

SELECT MEDICAL HOLDINGS CORP
Form 10-Q
August 07, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 30, 2014

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 34465 and 001 31441

SELECT MEDICAL HOLDINGS CORPORATION

SELECT MEDICAL CORPORATION

(Exact name of Registrant as specified in its charter)

Delaware

20-1764048

Delaware

23-2872718

(State or other jurisdiction of
incorporation or organization)

(I.R.S. employer identification
number)

4714 Gettysburg Road, P.O. Box 2034, Mechanicsburg, Pennsylvania 17055

(Address of principal executive offices and zip code)

(717) 972-1100

(Registrants telephone number, including area code)

Indicate by check mark whether the Registrants (1) have 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 periods as such Registrants were required to file such reports), and (2) have been subject to such filing requirements for the past 90 days. YES NO

Indicate by check mark whether the Registrants have 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 during the preceding 12 months (or for such shorter period that the Registrants were required to submit and post such files). YES NO

Indicate by check mark whether the Registrants are large accelerated filers, accelerated filers, non-accelerated filers, or smaller reporting companies. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

Smaller reporting company

Indicate by check mark whether the Registrants are shell companies (as defined in Rule 12b-2 of the Exchange Act). YES NO

As of July 31, 2014, Select Medical Holdings Corporation had outstanding 130,018,588 shares of common stock.

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This Form 10-Q is a combined quarterly report being filed separately by two Registrants: Select Medical Holdings Corporation and Select Medical Corporation. Unless the context indicates otherwise, any reference in this report to Holdings refers to Select Medical Holdings Corporation and any reference to Select refers to Select Medical Corporation, the wholly-owned operating subsidiary of Holdings. References to the Company, we, us and our refer collectively to Holdings and Select.

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Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS****Consolidated Balance Sheets**

(unaudited)

(in thousands, except share and per share amounts)

| | Select Medical Holdings Corporation | | Select Medical Corporation | |
|---|-------------------------------------|---------------------|----------------------------|---------------------|
| | December 31, 2013 | June 30, 2014 | December 31, 2013 | June 30, 2014 |
| ASSETS | | | | |
| Current Assets: | | | | |
| Cash and cash equivalents | \$ 4,319 | \$ 3,140 | \$ 4,319 | \$ 3,140 |
| Accounts receivable, net of allowance for doubtful accounts of \$40,815 and \$41,021 at 2013 and 2014, respectively | 391,319 | 453,184 | 391,319 | 453,184 |
| Current deferred tax asset | 17,624 | 16,042 | 17,624 | 16,042 |
| Prepaid income taxes | | 678 | | 678 |
| Other current assets | 41,140 | 44,081 | 41,140 | 44,081 |
| Total Current Assets | 454,402 | 517,125 | 454,402 | 517,125 |
| Property and equipment, net | 509,102 | 526,349 | 509,102 | 526,349 |
| Goodwill | 1,642,633 | 1,642,869 | 1,642,633 | 1,642,869 |
| Other identifiable intangibles | 71,907 | 72,023 | 71,907 | 72,023 |
| Other assets | 139,578 | 145,405 | 139,578 | 145,405 |
| Total Assets | \$ 2,817,622 | \$ 2,903,771 | \$ 2,817,622 | \$ 2,903,771 |
| LIABILITIES AND EQUITY | | | | |
| Current Liabilities: | | | | |
| Bank overdrafts | \$ 12,506 | \$ 9,192 | \$ 12,506 | \$ 9,192 |
| Current portion of long-term debt and notes payable | 17,565 | 14,778 | 17,565 | 14,778 |
| Accounts payable | 88,285 | 98,638 | 88,285 | 98,638 |
| Accrued payroll | 90,011 | 74,736 | 90,011 | 74,736 |
| Accrued vacation | 59,730 | 64,127 | 59,730 | 64,127 |
| Accrued interest | 12,297 | 10,985 | 12,297 | 10,985 |
| Accrued other | 90,471 | 81,424 | 90,471 | 81,424 |
| Income taxes payable | 622 | | 622 | |
| Due to third party payors | 37 | 1,981 | 37 | 1,981 |
| Total Current Liabilities | 371,524 | 355,861 | 371,524 | 355,861 |
| Long-term debt, net of current portion | 1,427,710 | 1,598,754 | 1,427,710 | 1,598,754 |
| Non-current deferred tax liability | 96,287 | 95,981 | 96,287 | 95,981 |
| Other non-current liabilities | 91,875 | 96,335 | 91,875 | 96,335 |
| Total Liabilities | 1,987,396 | 2,146,931 | 1,987,396 | 2,146,931 |

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| | | | | |
|---|---------------------|---------------------|---------------------|---------------------|
| Redeemable non-controlling interests | 11,584 | 11,238 | 11,584 | 11,238 |
| Stockholders' Equity: | | | | |
| Common stock of Holdings, \$0.001 par value, 700,000,000 shares authorized, 140,260,968 shares and 130,002,788 shares issued and outstanding at 2013 and 2014, respectively | 140 | 130 | | |
| Common stock of Select, \$0.01 par value, 100 shares issued and outstanding | | | 0 | 0 |
| Capital in excess of par | 474,729 | 410,721 | 869,576 | 880,584 |
| Retained earnings (accumulated deficit) | 311,365 | 300,481 | (83,342) | (169,252) |
| Total Select Medical Holdings Corporation and Select Medical Corporation Stockholders Equity | 786,234 | 711,332 | 786,234 | 711,332 |
| Non-controlling interest | 32,408 | 34,270 | 32,408 | 34,270 |
| Total Equity | 818,642 | 745,602 | 818,642 | 745,602 |
| Total Liabilities and Equity | \$ 2,817,622 | \$ 2,903,771 | \$ 2,817,622 | \$ 2,903,771 |

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**Consolidated Statements of Operations**

(unaudited)

(in thousands, except per share amounts)

| | Select Medical Holdings Corporation For the Three Months Ended June 30, | | Select Medical Corporation For the Three Months Ended June 30, | |
|---|--|------------|---|------------|
| | 2013 | 2014 | 2013 | 2014 |
| Net operating revenues | \$ 756,673 | \$ 772,762 | \$ 756,673 | \$ 772,762 |
| Costs and expenses: | | | | |
| Cost of services | 625,730 | 642,881 | 625,730 | 642,881 |
| General and administrative | 17,927 | 19,377 | 17,927 | 19,377 |
| Bad debt expense | 8,846 | 11,115 | 8,846 | 11,115 |
| Depreciation and amortization | 15,907 | 17,196 | 15,907 | 17,196 |
| Total costs and expenses | 668,410 | 690,569 | 668,410 | 690,569 |
| Income from operations | 88,263 | 82,193 | 88,263 | 82,193 |
| Other income and expense: | | | | |
| Loss on early retirement of debt | (17,280) | | (17,280) | |
| Equity in earnings of unconsolidated subsidiaries | 568 | 1,239 | 568 | 1,239 |
| Interest expense | (21,904) | (21,663) | (21,904) | (21,663) |
| Income before income taxes | 49,647 | 61,769 | 49,647 | 61,769 |
| Income tax expense | 19,769 | 23,775 | 19,769 | 23,775 |
| Net income | 29,878 | 37,994 | 29,878 | 37,994 |
| Less: Net income attributable to non-controlling interests | 2,098 | 2,653 | 2,098 | 2,653 |
| Net income attributable to Select Medical Holdings Corporation and Select Medical Corporation | \$ 27,780 | \$ 35,341 | \$ 27,780 | \$ 35,341 |
| Income per common share: | | | | |
| Basic | \$ 0.20 | \$ 0.27 | \$ 0.20 | \$ 0.27 |
| Diluted | \$ 0.20 | \$ 0.27 | \$ 0.20 | \$ 0.27 |

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**Consolidated Statements of Operations**

(unaudited)

(in thousands, except per share amounts)

| | Select Medical Holdings Corporation For the Six Months Ended June 30, | | Select Medical Corporation For the Six Months Ended June 30, | |
|---|--|--------------|---|--------------|
| | 2013 | 2014 | 2013 | 2014 |
| Net operating revenues | \$ 1,506,628 | \$ 1,535,340 | \$ 1,506,628 | \$ 1,535,340 |
| Costs and expenses: | | | | |
| Cost of services | 1,250,634 | 1,281,645 | 1,250,634 | 1,281,645 |
| General and administrative | 35,325 | 37,500 | 35,325 | 37,500 |
| Bad debt expense | 18,167 | 22,133 | 18,167 | 22,133 |
| Depreciation and amortization | 31,709 | 33,425 | 31,709 | 33,425 |
| Total costs and expenses | 1,335,835 | 1,374,703 | 1,335,835 | 1,374,703 |
| Income from operations | 170,793 | 160,637 | 170,793 | 160,637 |
| Other income and expense: | | | | |
| Loss on early retirement of debt | (18,747) | (2,277) | (17,788) | (2,277) |
| Equity in earnings of unconsolidated subsidiaries | 1,626 | 2,147 | 1,626 | 2,147 |
| Interest expense | (45,362) | (42,279) | (42,952) | (42,279) |
| Income before income taxes | 108,310 | 118,228 | 111,679 | 118,228 |
| Income tax expense | 41,630 | 45,867 | 42,809 | 45,867 |
| Net income | 66,680 | 72,361 | 68,870 | 72,361 |
| Less: Net income attributable to non-controlling interests | 4,482 | 3,976 | 4,482 | 3,976 |
| Net income attributable to Select Medical Holdings Corporation and Select Medical Corporation | \$ 62,198 | \$ 68,385 | \$ 64,388 | \$ 68,385 |
| Income per common share: | | | | |
| Basic | \$ 0.44 | \$ 0.51 | | |
| Diluted | \$ 0.44 | \$ 0.51 | | |

