,911	8,649	8,887	8,861	8,537
Other operating expenses	165,727	167,607	167,453	156,005	158,824	182,161	155,949
General and administrative expenses	303,284	283,610	262,051	258,703	275,503	266,156	258,834
Other (income) expense	(1,833 )	(505 )	(341 )	(2,387 )	30	(2,287 )	(638 )
Litigation contingency expense	1,910	930	-	-	-	-	4,000
Impairment charges	7,788	6,131	297,276	3,534	474	135,829	-
Restructuring charges	1,952	798	81,463	11,913	10,006	5,050	16,500
Depreciation and amortization	33,554	33,198	32,995	32,072	29,820	25,651	24,808
Interest expense	57,489	58,053	59,856	59,214	59,328	60,801	61,146
Investment income	(236 )	(486 )	(1,797 )	(589 )	(509 )	(2,228 )	(705 )
	1,570,417	1,559,563	1,928,893	1,517,082	1,526,933	1,656,342	1,496,755
Income (loss) from continuing operations before							
income taxes	32,855	48,702	(365,617 )	(2,717 )	11,749	(121,324 )	(19,614 )
Provision (benefit) for income taxes	11,462	19,014	283,630	156	2,234	(16,116 )	(1,225 )
Income (loss) from continuing operations	21,393	29,688	(649,247 )	(2,873 )	9,515	(105,208 )	(18,389 )
Discontinued operations, net of income taxes:							
Income (loss) from operations	3,862	7,709	(22,060 )	7,648	5,867	5,874	(13,612 )
	262	(83 )	-	(6,923 )	(6,166 )	(294,039 )	(49,663 )

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Gain (loss) on divestiture of operations								
Income (loss) from discontinued operations	4,124	7,626	(22,060 )	725	(299 )	(288,165 )	(63,275 )	
Net income (loss)	25,517	37,314	(671,307 )	(2,148 )	9,216	(393,373 )	(81,664 )	
Earnings attributable to noncontrolling interests:								
Continuing operations	(7,851 )	(8,847 )	(9,574 )	(8,575 )	(10,483 )	(10,791 )	(10,960 )	
Discontinued operations	(4,665 )	(4,678 )	(4,732 )	(4,684 )	(4,481 )	(4,954 )	(3,162 )	
	(12,516 )	(13,525 )	(14,306 )	(13,259 )	(14,964 )	(15,745 )	(14,122 )	
Income (loss) attributable to								
Kindred	\$13,001	\$23,789	\$(685,613 )	\$(15,407 )	\$(5,748 )	\$(409,118 )	\$(95,786 )	
Amounts attributable to Kindred stockholders:								
Income (loss) from continuing operations	\$13,542	\$20,841	\$(658,821 )	\$(11,448 )	\$(968 )	\$(115,999 )	\$(29,349 )	
Income (loss) from discontinued operations	(541 )	2,948	(26,792 )	(3,959 )	(4,780 )	(293,119 )	(66,437 )	
Net income (loss)	\$13,001	\$23,789	\$(685,613 )	\$(15,407 )	\$(5,748 )	\$(409,118 )	\$(95,786 )	
Earnings (loss) per common share:								
Basic:								
Income (loss) from continuing operations	\$0.15	\$0.24	\$(7.58 )	\$(0.13 )	\$(0.01 )	\$(1.33 )	\$(0.33 )	
Discontinued operations:								
Income (loss) from operations	-	0.03	(0.31 )	0.03	0.01	0.01	(0.19 )	
Gain (loss) on divestiture of operations	-	-	-	(0.08 )	(0.07 )	(3.36 )	(0.57 )	
Income (loss) from discontinued operations	-	0.03	(0.31 )	(0.05 )	(0.06 )	(3.35 )	(0.76 )	
Net income (loss)	\$0.15	\$0.27	\$(7.89 )	\$(0.18 )	\$(0.07 )	\$(4.68 )	\$(1.09 )	
Diluted:								
Income (loss) from continuing operations	\$0.15	\$0.23	\$(7.58 )	\$(0.13 )	\$(0.01 )	\$(1.33 )	\$(0.33 )	
Discontinued operations:								
Income (loss) from operations	-	0.03	(0.31 )	0.03	0.01	0.01	(0.19 )	
Gain (loss) on divestiture of operations	-	-	-	(0.08 )	(0.07 )	(3.36 )	(0.57 )	
Income (loss) from discontinued operations	-	0.03	(0.31 )	(0.05 )	(0.06 )	(3.35 )	(0.76 )	
Net income (loss)	\$0.15	\$0.26	\$(7.89 )	\$(0.18 )	\$(0.07 )	\$(4.68 )	\$(1.09 )	

Shares used in  
computing earnings  
(loss) per

common share:

Basic	86,590	86,836	86,869	86,904	87,085	87,506	87,597
Diluted	87,249	87,500	86,869	86,904	87,085	87,506	87,597

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

## Operating Data

(Unaudited)

(In thousands)

	2016 Quarters				2017 Quarters		
	First	Second	Third	Fourth	First	Second	Third
<b>Revenues:</b>							
<b>Kindred at Home:</b>							
Home health	\$430,035	\$438,556	\$449,958	\$444,073	\$450,831	\$459,176	\$453,684
Hospice	176,426	185,641	188,575	186,161	179,378	185,281	188,414
	606,461	624,197	638,533	630,234	630,209	644,457	642,098
Hospital division	654,098	645,406	588,943	545,864	556,646	540,809	503,138
<b>Kindred Rehabilitation Services:</b>							
<b>Kindred Hospital Rehabilitation</b>							
Services	167,045	171,095	170,308	171,352	178,115	178,439	173,638
RehabCare	201,081	193,060	189,972	189,332	197,318	193,902	179,095
	368,126	364,155	360,280	360,684	375,433	372,341	352,733
	1,628,685	1,633,758	1,587,756	1,536,782	1,562,288	1,557,607	1,497,969
<b>Eliminations:</b>							
<b>Kindred Hospital Rehabilitation</b>							
Services	(23,713 )	(23,472 )	(22,330 )	(20,209 )	(21,148 )	(20,086 )	(18,376 )
RehabCare	(1,171 )	(1,333 )	(1,632 )	(1,667 )	(1,878 )	(1,867 )	(1,893 )
Hospitals	(529 )	(688 )	(518 )	(541 )	(580 )	(636 )	(559 )
	(25,413 )	(25,493 )	(24,480 )	(22,417 )	(23,606 )	(22,589 )	(20,828 )
	\$1,603,272	\$1,608,265	\$1,563,276	\$1,514,365	\$1,538,682	\$1,535,018	\$1,477,141
<b>Income (loss) from continuing operations:</b>							
<b>Segment adjusted operating income (loss):</b>							
<b>Kindred at Home:</b>							
Home health	\$66,941	\$76,030	\$75,073	\$61,487	\$63,750	\$76,592	\$66,431
Hospice	24,866	31,329	31,326	28,805	27,581	32,784	34,761
	91,807	107,359	106,399	90,292	91,331	109,376	101,192
Hospital division	136,416	127,510	83,940	93,778	93,438	91,580	61,455

Kindred Rehabilitation  
Services:Kindred Hospital  
Rehabilitation

Services	48,119	50,729	49,759	49,728	51,760	53,422	49,151
RehabCare	8,820	10,254	6,740	3,421	7,896	(14,305 )	7,619
	56,939	60,983	56,499	53,149	59,656	39,117	56,770
Support center expenses	(72,022 )	(68,444 )	(62,823 )	(58,627 )	(60,014 )	(62,572 )	(60,323 )
Litigation contingency expense	(1,910 )	(930 )	-	-	-	-	(4,000 )
Impairment charges	(7,788 )	(6,131 )	(297,276 )	(3,534 )	(474 )	(135,829 )	-
Restructuring charges	(1,701 )	(336 )	(22,813 )	(9,884 )	(8,101 )	(3,116 )	(14,375 )
Transaction costs	(1,685 )	(1,846 )	(2,982 )	(2,166 )	-	-	-
Building rent	(65,985 )	(67,025 )	(66,946 )	(64,350 )	(64,656 )	(64,861 )	(64,422 )
Equipment rent	(10,158 )	(11,211 )	(9,911 )	(8,649 )	(8,887 )	(8,861 )	(8,537 )
Restructuring charges - rent	(251 )	(462 )	(58,650 )	(2,029 )	(1,905 )	(1,934 )	(2,125 )
Depreciation and amortization	(33,554 )	(33,198 )	(32,995 )	(32,072 )	(29,820 )	(25,651 )	(24,808 )
Interest, net	(57,253 )	(57,567 )	(58,059 )	(58,625 )	(58,819 )	(58,573 )	(60,441 )
Income (loss) from continuing operations							
before income taxes	32,855	48,702	(365,617 )	(2,717 )	11,749	(121,324 )	(19,614 )
Provision (benefit) for income taxes	11,462	19,014	283,630	156	2,234	(16,116 )	(1,225 )
	\$21,393	\$29,688	\$(649,247 )	\$(2,873 )	\$9,515	\$(105,208 )	\$(18,389 )