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**Consolidated Statement of Changes in Equity and Income**

(unaudited)

(in thousands)

Select Medical Holdings Corporation Stockholders

| | Comprehensive Income | Total | Common Stock Issued | Common Stock Par Value | Capital in Excess of Par | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Non-controlling Interests |
|---|---------------------------------|--------------|--------------------------------|---------------------------------------|-------------------------------------|------------------------------|--|--------------------------------------|
| Balance at December 31, 2013 | | \$ 818,642 | 140,261 | \$ 140 | \$ 474,729 | \$ 311,365 | \$ | \$ 32,408 |
| Net income | \$ 71,775 | 71,775 | | | | 68,385 | | 3,390 |
| Net income - attributable to redeemable non-controlling interests | 586 | | | | | | | |
| Total comprehensive income | \$ 72,361 | | | | | | | |
| Dividends paid to common stockholders | | (27,153) | | | | (27,153) | | |
| Issuance and vesting of restricted stock | | 5,329 | 285 | 0 | 5,329 | | | |
| Repurchase of common shares | | (127,500) | (11,286) | (11) | (75,015) | (52,474) | | |
| Stock option expense | | 382 | | | 382 | | | |
| Exercise of stock options | | 5,297 | 743 | 1 | 5,296 | | | |
| Distributions to non-controlling interests | | (1,267) | | | | | | (1,267) |
| Other | | 97 | | | | 358 | | (261) |
| Balance at June 30, 2014 | | \$ 745,602 | 130,003 | \$ 130 | \$ 410,721 | \$ 300,481 | \$ | \$ 34,270 |

Select Medical Corporation Stockholders

| | Comprehensive Income | Total | Common Stock Issued | Common Stock Par Value | Capital in Excess of Par | Accumulated Deficit | Accumulated Other Comprehensive Income (Loss) | Non-controlling Interests |
|---|---------------------------------|--------------|--------------------------------|---------------------------------------|-------------------------------------|--------------------------------|--|--------------------------------------|
| Balance at December 31, 2013 | | \$ 818,642 | 0 | \$ 0 | \$ 869,576 | \$ (83,342) | \$ | \$ 32,408 |
| Net income | \$ 71,775 | 71,775 | | | | 68,385 | | 3,390 |
| Net income - attributable to redeemable non-controlling interests | 586 | | | | | | | |
| Total comprehensive income | \$ 72,361 | | | | | | | |
| Additional investment by Holdings | | 5,297 | | | 5,297 | | | |
| Dividends declared and paid to Holdings | | (154,653) | | | | (154,653) | | |
| Contribution related to restricted stock awards and stock option issuances by Holdings | | 5,711 | | | 5,711 | | | |

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| | | | | | | | | | | | |
|--|----|---------|---|----|---|----|---------|-----|-----------|----|--------|
| Distributions to non-controlling interests | | | | | | | | | (1,267) | | |
| Other | | (1,267) | | | | | | 358 | (1,267) | | |
| Balance at June 30, 2014 | \$ | 745,602 | 0 | \$ | 0 | \$ | 880,584 | \$ | (169,252) | \$ | 34,270 |

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**Consolidated Statements of Cash Flows**

(unaudited)

(in thousands)

| | Select Medical Holdings Corporation For the Six Months Ended June 30, | | Select Medical Corporation For the Six Months Ended June 30, | |
|---|--|-----------|---|-----------|
| | 2013 | 2014 | 2013 | 2014 |
| Operating activities | | | | |
| Net income | \$ 66,680 | \$ 72,361 | \$ 68,870 | \$ 72,361 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Depreciation and amortization | 31,709 | 33,425 | 31,709 | 33,425 |
| Provision for bad debts | 18,167 | 22,133 | 18,167 | 22,133 |
| Equity in earnings of unconsolidated subsidiaries | (1,626) | (2,147) | (1,626) | (2,147) |
| Loss on early retirement of debt | 18,747 | 2,277 | 17,788 | 2,277 |
| Loss from disposal of assets | 81 | 143 | 81 | 143 |
| Non-cash stock compensation expense | 3,537 | 4,120 | 3,537 | 4,120 |
| Amortization of debt discount, premium and issuance costs | 4,588 | 3,849 | 4,499 | 3,849 |
| Deferred income taxes | 3,192 | 1,275 | 3,192 | 1,275 |
| Changes in operating assets and liabilities, net of effects from acquisition of businesses: | | | | |
| Accounts receivable | (83,832) | (84,249) | (83,832) | (84,249) |
| Other current assets | (5,894) | (2,935) | (5,894) | (2,935) |
| Other assets | 144 | (3,462) | 144 | (3,462) |
| Accounts payable | (2,665) | 10,343 | (2,665) | 10,343 |
| Due to third-party payors | 5,217 | 1,944 | 5,217 | 1,944 |
| Accrued expenses | (28,203) | (16,030) | (24,945) | (16,030) |
| Income taxes | (7,819) | (878) | (6,640) | (878) |
| Net cash provided by operating activities | 22,023 | 42,169 | 27,602 | 42,169 |
| Investing activities | | | | |
| Purchases of property and equipment | (27,962) | (50,493) | (27,962) | (50,493) |
| Investment in businesses, net of distributions | (28,716) | (175) | (28,716) | (175) |
| Acquisition of businesses, net of cash acquired | (171) | (454) | (171) | (454) |
| Net cash used in investing activities | (56,849) | (51,122) | (56,849) | (51,122) |
| Financing activities | | | | |
| Borrowings on revolving credit facility | 455,000 | 515,000 | 455,000 | 515,000 |
| Payments on revolving credit facility | (480,000) | (425,000) | (480,000) | (425,000) |
| Borrowings on credit facility term loans, net of discount | 298,500 | | 298,500 | |
| Payments on credit facility term loans | (592,615) | (33,994) | (592,615) | (33,994) |
| Issuance of 6.375% senior notes, includes premium | 600,000 | 111,650 | 600,000 | 111,650 |
| Repurchase of senior floating rate notes | (167,300) | | | |
| Repurchase of 7 5/8% senior subordinated notes | (70,000) | | (70,000) | |
| Borrowings of other debt | 6,909 | 6,111 | 6,909 | 6,111 |
| Principal payments on other debt | (4,673) | (7,049) | (4,673) | (7,049) |
| Debt issuance costs | (18,583) | (4,434) | (18,583) | (4,434) |

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| | | | | |
|---|-----------|-----------|-----------|-----------|
| Dividends paid to common stockholders | (13,963) | (27,153) | | |
| Dividends paid to Holdings | | | (196,825) | (154,653) |
| Repurchase of common stock | (9,983) | (127,500) | | |
| Proceeds from issuance of common stock | | 5,297 | | |
| Equity investment by Holdings | | | | 5,297 |
| Proceeds from (repayment of) bank overdrafts | 1,625 | (3,314) | 1,625 | (3,314) |
| Distributions to non-controlling interests | (1,467) | (1,840) | (1,467) | (1,840) |
| Net cash provided by (used in) financing activities | 3,450 | 7,774 | (2,129) | 7,774 |
| Net decrease in cash and cash equivalents | (31,376) | (1,179) | (31,376) | (1,179) |
| Cash and cash equivalents at beginning of period | 40,144 | 4,319 | 40,144 | 4,319 |
| Cash and cash equivalents at end of period | \$ 8,768 | \$ 3,140 | \$ 8,768 | \$ 3,140 |
| Supplemental Cash Flow Information | | | | |
| Cash paid for interest | \$ 53,914 | \$ 39,107 | \$ 48,335 | \$ 39,107 |
| Cash paid for taxes | \$ 46,832 | \$ 45,471 | \$ 46,832 | \$ 45,471 |

The accompanying notes are an integral part of these consolidated financial statements.