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

## Operating Data (Continued)

(Unaudited)

(In thousands)

	2016 Quarters				2017 Quarters		
	First	Second	Third	Fourth	First	Second	Third
<b>Rent:</b>							
<b>Kindred at Home:</b>							
<b>Home health:</b>							
Building	\$8,147	\$8,390	\$8,188	\$8,301	\$8,147	\$8,078	\$7,993
Equipment	377	344	284	297	306	274	251
	8,524	8,734	8,472	8,598	8,453	8,352	8,244
<b>Hospice:</b>							
Building	4,271	4,259	4,264	4,311	4,256	4,118	4,139
Equipment	88	87	78	81	84	88	82
	4,359	4,346	4,342	4,392	4,340	4,206	4,221
<b>Hospital division:</b>							
Building	44,379	45,075	45,173	42,754	43,271	43,662	43,193
Equipment	8,664	9,809	8,521	7,245	7,474	7,480	7,193
	53,043	54,884	53,694	49,999	50,745	51,142	50,386
<b>Kindred Rehabilitation Services:</b>							
<b>Kindred Hospital Rehabilitation Services:</b>							
Building	8,359	8,522	8,448	8,381	8,423	8,481	8,559
Equipment	404	374	404	385	375	381	399
	8,763	8,896	8,852	8,766	8,798	8,862	8,958
<b>RehabCare:</b>							
Building	293	325	331	327	323	320	317
Equipment	586	568	594	613	621	610	585
	879	893	925	940	944	930	902
<b>Support center:</b>							
Building	536	454	542	276	236	202	221
Equipment	39	29	30	28	27	28	27
	575	483	572	304	263	230	248
<b>Totals:</b>							
Building	65,985	67,025	66,946	64,350	64,656	64,861	64,422
Equipment	10,158	11,211	9,911	8,649	8,887	8,861	8,537
	\$76,143	\$78,236	\$76,857	\$72,999	\$73,543	\$73,722	\$72,959
<b>Depreciation and amortization:</b>							
<b>Kindred at Home:</b>							
Home health	\$4,236	\$3,877	\$3,803	\$3,805	\$3,128	\$2,491	\$2,662
Hospice	1,600	1,525	1,563	1,676	1,285	1,102	946

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	5,836	5,402	5,366	5,481	4,413	3,593	3,608
Hospital division	13,322	13,223	12,789	11,284	10,874	10,357	10,637
Kindred Rehabilitation Services:							
Kindred Hospital Rehabilitation Services	3,524	3,529	3,576	3,909	3,843	3,555	3,808
RehabCare	1,989	1,983	2,011	1,978	1,845	1,596	338
	5,513	5,512	5,587	5,887	5,688	5,151	4,146
Support center	8,883	9,061	9,253	9,420	8,845	6,550	6,417
	\$33,554	\$33,198	\$32,995	\$32,072	\$29,820	\$25,651	\$24,808

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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)

	2016 Quarters				2017 Quarters		
	First	Second	Third	Fourth	First	Second	Third
Capital expenditures, excluding acquisitions (including discontinued operations):							
Kindred at Home:							
Home health:							
Routine	\$2,391	\$1,318	\$1,300	\$1,392	\$1,038	\$1,066	\$1,105
Development	-	-	-	-	-	-	-
	2,391	1,318	1,300	1,392	1,038	1,066	1,105
Hospice:							
Routine	671	620	637	414	629	414	674
Development	-	-	-	-	-	-	-
	671	620	637	414	629	414	674
Hospital division:							
Routine	5,440	6,410	5,649	6,359	3,123	3,877	3,325
Development	-	-	-	-	-	-	-
	5,440	6,410	5,649	6,359	3,123	3,877	3,325
Kindred Rehabilitation Services:							
Kindred Hospital Rehabilitation Services:							
Routine	301	377	380	331	418	1,225	621
Development	4,246	6,125	4,973	5,429	482	2	14
	4,547	6,502	5,353	5,760	900	1,227	635
RehabCare:							
Routine	175	332	698	662	187	183	264
Development	-	-	-	-	-	-	-
	175	332	698	662	187	183	264
Support center:							
Routine:							
Information systems	5,815	11,898	7,031	13,379	4,109	9,000	8,511
Other	147	3,174	692	682	842	66	396
	5,962	15,072	7,723	14,061	4,951	9,066	8,907
Development	1,701	1,316	2,828	2,272	4,951	5,833	6,386
	7,663	16,388	10,551	16,333	9,902	14,899	15,293
Discontinued operations - nursing centers:							
Routine	3,166	4,595	5,486	4,130	1,595	1,565	1,567
Development	4,072	1,266	585	12	6	22	15
	7,238	5,861	6,071	4,142	1,601	1,587	1,582

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Totals:							
Routine	18,106	28,724	21,873	27,349	11,941	17,396	16,463
Development	10,019	8,707	8,386	7,713	5,439	5,857	6,415
	\$28,125	\$37,431	\$30,259	\$35,062	\$17,380	\$23,253	\$22,878

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

## Operating Data (Continued)

(Unaudited)

	2016 Quarters				2017 Quarters		
	First	Second	Third	Fourth	First	Second	Third
Kindred at Home:							
Home health:							
Sites of service (at end of period)	384	384	395	390	379	377	376
Revenue mix %:							
Medicare	79.8	79.3	78.1	77.9	76.7	75.7	74.0
Medicaid	2.1	2.1	2.5	1.9	1.7	1.7	1.7
Commercial and other	8.4	8.2	8.6	10.6	11.5	11.4	12.7
Commercial paid at episodic rates	9.7	10.4	10.8	9.6	10.1	11.2	11.6
Episodic revenues (\$ 000s)	\$325,821	\$332,193	\$332,562	\$323,398	\$326,881	\$334,420	\$320,279
Total admissions	88,696	87,084	86,761	87,148	94,510	89,018	87,156
Same-store total admissions	87,394	85,922	85,511	86,056	93,922	88,300	86,312
Total episodic admissions	71,426	70,212	69,219	67,501	73,270	69,657	67,790
Same-store total episodic admissions	70,416	69,317	68,285	66,784	72,911	69,207	67,191
Medicare episodic admissions	62,011	60,730	59,823	59,540	62,404	58,575	56,772
Total episodes	113,887	113,278	113,256	111,164	114,964	113,579	111,488
Episodes per admission	1.59	1.61	1.64	1.65	1.57	1.63	1.64
Revenue per episode	\$2,861	\$2,933	\$2,936	\$2,909	\$2,843	\$2,944	\$2,873
Hospice:							
Sites of service (at end of period)	177	177	185	183	180	177	178
Admissions	13,234	13,149	12,916	12,660	13,649	12,561	12,236
Same-store admissions	12,761	12,743	12,541	12,362	13,332	12,363	11,997
Average length of stay	92	91	98	100	96	94	97
Patient days	1,183,908	1,238,584	1,277,125	1,246,152	1,193,061	1,215,619	1,239,094
Average daily census	13,010	13,611	13,882	13,545	13,256	13,358	13,468
Revenue per patient day	\$149	\$150	\$148	\$149	\$150	\$152	\$152
Community Care and other revenues	\$66,305	\$68,229	\$75,978	\$74,875	\$74,095	\$74,222	\$79,720

(included in home  
health business segment)

(\$ 000s)

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

## Operating Data (Continued)

(Unaudited)