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SELECT MEDICAL HOLDINGS CORPORATION AND SELECT MEDICAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. Basis of Presentation

The unaudited consolidated financial statements of Select Medical Holdings Corporation (Holdings) and Select Medical Corporation (Select) as of June 30, 2014 and for the three and six month periods ended June 30, 2013 and 2014 have been prepared in accordance with generally accepted accounting principles (GAAP). In the opinion of management, such information contains all adjustments, which are normal and recurring in nature, necessary for a fair statement of the financial position, results of operations and cash flow for such periods. All significant intercompany transactions and balances have been eliminated. The results of operations for the three and six months ended June 30, 2014 are not necessarily indicative of the results to be expected for the full fiscal year ending December 31, 2014. Holdings and Select and their subsidiaries are collectively referred to as the Company. The consolidated financial statements of Holdings include the accounts of its wholly-owned subsidiary Select. Holdings conducts substantially all of its business through Select and its subsidiaries.

Certain information and disclosures normally included in the notes to consolidated financial statements have been condensed or omitted consistent with the rules and regulations of the Securities and Exchange Commission (the SEC), although the Company believes the disclosure is adequate to make the information presented not misleading. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2013 contained in the Company s Annual Report on Form 10-K filed with the SEC on February 25, 2014.

2. Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, which supersedes most of the current revenue recognition requirements. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. New disclosures about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers are also required. This guidance is effective for the

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Company in the first quarter of 2017 and early application is not permitted. Entities must adopt the new guidance using one of two retrospective application methods. The Company is currently evaluating the standard to determine the impact of its adoption on the consolidated financial statements.

In April 2014, the FASB issued ASU No. 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*, which changes the criteria for determining which disposals can be presented as discontinued operations and modifies the related disclosure requirements. Under the new guidance,

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a discontinued operation is defined as a disposal of a component or group of components that represents a strategic shift that has, or will have, a major effect on an entity's operations and financial results. The revised guidance is effective for annual fiscal periods beginning after December 15, 2014. Early adoption is permitted and the Company intends to prospectively adopt ASU No. 2014-08, as applicable.

3. Intangible Assets

The gross carrying amounts of the Company's indefinite-lived intangible assets consist of the following:

| | December 31, 2013 | June 30, 2014 |
|----------------------|----------------------|------------------|
| | (in thousands) | |
| Goodwill | \$ 1,642,633 | \$ 1,642,869 |
| Trademarks | 57,709 | 57,709 |
| Certificates of need | 12,115 | 12,231 |
| Accreditations | 2,083 | 2,083 |
| Total | \$ 1,714,540 | \$ 1,714,892 |

The Company's accreditations and trademarks have renewal terms. The costs to renew these intangibles are expensed as incurred. At June 30, 2014, the accreditations and trademarks have a weighted average time until next renewal of approximately 1.5 years and 6.0 years, respectively.

The changes in the carrying amount of goodwill for the Company's reportable segments for the six months ended June 30, 2014 are as follows:

| | Specialty Hospitals | Outpatient Rehabilitation (in thousands) | Total |
|-------------------------------------|------------------------|--|--------------|
| Balance as of December 31, 2013 | \$ 1,334,615 | \$ 308,018 | \$ 1,642,633 |
| Goodwill acquired during the period | | 246 | 246 |
| Purchase accounting adjustment | (10) | | (10) |
| Balance as of June 30, 2014 | \$ 1,334,605 | \$ 308,264 | \$ 1,642,869 |

4. Share Repurchase

On April 30, 2014, Holdings' board of directors authorized an increase of \$150.0 million in the capacity of its common stock repurchase program from \$350.0 million to \$500.0 million and extended the program until December 31, 2016. Holdings repurchased 11,285,714 shares of common stock at a total cost of \$127.5 million, or an average of \$11.30 per share, during the six months ended June 30, 2014. The shares were repurchased from Welsh, Carson, Anderson & Stowe IX, L.P. and WCAS Capital Partners IV, L.P. pursuant to stock purchase agreements dated February 26, 2014 and May 5, 2014. The common stock repurchase program has available capacity of \$198.9 million as of June 30, 2014.

Table of Contents**5. Indebtedness**

The components of long-term debt and notes payable are as follows:

| | December 31, 2013 | June 30, 2014 |
|-----------------------------------|----------------------|------------------|
| | (in thousands) | |
| 6.375% senior notes (1) | \$ 600,000 | \$ 711,580 |
| Senior secured credit facilities: | | |
| Revolving loan | 20,000 | 110,000 |
| Term loans (2) | 807,815 | 775,329 |
| Other | 17,460 | 16,623 |
| Total debt | 1,445,275 | 1,613,532 |
| Less: current maturities | 17,565 | 14,778 |
| Total long-term debt | \$ 1,427,710 | \$ 1,598,754 |

(1) Includes unamortized premium of \$1.6 million at June 30, 2014.

(2) Includes unamortized discounts of \$6.3 million and \$4.8 million at December 31, 2013 and June 30, 2014, respectively.

Senior Secured Credit Facilities

On June 1, 2011, Select entered into its existing senior secured credit agreement that provided for \$1.15 billion in senior secured credit facilities. The following discussion summarizes amendments and significant transactions affecting its senior secured credit facilities.

On August 13, 2012, Select entered into an additional credit extension amendment to its senior secured credit facilities providing for a \$275.0 million series A term loan at the same interest rate and with the same term as the original term loan.

On February 20, 2013, Select entered into a credit extension amendment to its senior secured credit facilities providing for a \$300.0 million series B term loan. Select used the borrowings under the series B term loan to redeem all of its outstanding 7 5/8% senior subordinated notes due 2015 on March 22, 2013, to finance Holdings' redemption of all of its senior floating rate notes due 2015 on March 22, 2013 and to repay a portion of the balance outstanding under Select's revolving credit facility.

On May 28, 2013, Select issued and sold \$600.0 million aggregate principal amount of 6.375% senior notes due June 1, 2021. Select used the proceeds of the 6.375% senior notes to pay a portion of the amounts then outstanding on the original term loan and the series A term loan and to pay related fees and expenses.

On June 3, 2013, Select amended its existing senior secured credit facilities in order to, among other things:

- extend the maturity date on \$293.3 million of its \$300.0 million revolving credit facility from June 1, 2016 to March 1, 2018;
- convert the remaining original term loan and series A term loan to a new series C term loan, and lower the interest rate payable on the series C term loan from Adjusted LIBO plus 3.75%, or Alternate Base Rate plus 2.75%, to Adjusted LIBO plus 3.00%, or Alternate Base Rate plus 2.00%, and amend the

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provision of the series C term loan from providing that Adjusted LIBO will at no time be less than 1.75% to providing that Adjusted LIBO will at no time be less than 1.00%;

- lower the interest rate payable on the series B term loan from Adjusted LIBO plus 3.75%, or Alternate Base Rate plus 2.75%, to Adjusted LIBO plus 3.25%, or Alternate Base Rate plus 2.25%;
- amend the restrictive covenants governing the senior secured credit facilities in order to allow for unlimited restricted payments so long as there is no event of default under the senior secured credit facilities and the total pro forma ratio of total indebtedness to Consolidated EBITDA (as defined in the senior secured credit facilities) is less than or equal to 2.75 to 1.00; and
- amend the definition of Available Amount in a manner the effect of which was to increase the amount available for investments, restricted payments and payment of specified indebtedness.

On March 4, 2014, Select made a principal prepayment of \$34.0 million associated with its term loans in accordance with the provision in its senior secured credit facilities agreement that requires mandatory prepayments of term loans resulting from excess cash flow as defined in the senior secured credit facilities.

On March 4, 2014, Select amended its senior secured credit facilities in order to, among other things:

- convert the remaining series B term loan to a new series D term loan, and lower the interest rate payable on the series D term loan from Adjusted LIBO plus 3.25%, or Alternate Base Rate plus 2.25%, to Adjusted LIBO plus 2.75%, or Alternate Base Rate plus 1.75%;
- set the maturity date of the series D term loan at December 20, 2016;
- convert the remaining series C term loan to a new series E term loan, and lower the interest rate payable on the series E term loan from Adjusted LIBO plus 3.00% (subject to an Adjusted LIBO rate floor of 1.00%), or Alternate Base Rate plus 2.00%, to Adjusted LIBO plus 2.75% (subject to an Adjusted LIBO rate floor of 1.00%), or Alternate Base Rate plus 1.75%;
- set the maturity date of the series E term loan at June 1, 2018;
- beginning with the quarter ending March 31, 2014, increase the quarterly compliance threshold set forth in the leverage ratio financial maintenance covenant to a level of 5.00 to 1.00 from 4.50 to 1.00;
- provide for a prepayment premium of 1.00% if the senior secured credit facilities are amended at any time prior to September 4, 2014 in the case of the series D term loans and March 4, 2015 in the case of the series E term loans and such amendment reduces the yield applicable to such loans; and
- amend the definition of Available Amount in a manner the effect of which was to increase the amount available for investments, restricted payments and the payment of specified indebtedness.

At June 30, 2014, Select's senior secured credit facilities provide for senior secured financing consisting of:

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- a \$300.0 million, revolving credit facility, \$293.3 million of which matures on March 1, 2018 and the remaining \$6.7 million maturing on June 1, 2016, including a \$75.0 million sublimit for the issuance of standby letters of credit and a \$25.0 million sublimit for swingline loans;
- a \$284.6 million series D term loan, maturing on December 20, 2016; and
- a \$495.6 million series E term loan, maturing on June 1, 2018.

All borrowings under Select's senior secured credit facilities are subject to the satisfaction of required conditions, including the absence of a default at the time of and after giving effect to such borrowing and the accuracy of the representations and warranties of the borrowers.

The interest rates per annum applicable to borrowings under Select's senior secured credit facilities are, at its option, equal to either an Alternate Base Rate or an Adjusted LIBO rate for a one, two, three or six month

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interest period, or a nine or twelve month period if available, in each case, plus an applicable margin percentage. The Alternate Base Rate is the greatest of (1) JPMorgan Chase Bank, N.A.'s prime rate, (2) one-half of 1% over the weighted average of rates on overnight Federal funds as published by the Federal Reserve Bank of New York and (3) the Adjusted LIBO rate from time to time for an interest period of one month, plus 1.00%. The Adjusted LIBO rate is, with respect to any interest period, the London interbank offered rate for such interest period, adjusted for any applicable statutory reserve requirements.

Borrowings under the series D term loan bear interest at a rate equal to Adjusted LIBO plus 2.75%, or Alternate Base Rate plus 1.75%. Borrowings under the series E term loan bear interest at a rate equal to Adjusted LIBO plus 2.75%, or Alternate Base Rate plus 1.75%. The Adjusted LIBO for the series E term loan will at no time be less than 1.00%.

Borrowings under the revolving credit facility bear interest at a rate equal to Adjusted LIBO plus a percentage ranging from 2.75% to 3.75%, or Alternate Base Rate plus a percentage ranging from 1.75% to 2.75%, in each case based on Select's ratio of total indebtedness to Consolidated EBITDA (as defined in the senior secured credit facilities).

On the last day of each calendar quarter Select is required to pay each lender a commitment fee in respect of any unused commitments under the revolving credit facility, which is currently 0.50% per annum subject to adjustment based upon the ratio of Select's total indebtedness to Consolidated EBITDA (as defined in the senior secured credit facilities).

Subject to exceptions, Select's senior secured credit facilities require mandatory prepayments of term loans in amounts equal to:

- 50% (as may be reduced based on Select's ratio of total indebtedness to Consolidated EBITDA (as defined in the senior secured credit facilities)) of Select's annual excess cash flow;
- 100% of the net cash proceeds from non-ordinary course asset sales or other dispositions, or as a result of a casualty or condemnation event, subject to reinvestment rights and certain other exceptions; and
- 100% of the net cash proceeds from certain incurrences of debt.

Beginning on March 31, 2015, the senior secured credit facilities principal amount will amortize as follows:

- the series D term loan has quarterly principal repayment requirements of \$0.7 million until maturity, at which time the remaining balance of \$279.5 million is due on December 20, 2016; and
- the series E term loan has quarterly principal repayment requirements of \$1.3 million until maturity, at which time the remaining balance of \$479.2 million is due on June 1, 2018.

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Select's senior secured credit facilities are guaranteed by Holdings, Select and substantially all of its current subsidiaries, and will be guaranteed by substantially all of Select's future subsidiaries and secured by substantially all of Select's existing and future property and assets and by a pledge of its capital stock and the capital stock of its subsidiaries.

Select's senior secured credit facilities require that it comply on a quarterly basis with certain financial covenants, including a maximum leverage ratio test.

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In addition, Select's senior secured credit facilities include negative covenants, subject to significant exceptions, restricting or limiting its ability and the ability of Holdings and Select's restricted subsidiaries, to, among other things:

- incur, assume, permit to exist or guarantee additional debt and issue or sell or permit any subsidiary to issue or sell preferred stock;
- amend, modify or waive any rights under the certificate of indebtedness, credit agreements, certificate of incorporation, bylaws or other organizational documents which would be materially adverse to the creditors;
- pay dividends or other distributions on, redeem, repurchase, retire or cancel capital stock;
- purchase or acquire any debt or equity securities of, make any loans or advances to, guarantee any obligation of, or make any other investment in, any other company;
- incur or permit to exist certain liens on property or assets owned or accrued or assign or sell any income or revenues with respect to such property or assets;
- sell or otherwise transfer property or assets to, purchase or otherwise receive property or assets from, or otherwise enter into transactions with affiliates;
- merge, consolidate or amalgamate with another company or permit any subsidiary to merge, consolidate or amalgamate with another company;
- sell, transfer, lease or otherwise dispose of assets, including any equity interests;
- repay, redeem, repurchase, retire or cancel any subordinated debt;
- incur capital expenditures;
- engage to any material extent in any business other than business of the type currently conducted by Select or reasonably related businesses; and
- incur obligations that restrict the ability of its subsidiaries to incur or permit to exist any liens on Select's property or assets or to make dividends or other payments to Select.

Select's senior secured credit facilities also contain certain representations and warranties, affirmative covenants and events of default. The events of default include payment defaults, breaches of representations and warranties, covenant defaults, cross-defaults to certain indebtedness, certain events of bankruptcy, certain events under ERISA, material judgments, actual or asserted failure of any guaranty or security document supporting Select's senior secured credit facilities to be in full force and effect and any change of control. If such an event of default occurs, the lenders under Select's senior secured credit facilities will be entitled to take various actions, including the acceleration of amounts due under the senior secured credit facilities and all actions permitted to be taken by a secured creditor.

At June 30, 2014, Select had outstanding borrowings of \$780.2 million (excluding unamortized original issue discounts of \$4.8 million) under the term loans and borrowings of \$110.0 million (excluding letters of credit) under the revolving loan portion of the senior secured credit facilities. Select had \$147.7 million of availability under its revolving credit facility (after giving effect to \$42.3 million of outstanding letters of

credit) at June 30, 2014.

The applicable margin percentage for borrowings under Select's revolving loan is subject to change based upon the ratio of Select's leverage ratio (as defined in the senior secured credit facility). The applicable interest rate for revolving loans as of June 30, 2014 was (1) Alternate Base plus 2.75% for alternate base rate loans and (2) LIBO plus 3.75% for adjusted LIBO rate loans.

Select's senior secured credit facility requires it to maintain certain leverage ratios (as defined in the senior secured credit facility). For the four consecutive fiscal quarters ended June 30, 2014, Select was required

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to maintain its leverage ratio (its ratio of total indebtedness to consolidated EBITDA) at less than 5.00 to 1.00. Select's leverage ratio was 4.47 to 1.00 as of June 30, 2014.

Senior Notes

On March 11, 2014, Select issued and sold \$110.0 million aggregate principal amount of additional 6.375% senior notes due June 1, 2021 (the Additional Notes), at 101.50% of the aggregate principal amount resulting in gross proceeds of \$111.7 million. The notes were issued as additional notes under the indenture pursuant to which it previously issued \$600.0 million of 6.375% senior notes due June 1, 2021 (the Existing Notes and, together with the Additional notes, the Notes). The Additional Notes are treated as a single series with the Existing Notes and have the same terms as those of the Existing Notes.

Interest on the Notes accrues at the rate of 6.375% per annum and is payable semi-annually in cash in arrears on June 1 and December 1 of each year. The Notes are Select's senior unsecured obligations and rank equally in right of payment with all of its other existing and future senior unsecured indebtedness and senior in right of payment to all of its existing and future subordinated indebtedness. The Notes are fully and unconditionally guaranteed by all of Select's wholly owned subsidiaries. The Notes are guaranteed, jointly and severally, by Select's direct or indirect existing and future domestic restricted subsidiaries other than certain non-guarantor subsidiaries.

Select may redeem some or all of the Notes prior to June 1, 2016 by paying a make-whole premium. Select may redeem some or all of the Notes on or after June 1, 2016 at specified redemption prices. In addition, prior to June 1, 2016, Select may redeem up to 35% of the Notes with the net proceeds of certain equity offerings at a price of 106.375% plus accrued and unpaid interest, if any. Select is obligated to offer to repurchase the Notes at a price of 101% of their principal amount plus accrued and unpaid interest, if any, as a result of certain change of control events. These restrictions and prohibitions are subject to certain qualifications and exceptions.

The indenture relating to the Notes contains covenants that, among other things, limit Select's ability and the ability of certain of its subsidiaries to (i) grant liens on its assets, (ii) make dividend payments, other distributions or other restricted payments, (iii) incur restrictions on the ability of Select's restricted subsidiaries to pay dividends or make other payments, (iv) enter into sale and leaseback transactions, (v) merge, consolidate, transfer or dispose of substantially all of their assets, (vi) incur additional indebtedness, (vii) make investments, (viii) sell assets, including capital stock of subsidiaries, (ix) use the proceeds from sales of assets, including capital stock of restricted subsidiaries, and (x) enter into transactions with affiliates. In addition, the Indenture requires, among other things, Select to provide financial and current reports to holders of the Notes or file such reports electronically with the SEC. These covenants are subject to a number of exceptions, limitations and qualifications set forth in the Indenture.