	2016 Quarters				2017 Quarters			
	First	Second	Third	Fourth	First	Second	Third	
Hospitals (excluding sub-acute units and skilled nursing facility):								
End of period data:								
Number of transitional care hospitals	95	97	94	82	82	81	77	
Number of licensed beds	7,089	7,067	6,890	6,107	6,107	6,041	5,797	
Revenue mix %:								
Medicare	57.8	55.5	54.6	53.5	52.8	50.3	50.6	
Medicaid	4.2	4.2	4.0	4.5	3.9	5.0	4.3	
Medicare Advantage	11.5	12.0	12.1	11.0	12.2	12.3	12.3	
Medicaid Managed	5.6	6.3	7.3	8.0	9.1	9.1	10.1	
Commercial insurance and other	20.9	22.0	22.0	23.0	22.0	23.3	22.7	
Patient criteria data:								
Revenues:								
Compliant patients				88.5	% 86.0	% 88.3	% 89.1	%
Site neutral				11.5	% 14.0	% 11.7	% 10.9	%
Revenues per patient day:								
Compliant patients				\$1,853	\$1,816	\$1,806	\$1,799	
Site neutral				926	1,041	1,053	1,067	
Total				1,662	1,645	1,667	1,674	
Admissions:								
Medicare	8,919	8,253	7,861	7,351	7,529	6,743	6,073	
Medicaid	463	386	375	336	354	381	362	
Medicare Advantage	1,453	1,382	1,327	1,210	1,354	1,239	1,197	
Medicaid Managed	733	768	861	787	851	903	861	
Commercial insurance and other	1,871	1,807	1,727	1,488	1,614	1,608	1,483	
	13,439	12,596	12,151	11,172	11,702	10,874	9,976	
Patient days:								
Medicare	229,004	219,013	202,482	186,290	187,738	173,916	158,083	
Medicaid	21,134	19,409	16,781	12,181	13,334	13,333	13,429	
Medicare Advantage	45,760	47,697	43,241	37,526	41,020	40,555	38,338	
Medicaid Managed	25,341	27,267	28,534	29,275	32,713	32,635	31,249	
Commercial insurance and other	62,769	63,009	59,856	54,148	53,695	54,809	49,895	

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	384,008	376,395	350,894	319,420	328,500	315,248	290,994
Average length of stay:							
Medicare	25.7	26.5	25.8	25.3	24.9	25.8	26.0
Medicaid	45.6	50.3	44.7	36.3	37.7	35.0	37.1
Medicare Advantage	31.5	34.5	32.6	31.0	30.3	32.7	32.0
Medicaid Managed	34.6	35.5	33.1	37.2	38.4	36.1	36.3
Commercial insurance and other	33.5	34.9	34.7	36.4	33.3	34.1	33.6
Weighted average	28.6	29.9	28.9	28.6	28.1	29.0	29.2
Revenues per admission:							
Medicare	\$41,717	\$42,579	\$39,945	\$38,602	\$37,867	\$39,219	\$40,577
Medicaid	57,928	69,797	61,338	70,333	60,091	69,304	57,365
Medicare Advantage	51,080	55,105	52,363	48,387	48,555	51,958	50,301
Medicaid Managed	49,287	51,696	48,631	54,238	57,736	53,159	57,172
Commercial insurance and other	71,651	77,193	73,515	82,066	73,750	76,007	74,435
Weighted average	47,868	50,309	47,348	47,507	46,170	48,322	48,818
Revenues per patient day:							
Medicare	\$1,625	\$1,605	\$1,551	\$1,523	\$1,519	\$1,521	\$1,559
Medicaid	1,269	1,388	1,371	1,940	1,595	1,980	1,546
Medicare Advantage	1,622	1,597	1,607	1,560	1,603	1,587	1,571
Medicaid Managed	1,426	1,456	1,467	1,458	1,502	1,471	1,575
Commercial insurance and other	2,136	2,214	2,121	2,255	2,217	2,230	2,212
Weighted average	1,675	1,684	1,640	1,662	1,645	1,667	1,674
Medicare case mix index (discharged patients only)							
	1.163	1.179	1.172	1.153	1.172	1.171	1.180
Average daily census	4,220	4,136	3,814	3,472	3,650	3,464	3,163
Occupancy %	68.0	67.5	61.6	64.1	67.6	64.3	59.9

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

## Operating Data (Continued)

(Unaudited)