Table of Contents***Maturities of Long-Term Debt and Notes Payable***

Maturities of the Company's long-term debt for the period from July 1, 2014 through December 31, 2014 and the years after 2014 are approximately as follows and are presented including the discounts on the senior secured credit facility term loans and premium on the senior notes (in thousands):

| | | | |
|-----------------|-------------------|----|---------|
| July 1, 2014 | December 31, 2014 | \$ | 9,647 |
| 2015 | | | 10,538 |
| 2016 | | | 286,916 |
| 2017 | | | 4,265 |
| 2018 | | | 590,216 |
| 2019 and beyond | | | 711,950 |

Loss on Early Retirement of Debt

On March 4, 2014, Select amended its term loans under its senior secured credit facilities. During the six months ended June 30, 2014, the Company recognized a loss of \$2.3 million for unamortized debt issuance costs, unamortized original issue discount, and certain fees incurred related to term loan modifications.

On May 28, 2013, Select repaid a portion of its original term loan and series A term loan under its senior secured credit facilities, and on June 3, 2013, Select amended its existing senior secured credit facilities. During the six months ended June 30, 2013, the Company recognized a loss of \$17.3 million for unamortized debt issuance costs, unamortized original issue discount and certain debt issuance costs associated with refinancing activities.

On March 22, 2013, the Company redeemed Select's 7 5/8% senior subordinated notes due 2015 and redeemed Holdings' senior floating rate notes due 2015. During the three months ended March 31, 2013, the Company recognized a loss on early retirement of debt of \$1.5 million for unamortized debt issuance costs of which approximately \$0.5 million was associated with Select's redemption of its 7 5/8% senior subordinated notes due 2015 and approximately \$1.0 million was associated with Holdings' redemption of its senior floating rate notes due 2015.

6. Fair Value

Financial instruments include cash and cash equivalents, notes payable and long-term debt. The carrying amount of cash and cash equivalents approximates fair value because of the short-term maturity of these instruments.

The carrying value of Select's senior secured credit facilities was \$827.8 million and \$885.3 million at December 31, 2013 and June 30, 2014, respectively. The fair value of Select's senior secured credit facilities was \$834.7 million and \$881.1 million at December 31, 2013 and June 30,

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2014, respectively. The fair value of Select's senior secured credit facilities was based on quoted market prices for this debt in the syndicated loan market.

The carrying value of Select's 6.375% senior notes was \$600.0 million and \$711.6 million at December 31, 2013 and June 30, 2014, respectively. The fair value of Select's 6.375% senior notes was \$586.5 million and \$742.0 million at December 31, 2013 and June 30, 2014, respectively. The fair value of this debt was based on quoted market prices.

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The Company considers the inputs in the valuation process of its senior secured credit facility and 6.375% senior notes to be Level 2 in the fair value hierarchy. Level 2 in the fair value hierarchy is defined as inputs that are observable for the asset or liability, either directly or indirectly which includes quoted prices for identical assets or liabilities in markets that are not active.

7. Segment Information

The Company's reportable segments consist of (i) specialty hospitals and (ii) outpatient rehabilitation. Other activities include the Company's corporate services and certain other non-consolidating joint ventures and minority investments in other healthcare related businesses. The outpatient rehabilitation reportable segment has two operating segments: outpatient rehabilitation clinics and contract therapy. These operating segments are aggregated for reporting purposes as they have common economic characteristics and provide a similar service to a similar patient base. The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company evaluates performance of the segments based on Adjusted EBITDA. Adjusted EBITDA is defined as net income before interest, income taxes, depreciation and amortization, gain (loss) on early retirement of debt, stock compensation expense, equity in earnings (losses) of unconsolidated subsidiaries and other income (expense).

The following tables summarize selected financial data for the Company's reportable segments. The segment results of Holdings are identical to those of Select.

| | Three Months Ended June 30, 2013 | | | | Total |
|------------------------|---|--------------------------------------|--------------|------------|--------------|
| | Specialty Hospitals | Outpatient Rehabilitation | Other | | |
| | (in thousands) | | | | |
| Net operating revenues | \$ 559,386 | \$ 197,080 | \$ 207 | \$ 756,673 | |
| Adjusted EBITDA | 96,393 | 26,054 | (16,489) | 105,958 | |
| Total assets | 2,229,458 | 502,497 | 113,100 | 2,845,055 | |
| Capital expenditures | 10,203 | 2,999 | 761 | 13,963 | |

| | Three Months Ended June 30, 2014 | | | | Total |
|------------------------|---|--------------------------------------|--------------|------------|--------------|
| | Specialty Hospitals | Outpatient Rehabilitation | Other | | |
| | (in thousands) | | | | |
| Net operating revenues | \$ 557,833 | \$ 214,798 | \$ 131 | \$ 772,762 | |
| Adjusted EBITDA | 88,688 | 30,432 | (17,766) | 101,354 | |
| Total assets | 2,271,256 | 532,529 | 99,986 | 2,903,771 | |
| Capital expenditures | 19,800 | 2,546 | 848 | 23,194 | |

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| | Six Months Ended June 30, 2013 | | | | Total |
|------------------------|---------------------------------------|---|--------------|--|--------------|
| | Specialty Hospitals | Outpatient Rehabilitation (in thousands) | Other | | |
| Net operating revenues | \$ 1,117,137 | \$ 389,181 | \$ 310 | | \$ 1,506,628 |
| Adjusted EBITDA | 189,740 | 48,887 | (32,588) | | 206,039 |
| Total assets | 2,229,458 | 502,497 | 113,100 | | 2,845,055 |
| Capital expenditures | 21,100 | 5,844 | 1,018 | | 27,962 |

| | Six Months Ended June 30, 2014 | | | | Total |
|------------------------|---------------------------------------|---|--------------|--|--------------|
| | Specialty Hospitals | Outpatient Rehabilitation (in thousands) | Other | | |
| Net operating revenues | \$ 1,122,458 | \$ 412,648 | \$ 234 | | \$ 1,535,340 |
| Adjusted EBITDA | 180,838 | 51,421 | (34,077) | | 198,182 |
| Total assets | 2,271,256 | 532,529 | 99,986 | | 2,903,771 |
| Capital expenditures | 41,298 | 6,176 | 3,019 | | 50,493 |

A reconciliation of Adjusted EBITDA to income before income taxes is as follows:

| | Three Months Ended June 30, 2013 | | | | Select Medical Holdings Corporation | Select Medical Corporation |
|---|---|---|--------------|--|--|---|
| | Specialty Hospitals | Outpatient Rehabilitation (in thousands) | Other | | | |
| Adjusted EBITDA | \$ 96,393 | \$ 26,054 | \$ (16,489) | | | |
| Depreciation and amortization | (11,932) | (3,001) | (974) | | | |
| Stock compensation expense | | | (1,788) | | | |
| Income (loss) from operations | \$ 84,461 | \$ 23,053 | \$ (19,251) | | \$ 88,263 | \$ 88,263 |
| Loss on early retirement of debt | | | | | (17,280) | (17,280) |
| Equity in earnings of unconsolidated subsidiaries | | | | | 568 | 568 |
| Interest expense | | | | | (21,904) | (21,904) |
| Income before income taxes | | | | | \$ 49,647 | \$ 49,647 |

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| | Three Months Ended June 30, 2014 | | | | |
|---|---|---|--------------|--|---|
| | Specialty Hospitals | Outpatient Rehabilitation (in thousands) | Other | Select Medical Holdings Corporation | Select Medical Corporation |
| Adjusted EBITDA | \$ 88,688 | \$ 30,432 | \$ (17,766) | | |
| Depreciation and amortization | (13,067) | (3,225) | (904) | | |
| Stock compensation expense | | | (1,965) | | |
| Income (loss) from operations | \$ 75,621 | \$ 27,207 | \$ (20,635) | \$ 82,193 | \$ 82,193 |
| Equity in earnings of unconsolidated subsidiaries | | | | 1,239 | 1,239 |
| Interest expense | | | | (21,663) | (21,663) |
| Income before income taxes | | | | \$ 61,769 | \$ 61,769 |
| | Six Months Ended June 30, 2013 | | | | |
| | Specialty Hospitals | Outpatient Rehabilitation (in thousands) | Other | Select Medical Holdings Corporation | Select Medical Corporation |
| Adjusted EBITDA | \$ 189,740 | \$ 48,887 | \$ (32,588) | | |
| Depreciation and amortization | (23,794) | (5,970) | (1,945) | | |
| Stock compensation expense | | | (3,537) | | |
| Income (loss) from operations | \$ 165,946 | \$ 42,917 | \$ (38,070) | \$ 170,793 | \$ 170,793 |
| Loss on early retirement of debt | | | | (18,747) | (17,788) |
| Equity in earnings of unconsolidated subsidiaries | | | | 1,626 | 1,626 |
| Interest expense | | | | (45,362) | (42,952) |
| Income before income taxes | | | | \$ 108,310 | \$ 111,679 |