	2016 Quarters				2017 Quarters						
	First	Second	Third	Fourth	First	Second	Third				
Same-hospital data:											
End of period data:											
Number of transitional care											
hospitals	74	74	77	77	74	74	77				
Number of licensed beds	5,680	5,680	5,797	5,797	5,680	5,680	5,797				
Revenue mix %:											
Medicare	58.0	55.2	53.9	53.1	52.0	50.2	50.6				
Medicaid	3.8	3.9	3.6	4.5	4.2	5.2	4.3				
Medicare Advantage	11.2	11.7	12.3	11.0	12.1	11.9	12.4				
Medicaid Managed	5.9	6.8	7.9	8.3	9.4	9.4	10.1				
Commercial insurance and other	21.1	22.4	22.3	23.1	22.3	23.3	22.6				
Patient criteria data:											
Revenues:											
Compliant patients				88.7	%	86.0	%	88.5	%	89.1	%
Site neutral				11.3	%	14.0	%	11.5	%	10.9	%
Revenues per patient day:											
Compliant patients				\$1,860		\$1,827		\$1,811		\$1,799	
Site neutral				924		1,049		1,060		1,067	
Total				1,669		1,656		1,674		1,673	
Admissions:											
Medicare	7,524	6,946	6,758	7,023	7,045	6,408	6,018				
Medicaid	391	334	333	328	351	377	361				
Medicare Advantage	1,178	1,101	1,140	1,160	1,274	1,150	1,190				
Medicaid Managed	629	694	783	784	830	865	851				
Commercial insurance and other	1,500	1,467	1,415	1,416	1,507	1,507	1,468				
	11,222	10,542	10,429	10,711	11,007	10,307	9,888				
Patient days:											
Medicare	193,263	184,241	173,863	178,719	175,712	165,065	156,412				
Medicaid	14,382	13,304	11,631	11,923	13,580	13,180	13,433				
Medicare Advantage	37,161	39,474	38,245	36,329	38,640	37,685	38,098				
Medicaid Managed	22,332	24,736	26,552	29,216	32,097	31,858	30,816				
Commercial insurance and other	51,709	52,030	51,043	52,162	51,097	52,033	49,402				
	318,847	313,785	301,334	308,349	311,126	299,821	288,161				
Average length of stay:											
Medicare	25.7	26.5	25.7	25.4	24.9	25.8	26.0				
Medicaid	36.8	39.8	34.9	36.4	38.7	35.0	37.2				

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Medicare Advantage	31.5	35.9	33.5	31.3	30.3	32.8	32.0
Medicaid Managed	35.5	35.6	33.9	37.3	38.7	36.8	36.2
Commercial insurance and other	34.5	35.5	36.1	36.8	33.9	34.5	33.7
Weighted average	28.4	29.8	28.9	28.8	28.3	29.1	29.1
Revenues per admission:							
Medicare	\$42,061	\$43,021	\$40,020	\$38,946	\$38,018	\$39,353	\$40,513
Medicaid	52,717	63,223	54,880	70,959	61,618	68,915	57,689
Medicare Advantage	51,952	57,600	54,398	48,889	48,906	52,111	50,241
Medicaid Managed	51,560	52,725	50,360	54,345	58,187	54,199	57,158
Commercial insurance and other	76,679	82,451	79,176	83,792	76,366	77,666	74,312
Weighted average	48,630	51,310	48,155	48,059	46,802	48,705	48,761
Revenues per patient day:							
Medicare	\$1,638	\$1,622	\$1,556	\$1,530	\$1,524	\$1,528	\$1,559
Medicaid	1,433	1,587	1,571	1,952	1,593	1,971	1,550
Medicare Advantage	1,647	1,607	1,621	1,561	1,612	1,590	1,569
Medicaid Managed	1,452	1,479	1,485	1,458	1,505	1,472	1,578
Commercial insurance and other	2,224	2,325	2,195	2,275	2,252	2,249	2,208
Weighted average	1,712	1,724	1,667	1,669	1,656	1,674	1,673
Average daily census	3,504	3,448	3,275	3,352	3,457	3,295	3,132

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

## Operating Data (Continued)

(Unaudited)

	2016 Quarters				2017 Quarters		
	First	Second	Third	Fourth	First	Second	Third
<b>Kindred Rehabilitation Services:</b>							
Kindred Hospital Rehabilitation Services:							
Freestanding IRFs:							
End of period data:							
Number of IRFs	19	19	19	19	19	19	19
Number of licensed beds	969	969	969	995	995	995	995
Discharges (a)	4,448	4,646	4,644	4,671	4,775	4,766	4,755
Same-hospital discharges (a)	4,295	4,535	4,546	4,538	4,393	4,517	4,477
Occupancy % (a)	70.6	70.6	68.8	66.5	71.4	70.0	68.8
Average length of stay (a)	13.2	12.9	12.7	12.6	12.8	12.8	12.7
Revenue per discharge (a)	\$19,731	\$19,318	\$19,599	\$19,486	\$20,097	\$20,620	\$20,329
Contract services:							
Sites of service (at end of period):							
Inpatient rehabilitation units (ARUs)	104	105	104	102	101	102	101
LTAC hospitals	119	121	120	119	119	116	110
Sub-acute units	7	7	7	5	7	6	6
Outpatient units	139	138	139	132	129	121	123
	369	371	370	358	356	345	340
Revenue per site	\$211,417	\$215,798	\$210,810	\$220,733	\$227,100	\$228,534	\$222,504
RehabCare:							
Sites of service (at end of period)	1,767	1,759	1,754	1,718	1,703	1,734	1,624
Revenue per site	\$113,798	\$109,756	\$108,308	\$110,204	\$115,865	\$111,823	\$110,281

(a) Excludes non-consolidating IRF.

## 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. 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 LIBOR, which affect the interest paid on certain borrowings.

The following table provides information as of September 30, 2017 about the Company's financial instruments that are sensitive to changes in interest rates. The table presents principal cash flows and related weighted average interest rates by expected maturity date.

## Interest Rate Sensitivity

## Principal (Notional) Amount by Expected Maturity

## Average Interest Rate

(Dollars in thousands)

	Expected maturities							Fair value September 30, 2017
	2017	2018	2019	2020	2021	Thereafter	Total	
<b>Liabilities:</b>								
Long-term debt, including								
amounts due within one								
year:								
<b>Fixed rate:</b>								
Notes due 2020 (a)	\$-	\$-	\$-	\$750,000	\$-	\$-	\$750,000	\$742,500
Notes due 2022 (a)	-	-	-	-	-	500,000	500,000	463,800
Notes due 2023 (a)	-	-	-	-	-	600,000	600,000	562,500
<b>Mandatory Redeemable</b>								
Preferred Stock (a)	3,177	-	-	-	-	-	3,177	1,033
Other	86	143	-	-	-	-	229	229 (b)
	\$3,263	\$143	\$-	\$750,000	\$-	\$1,100,000	\$1,853,406	\$1,770,062
<b>Average interest</b>								
rate	7.1	%	2.7	%	8.0	%	7.7	%
<b>Variable rate:</b>								
ABL Facility (c)	\$-	\$-	\$156,200	\$-	\$-	\$-	\$156,200	\$156,200

Term Loan								
Facility (a,d,e)	3,508	14,034	14,034	14,034	1,313,326	-	1,358,936	1,360,635
Other (f)	587	-	-	-	-	-	587	587
	\$4,095	\$14,034	\$170,234	\$14,034	\$1,313,326	\$-	\$1,515,723	\$1,517,422

- (a) The expected maturities exclude total debt issuance costs, net of accumulated amortization, of approximately \$43 million, comprised of \$6 million for the Notes due 2020, \$5 million for the Notes due 2022, \$7 million for the Notes due 2023, \$0.1 million for the Mandatory Redeemable Preferred Stock, and \$25 million for the Term Loan Facility.
- (b) Calculated based upon the net present value of future principal and interest payments using an average interest rate of 2.7%.
- (c) Interest on borrowings under the ABL Facility is payable at a rate per annum equal to the applicable margin plus, at the Company's option, either: (1) LIBOR determined by reference to the costs of funds for Eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of: (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR as described in subclause (1) plus 1.00%. At September 30, 2017, the applicable margin for borrowings under the ABL Facility was 2.00% with respect to LIBOR borrowings and 1.00% with respect to base rate borrowings. The applicable margin is subject to adjustment each fiscal quarter, based upon average historical excess availability during the preceding quarter.
- (d) Interest on borrowings under the Term Loan Facility is payable at a rate per annum equal to an applicable margin plus, at the Company's option, either: (1) LIBOR determined by reference to the costs of funds for Eurodollar deposits for the interest period relevant to such borrowing adjusted for certain additional costs, or (2) a base rate determined by reference to the highest of: (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the federal funds effective rate plus one-half of 1.00% and (c) LIBOR described in subclause (1) plus 1.00%. LIBOR is subject to an interest rate floor of 1.00%. The applicable margin for borrowings under the Term Loan Facility is 3.50% with respect to LIBOR borrowings and 2.50% with respect to base rate borrowings. The expected maturities for the Term Loan Facility exclude the original issue discount of approximately \$6 million.
- (e) In January 2016, the Company entered into three interest rate swap agreements to hedge its floating interest rate on an aggregate of \$325 million of debt outstanding under its Term Loan Facility. The interest rate swaps have an effective date of January 11, 2016, and expire on January 9, 2021. The Company is required to make payments based upon a fixed interest rate of 1.862% and 1.855% calculated on the notional amount of \$175 million and \$150 million, respectively. In exchange, the Company will receive interest on \$325 million at a variable interest rate that is based upon the three-month LIBOR, subject to a minimum rate of 1.0%. In March 2014, the Company entered into an interest rate swap agreement to hedge its floating interest rate on an aggregate of \$400 million of debt outstanding under its Term Loan Facility. On April 8, 2014, the Company completed a novation of a portion of its \$400 million swap agreement to two new counterparties, each in the amount of \$125 million. The original swap contract was not amended, terminated, or otherwise modified. The interest rate swap had an effective date of April 9, 2014, will expire on April 9, 2018, and continues to apply to the Term Loan Facility. The Company is required to make payments based upon a fixed interest rate of 1.867% calculated on the notional amount of \$400 million. In exchange, the Company will receive interest on \$400 million at a variable interest rate that is based upon the three-month LIBOR, subject to a minimum rate of 1.0%.
- (f) Interest based upon prime less 0.5%.