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| | Six Months Ended June 30, 2014 | | | | | |
|---|--------------------------------|--|-------------|--|----------------------------------|--|
| | Specialty Hospitals | Outpatient Rehabilitation (in thousands) | Other | Select Medical Holdings Corporation | Select Medical Corporation | |
| Adjusted EBITDA | \$ 180,838 | \$ 51,421 | \$ (34,077) | | | |
| Depreciation and amortization | (25,162) | (6,437) | (1,826) | | | |
| Stock compensation expense | | | (4,120) | | | |
| Income (loss) from operations | \$ 155,676 | \$ 44,984 | \$ (40,023) | \$ 160,637 | \$ 160,637 | |
| Loss on early retirement of debt | | | | (2,277) | (2,277) | |
| Equity in earnings of unconsolidated subsidiaries | | | | 2,147 | 2,147 | |
| Interest expense | | | | (42,279) | (42,279) | |
| Income before income taxes | | | | \$ 118,228 | \$ 118,228 | |

8. Income per Common Share

The Company applies the two-class method for calculating and presenting income per common share. The two-class method is an earnings allocation formula that determines earnings per share for each class of stock participation rights in undistributed earnings. The following table sets forth for the periods indicated the calculation of income per common share in the Company's consolidated statement of operations and the differences between basic weighted average shares outstanding and diluted weighted average shares outstanding used to compute basic and diluted income per common share, respectively:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|--|--|-----------|--------------------------------------|-----------|
| | 2013 | 2014 | 2013 | 2014 |
| | (in thousands, except per share amounts) | | | |
| Numerator: | | | | |
| Net income attributable to Select Medical Holdings Corporation | \$ 27,780 | \$ 35,341 | \$ 62,198 | \$ 68,385 |
| Less: Earnings allocated to unvested restricted stockholders | 593 | 919 | 1,304 | 1,683 |
| Net income available to common stockholders | \$ 27,187 | \$ 34,422 | \$ 60,894 | \$ 66,702 |
| Denominator: | | | | |
| Weighted average shares basic | 136,609 | 127,038 | 136,997 | 131,266 |
| Effect of dilutive securities: | | | | |
| Stock options | 134 | 503 | 168 | 500 |
| Weighted average shares diluted | 136,743 | 127,541 | 137,165 | 131,766 |
| Basic income per common share | \$ 0.20 | \$ 0.27 | \$ 0.44 | \$ 0.51 |
| Diluted income per common share | \$ 0.20 | \$ 0.27 | \$ 0.44 | \$ 0.51 |

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The following share amounts are shown here for informational and comparative purposes only since their inclusion would be anti-dilutive:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|---------------|--|------|--------------------------------------|------|
| | 2013 | 2014 | 2013 | 2014 |
| | (in thousands) | | | |
| Stock options | 2,165 | | 1,554 | |

9. Commitments and Contingencies**Litigation**

The Company is a party to various legal actions, proceedings and claims (some of which are not insured), and regulatory and other governmental audits and investigations in the ordinary course of its business. The Company cannot predict the ultimate outcome of pending litigation, proceedings and regulatory and other governmental audits and investigations. These matters could potentially subject the Company to sanctions, damages, recoupments, fines and other penalties. The Department of Justice, Centers for Medicare & Medicaid Services (CMS) or other federal and state enforcement and regulatory agencies may conduct additional investigations related to the Company's businesses in the future that may, either individually or in the aggregate, have a material adverse effect on the Company's business, financial position, results of operations and liquidity.

To address claims arising out of the operations of the Company's specialty hospitals and outpatient rehabilitation facilities, the Company maintains professional malpractice liability insurance and general liability insurance, subject to self-insured retention of \$2.0 million per medical incident for professional liability claims and \$2.0 million per occurrence for general liability claims. The Company also maintains umbrella liability insurance covering claims which, due to their nature or amount, are not covered by or not fully covered by the Company's other insurance policies. These insurance policies also do not generally cover punitive damages and are subject to various deductibles and policy limits. Significant legal actions, as well as the cost and possible lack of available insurance, could subject the Company to substantial uninsured liabilities. In the Company's opinion, the outcome of these actions, individually or in the aggregate, will not have a material adverse effect on its financial position, results of operations, or cash flows.

Healthcare providers are subject to lawsuits under the qui tam provisions of the federal False Claims Act. Qui tam lawsuits typically remain under seal (hence, usually unknown to the defendant) for some time while the government decides whether or not to intervene on behalf of a private qui tam plaintiff (known as a relator) and take the lead in the litigation. These lawsuits can involve significant monetary damages and penalties and award bounties to private plaintiffs who successfully bring the suits. The Company has been a defendant in these cases in the past, and may be named as a defendant in similar cases from time to time in the future.

On January 8, 2013, a federal magistrate judge unsealed an Amended Complaint in United States of America and the State of Indiana, ex rel. Doe I, Doe II and Doe III v. Select Medical Corporation, Select Specialty Hospital-Evansville, Evansville Physician Investment Corporation, Dr. Richard Sloan and Dr. Jeffrey Selby. The Amended Complaint, which was served on the Company on February 15, 2013, is a civil action filed under seal on September 28, 2012 in the United States District Court for the Southern District of Indiana by private plaintiff-relators on behalf of the United States and the state of Indiana under the federal False Claims Act and Indiana False Claims and Whistleblower Protection Act. Although the Amended Complaint

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identifies the relators by fictitious pseudonyms, on March 28, 2013, the relators filed a Notice identifying themselves as the former CEO at the Company's long term acute care hospital in Evansville, Indiana (SSH-Evansville) and two former case managers at SSH-Evansville. The named defendants include the Company, SSH-Evansville, and two physicians who have practiced at SSH-Evansville. On March 26, 2013, the defendants, relators and the United States filed a joint motion seeking a stay of the proceedings, in which the United States notified the court that its investigation has not been completed and therefore it is not yet able to decide whether or not to intervene, and on March 29, 2013, the magistrate judge granted the motion and stayed all deadlines in the case for 90 days. The court has subsequently granted additional motions filed by the United States to continue the stay, and the current stay extends through September 15, 2014.

In January 2014, representatives of the United States Attorney's Office for the Southern District of Indiana and the Office of Attorney General for the State of Indiana informed the Company that, while they have not yet decided whether to intervene in the case, their investigation is continuing concerning allegations that SSH-Evansville admitted patients for whom long-term acute care was not medically necessary, up-coded diagnoses at admission, discharged patients too early or held patients too long, readmitted patients discharged to short-stay acute care hospitals only after nine days to enable billing for two admissions, and allowed unnecessary bronchoscopies to be performed. The Company is involved in ongoing discussions with the government regarding this matter.

As previously disclosed, beginning in April 2012, the Company and SSH-Evansville have received various subpoenas and demands for documents relating to SSH-Evansville, including a request for information and subpoenas from the Office of Inspector General of the U.S. Department of Health and Human Services and subpoenas from the Office of Attorney General for the State of Indiana, and the Evansville (Indiana) Police Department has executed a search warrant at SSH-Evansville. The Company has produced and will continue to produce documents in response to, and intends to fully cooperate with, these governmental investigations. At this time, the Company is unable to predict the timing and outcome of this matter.

On July 22, 2014, the United States District Court for the Western District of Wisconsin unsealed a *qui tam* Complaint in United States of America and State of Wisconsin ex rel. Todd Schmadl v. Select Medical Holdings Corporation and Select Specialty Hospital - Madison, Inc. The Complaint was unsealed after the United States notified the Court on July 21, 2014, that the United States and the State of Wisconsin have decided not to intervene in the case. The Complaint, which has not yet been served on the Company, is a civil action that was filed under seal on July 17, 2013, on behalf of the United States and the State of Wisconsin by a nurse formerly employed at the Company's long term acute care hospital in Madison. The Complaint alleges violations of the federal False Claims Act and the Wisconsin False Claims for Medical Assistance Act based on inadequate medical care; billing for services that were not performed, were performed by unqualified personnel or were unnecessary; manipulation of patient lengths of stay and readmissions; and providing substandard care at the hospital. The Company intends to vigorously defend this action if the relator pursues it, but at this time the Company is unable to predict the timing and outcome of this matter.

Construction Commitments

At June 30, 2014, the Company had outstanding commitments under construction contracts related to new construction, improvements and renovations at the Company's long term acute care properties and inpatient rehabilitation facilities totaling approximately \$13.8 million.

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10. Subsequent Event

On August 6, 2014, Holdings' board of directors declared a cash dividend of \$0.10 per share. The dividend will be payable on or about August 29, 2014 to stockholders of record as of the close of business on August 20, 2014.