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 September 30, 2017, the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Exchange Act, are effective.

There has been no change in the Company's internal control over financial reporting during the Company's quarter ended September 30, 2017, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

The Company provides services in a highly regulated industry and is a party to various legal actions and regulatory and other governmental and internal audits and investigations in the ordinary course of business (including investigations resulting from the Company's obligation to self-report suspected violations of law). The Company cannot predict the ultimate outcome of pending litigation and regulatory and other governmental and internal audits and investigations. The DOJ, CMS, or other federal and state enforcement and regulatory agencies may conduct additional investigations related to the Company's businesses in the future. These matters could potentially subject the Company to sanctions, damages, recoupments, fines, and other penalties (some of which may not be covered by insurance), which may, either individually or in the aggregate, have a material adverse effect on the Company's business, financial position, results of operations, and liquidity. See note 17 of the notes to unaudited condensed consolidated financial statements for a description of pending legal proceedings, governmental reviews, audits, and investigations to which the Company is subject.

## Shareholder derivative action

On March 16, 2016, a shareholder derivative action (previously defined as the "Complaint") was filed against certain of the Company's current and former officers and directors in circuit court for Jefferson County, Kentucky. The Complaint also names the Company as a nominal defendant. The Complaint alleges that the named current and former officers and directors breached their respective duties of good faith, loyalty, and candor, and other general fiduciary duties owed to the Company and its shareholders by, among other things, failing to exercise reasonable and prudent supervision over the management, policies, and controls of the Company in order to detect practices that existed at RehabCare resulting in the Company having to enter into two separate settlement agreements with the DOJ. The Company has tentatively settled this lawsuit and is awaiting final court approval of such settlement. The Company recorded a loss reserve of \$1 million in the third quarter of 2017 related to this matter. The Company disputes the allegations made in the Complaint and will defend this action and any related claims vigorously.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

## ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total number of shares (or units) purchased (a)	Average price paid per share (or unit) (b)	Total number of shares (or units) purchased as part of that may yet be purchased under the plans or programs	Maximum number (or approximate dollar value) of shares (or units) of that may yet be purchased under the plans or programs
Month #1 (July 1 – July 31)	5,965	\$ 9.30	–	\$ –
Month #2 (August 1 – August 31)	4,184	7.95	–	–
Month #3 (September 1 – September 30)	–	–	–	–
Total	10,149	\$ 8.74	–	\$ –

(a) These amounts represent shares of the Company's common stock, par value \$0.25 per share, withheld to offset tax withholding obligations that are triggered upon the vesting and release of service-based restricted share awards

previously granted under the Company's stock-based compensation plans for its employees (the "Withheld Shares"). The total tax withholding obligation is calculated by dividing the closing price of the Company's common stock on the New York Stock Exchange on the applicable vesting date to determine the total number of Withheld Shares required to satisfy such withholding obligation.

- (b) The average price per share for each period was calculated by dividing the sum of the aggregate value of the Withheld Shares by the total number of Withheld Shares.

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PART II. OTHER INFORMATION (Continued)

Item 6. Exhibits

Exhibit number	Description of document
10.1*	<u>Amendment to the Fourth Amended and Restated ABL Credit Agreement dated as of September 27, 2017 by and among Kindred Healthcare, Inc., the Consenting Lenders party thereto and JPMorgan Chase Bank, N.A. as administrative agent.</u>
31*	<u>Rule 13a-14(a)/15d-14(a) Certifications.</u>
32*	<u>Section 1350 Certifications.</u>
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Taxonomy Extension Schema Document.
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document.

\*Filed herewith.

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.  
/S/ Benjamin A. Breier

Date: November 6, 2017

Benjamin A. Breier  
President and Chief Executive Officer  
/S/ Stephen D. Farber

Date: November 6, 2017

Stephen D. Farber  
Executive Vice President,  
  
Chief Financial Officer