11. Financial Information for Subsidiary Guarantors and Non-Guarantor Subsidiaries under Select's 6.375% Senior Notes

Select's 6.375% senior notes are fully and unconditionally guaranteed, except for customary limitations, on a senior basis by all of Select's wholly-owned subsidiaries (the "Subsidiary Guarantors") which is defined as a subsidiary where Select or a subsidiary of Select holds all of the outstanding ownership interests. Certain of Select's subsidiaries did not guarantee the 6.375% senior notes (the "Non-Guarantor Subsidiaries").

Select conducts a significant portion of its business through its subsidiaries. Presented below is condensed consolidating financial information for Select, the Subsidiary Guarantors and the Non-Guarantor Subsidiaries at December 31, 2013 and June 30, 2014 and for the three and six months ended June 30, 2013 and 2014.

The equity method has been used by Select with respect to investments in subsidiaries. The equity method has been used by Subsidiary Guarantors with respect to investments in Non-Guarantor Subsidiaries. Separate financial statements for Subsidiary Guarantors are not presented.

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| Select Medical Corporation Consolidating Balance Sheet June 30, 2014 (unaudited) | | | | | |
|---|---|----------------------------------|--|-----------------------|---------------------|
| | Select Medical Corporation (Parent Company Only) | Subsidiary Guarantors | Non-Guarantor Subsidiaries (in thousands) | Eliminations | Consolidated |
| Assets | | | | | |
| Current Assets: | | | | | |
| Cash and cash equivalents | \$ 70 | \$ 2,008 | \$ 1,062 | \$ | \$ 3,140 |
| Accounts receivable, net | | 393,071 | 60,113 | | 453,184 |
| Current deferred tax asset | 6,438 | 5,170 | 4,434 | | 16,042 |
| Prepaid income taxes | 678 | | | | 678 |
| Intercompany receivables | | 1,598,454 | 119,844 | (1,718,298)(a) | |
| Other current assets | 9,494 | 30,293 | 4,294 | | 44,081 |
| Total Current Assets | 16,680 | 2,028,996 | 189,747 | (1,718,298) | 517,125 |
| Property and equipment, net | 16,515 | 450,197 | 59,637 | | 526,349 |
| Investment in affiliates | 3,670,956 | 95,534 | | (3,766,490)(b)(c) | |
| Goodwill | | 1,642,869 | | | 1,642,869 |
| Non-current deferred tax asset | 9,480 | | | (9,480)(d) | |
| Other identifiable intangibles | | 72,023 | | | 72,023 |
| Other assets | 37,662 | 107,159 | 584 | | 145,405 |
| Total Assets | \$ 3,751,293 | \$ 4,396,778 | \$ 249,968 | \$ (5,494,268) | \$ 2,903,771 |
| Liabilities and Equity | | | | | |
| Current Liabilities: | | | | | |
| Bank overdrafts | \$ 9,192 | \$ | \$ | \$ | \$ 9,192 |
| Current portion of long-term debt and notes payable | 6,650 | 7,401 | 727 | | 14,778 |
| Accounts payable | 10,823 | 75,188 | 12,627 | | 98,638 |
| Intercompany payables | 1,718,298 | | | (1,718,298)(a) | |
| Accrued payroll | 9,727 | 64,851 | 158 | | 74,736 |
| Accrued vacation | 4,916 | 51,188 | 8,023 | | 64,127 |
| Accrued interest | 10,581 | 404 | | | 10,985 |
| Accrued other | 39,317 | 35,896 | 6,211 | | 81,424 |
| Due to third party payors | | 1,103 | 878 | | 1,981 |
| Total Current Liabilities | 1,809,504 | 236,031 | 28,624 | (1,718,298) | 355,861 |
| Long-term debt, net of current portion | 1,174,534 | 359,610 | 64,610 | | 1,598,754 |
| Non-current deferred tax liability | | 97,430 | 8,031 | (9,480)(d) | 95,981 |
| Other non-current liabilities | 55,923 | 35,460 | 4,952 | | 96,335 |
| Total Liabilities | 3,039,961 | 728,531 | 106,217 | (1,727,778) | 2,146,931 |
| Redeemable non-controlling interests | | | 11,238 | | 11,238 |
| Stockholder's Equity: | | | | | |
| Common stock | 0 | | | | 0 |
| Capital in excess of par | 880,584 | | | | 880,584 |

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| | | | | | |
|--|--------------|--------------|------------|----------------|--------------|
| Retained earnings (accumulated deficit) | (169,252) | 988,645 | 19,053 | (1,007,698)(c) | (169,252) |
| Subsidiary investment | | 2,679,602 | 79,190 | (2,758,792)(b) | |
| Total Select Medical Corporation Stockholders Equity | 711,332 | 3,668,247 | 98,243 | (3,766,490) | 711,332 |
| Non-controlling interests | | | 34,270 | | 34,270 |
| Total Equity | 711,332 | 3,668,247 | 132,513 | (3,766,490) | 745,602 |
| Total Liabilities and Equity | \$ 3,751,293 | \$ 4,396,778 | \$ 249,968 | \$ (5,494,268) | \$ 2,903,771 |

(a) Elimination of intercompany.

(b) Elimination of investments in consolidated subsidiaries.

(c) Elimination of investments in consolidated subsidiaries earnings.

(d) Reclass of non-current deferred tax asset to report net non-current deferred tax liability in consolidation.

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Select Medical Corporation
Consolidating Statement of Operations
For the Three Months Ended June 30, 2014
(unaudited)

| | Select Medical Corporation (Parent Company Only) | Subsidiary Guarantors | Non- Guarantor Subsidiaries (in thousands) | Eliminations | Consolidated |
|--|--|--------------------------|---|--------------|--------------|
| Net operating revenues | \$ 131 | \$ 662,400 | \$ 110,231 | \$ | \$ 772,762 |
| Costs and expenses: | | | | | |
| Cost of services | 485 | 549,172 | 93,224 | | 642,881 |
| General and administrative | 19,331 | 46 | | | 19,377 |
| Bad debt expense | | 9,662 | 1,453 | | 11,115 |
| Depreciation and amortization | 904 | 13,632 | 2,660 | | 17,196 |
| Total costs and expenses | 20,720 | 572,512 | 97,337 | | 690,569 |
| Income (loss) from operations | (20,589) | 89,888 | 12,894 | | 82,193 |
| Other income and expense: | | | | | |
| Intercompany interest and royalty fees | (266) | 258 | 8 | | |
| Intercompany management fees | 34,799 | (29,335) | (5,464) | | |
| Equity in earnings of unconsolidated subsidiaries | | 1,226 | 13 | | 1,239 |
| Interest expense | (14,526) | (6,039) | (1,098) | | (21,663) |
| Income (loss) from operations before income taxes | (582) | 55,998 | 6,353 | | 61,769 |
| Income tax expense | 340 | 23,182 | 253 | | 23,775 |
| Equity in earnings of subsidiaries | 36,263 | 3,497 | | (39,760)(a) | |
| Net income | 35,341 | 36,313 | 6,100 | (39,760) | 37,994 |
| Less: Net income attributable to non-controlling interests | | | | | |
| | | | 2,653 | | 2,653 |
| Net income attributable to Select Medical Corporation | \$ 35,341 | \$ 36,313 | \$ 3,447 | \$ (39,760) | \$ 35,341 |

(a) Elimination of equity in earnings of subsidiaries.

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| | Select Medical Corporation Consolidating Statement of Operations For the Six Months Ended June 30, 2014 (unaudited) | | | | |
|--|--|----------------------------------|---|---------------------|---------------------|
| | Select Medical Corporation (Parent Company Only) | Subsidiary Guarantors | Non- Guarantor Subsidiaries (in thousands) | Eliminations | Consolidated |
| Net operating revenues | \$ 234 | \$ 1,317,633 | \$ 217,473 | \$ | \$ 1,535,340 |
| Costs and expenses: | | | | | |
| Cost of services | 930 | 1,094,981 | 185,734 | | 1,281,645 |
| General and administrative | 38,643 | (1,143) | | | 37,500 |
| Bad debt expense | | 18,826 | 3,307 | | 22,133 |
| Depreciation and amortization | 1,827 | 26,461 | 5,137 | | 33,425 |
| Total costs and expenses | 41,400 | 1,139,125 | 194,178 | | 1,374,703 |
| Income (loss) from operations | (41,166) | 178,508 | 23,295 | | 160,637 |
| Other income and expense: | | | | | |
| Intercompany interest and royalty fees | (548) | 543 | 5 | | |
| Intercompany management fees | 73,667 | (63,153) | (10,514) | | |
| Equity in earnings of unconsolidated subsidiaries | | 2,113 | 34 | | 2,147 |
| Loss on early retirement of debt | (2,277) | | | | (2,277) |
| Interest expense | (28,322) | (11,836) | (2,121) | | (42,279) |
| Income from operations before income taxes | 1,354 | 106,175 | 10,699 | | 118,228 |
| Income tax expense | 1,265 | 44,155 | 447 | | 45,867 |
| Equity in earnings of subsidiaries | 68,296 | 5,931 | | (74,227)(a) | |
| Net income | 68,385 | 67,951 | 10,252 | (74,227) | 72,361 |
| Less: Net income attributable to non-controlling interests | | | 3,976 | | 3,976 |
| Net income attributable to Select Medical Corporation | \$ 68,385 | \$ 67,951 | \$ 6,276 | \$ (74,227) | \$ 68,385 |

(a) Elimination of equity in earnings of subsidiaries.

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Select Medical Corporation
Consolidating Statement of Cash Flows
For the Six Months Ended June 30, 2014
(unaudited)

| | Select Medical Corporation (Parent Company Only) | Subsidiary Guarantors | Non- Guarantor Subsidiaries (in thousands) | Eliminations | Consolidated |
|---|---|--------------------------|---|----------------|--------------|
| Operating activities | | | | | |
| Net income | \$ 68,385 | \$ 67,951 | \$ 10,252 | \$ (74,227)(a) | \$ 72,361 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | | |
| Depreciation and amortization | 1,827 | 26,461 | 5,137 | | 33,425 |
| Provision for bad debts | | 18,826 | 3,307 | | 22,133 |
| Equity in earnings of unconsolidated subsidiaries | | (2,113) | (34) | | (2,147) |
| Loss on early retirement of debt | 2,277 | | | | 2,277 |
| Loss from disposal or sale of assets | | 28 | 115 | | 143 |
| Non-cash stock compensation expense | 4,120 | | | | 4,120 |
| Amortization of debt discount, premium and issuance costs | 3,849 | | | | 3,849 |
| Deferred income taxes | 1,275 | | | | 1,275 |
| Changes in operating assets and liabilities, net of effects from acquisition of businesses: | | | | | |
| Equity in earnings of subsidiaries | (68,296) | (5,931) | | 74,227(a) | |
| Accounts receivable | | (75,281) | (8,968) | | (84,249) |
| Other current assets | 251 | (3,742) | 556 | | (2,935) |
| Other assets | (2,388) | (1,098) | 24 | | (3,462) |
| Accounts payable | 4,074 | 6,604 | (335) | | 10,343 |
| Due to third-party payors | | 1,752 | 192 | | 1,944 |
| Accrued expenses | (11,570) | (3,449) | (1,011) | | (16,030) |
| Income taxes | (878) | | | | (878) |
| Net cash provided by operating activities | 2,926 | 30,008 | 9,235 | | 42,169 |
| Investing activities | | | | | |
| Purchases of property and equipment | (3,019) | (42,423) | (5,051) | | (50,493) |
| Investment in businesses, net of distributions | | (175) | | | (175) |
| Acquisition of businesses, net of cash acquired | | (454) | | | (454) |
| Net cash used in investing activities | (3,019) | (43,052) | (5,051) | | (51,122) |
| Financing activities | | | | | |
| Borrowings on revolving credit facility | 515,000 | | | | 515,000 |
| Payments on revolving credit facility | (425,000) | | | | (425,000) |
| Payments on credit facility term loans | (33,994) | | | | (33,994) |
| Issuance of 6.375% senior notes, includes premium | 111,650 | | | | 111,650 |
| Borrowings of other debt | 6,111 | | | | 6,111 |

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| | | | | |
|---|-----------|----------|----------|-----------|
| Principal payments on other debt | (5,046) | (173) | (1,830) | (7,049) |
| Debt issuance costs | (4,434) | | | (4,434) |
| Repayments of bank overdrafts | (3,314) | | | (3,314) |
| Equity investment by Holdings | 5,297 | | | 5,297 |
| Dividends paid to Holdings | (154,653) | | | (154,653) |
| Intercompany | (11,525) | 12,127 | (602) | |
| Distributions to non-controlling interests | | | (1,840) | (1,840) |
| Net cash provided by (used in) financing activities | 92 | 11,954 | (4,272) | 7,774 |
| Net decrease in cash and cash equivalents | (1) | (1,090) | (88) | (1,179) |
| Cash and cash equivalents at beginning of period | 71 | 3,098 | 1,150 | 4,319 |
| Cash and cash equivalents at end of period | \$ 70 | \$ 2,008 | \$ 1,062 | \$ 3,140 |

(a) Elimination of equity in earnings of consolidated subsidiaries.

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Select Medical Corporation
Consolidating Balance Sheet

December 31, 2013

(unaudited)

| | Select Medical Corporation (Parent Company Only) | Subsidiary Guarantors | Non-Guarantor Subsidiaries (in thousands) | Eliminations | Consolidated |
|--|--|--------------------------|---|-----------------------|---------------------|
| Assets | | | | | |
| Current Assets: | | | | | |
| Cash and cash equivalents | \$ 71 | \$ 3,098 | \$ 1,150 | \$ | \$ 4,319 |
| Accounts receivable, net | | 337,517 | 54,452 | (650)(a) | 391,319 |
| Current deferred tax asset | 7,965 | 5,214 | 4,445 | | 17,624 |
| Intercompany receivables | | 1,079,736 | 105,028 | (1,184,764)(b) | |
| Other current assets | 9,745 | 26,545 | 4,850 | | 41,140 |
| Total Current Assets | 17,781 | 1,452,110 | 169,925 | (1,185,414) | 454,402 |
| Property and equipment, net | 15,624 | 434,040 | 59,438 | | 509,102 |
| Investment in affiliates | 3,059,581 | 83,012 | | (3,142,593)(c)(d) | |
| Goodwill | | 1,642,633 | | | 1,642,633 |
| Non-current deferred tax asset | 7,662 | | | (7,662)(e) | |
| Other identifiable intangibles | | 71,907 | | | 71,907 |
| Other assets | 35,274 | 103,696 | 608 | | 139,578 |
| Total Assets | \$ 3,135,922 | \$ 3,787,398 | \$ 229,971 | \$ (4,335,669) | \$ 2,817,622 |
| Liabilities and Equity | | | | | |
| Current Liabilities: | | | | | |
| Bank overdrafts | \$ 12,506 | \$ | \$ | \$ | \$ 12,506 |
| Current portion of long-term debt and notes payable | 9,107 | 7,317 | 1,141 | | 17,565 |
| Accounts payable | 6,749 | 68,574 | 12,962 | | 88,285 |
| Intercompany payables | 1,184,764 | | | (1,184,764)(b) | |
| Accrued payroll | 1,167 | 88,599 | 245 | | 90,011 |
| Accrued vacation | 4,619 | 47,682 | 7,429 | | 59,730 |
| Accrued interest | 11,076 | 1,221 | | | 12,297 |
| Accrued other | 59,249 | 23,493 | 7,729 | | 90,471 |
| Income taxes payable | 622 | | | | 622 |
| Due to third party payors | | 1 | 686 | (650)(a) | 37 |
| Total Current Liabilities | 1,289,859 | 236,887 | 30,192 | (1,185,414) | 371,524 |
| Long-term debt, net of current portion | 1,006,201 | 364,060 | 57,449 | | 1,427,710 |
| Non-current deferred tax liability | | 96,111 | 7,838 | (7,662)(e) | 96,287 |
| Other non-current liabilities | 53,628 | 33,123 | 5,124 | | 91,875 |
| Total Liabilities | 2,349,688 | 730,181 | 100,603 | (1,193,076) | 1,987,396 |
| Redeemable non-controlling interests | | | 11,584 | | 11,584 |
| Stockholder's Equity: | | | | | |
| Common stock | 0 | | | | 0 |
| Capital in excess of par | 869,576 | | | | 869,576 |
| Retained earnings | (83,342) | 920,694 | 21,186 | (941,880)(d) | (83,342) |
| Subsidiary investment | | 2,136,523 | 64,190 | (2,200,713)(c) | |

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| | | | | | | |
|-------------------------------------|---------------------|---------------------|-------------------|-----------------------|---------------------|--|
| Total Select Medical Corporation | | | | | | |
| Stockholders' Equity | 786,234 | 3,057,217 | 85,376 | (3,142,593) | 786,234 | |
| Non-controlling interests | | | 32,408 | | 32,408 | |
| Total Equity | 786,234 | 3,057,217 | 117,784 | (3,142,593) | 818,642 | |
| Total Liabilities and Equity | \$ 3,135,922 | \$ 3,787,398 | \$ 229,971 | \$ (4,335,669) | \$ 2,817,622 | |

-
- (a) Reclass portion of due to third party payor to accounts receivable net in consolidation.
 - (b) Elimination of intercompany.
 - (c) Elimination of investments in consolidated subsidiaries.
 - (d) Elimination of investments in consolidated subsidiaries' earnings.
 - (e) Reclass of non-current deferred tax asset to report net non-current deferred tax liability in consolidation.

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| | Select Medical Corporation Consolidating Statement of Operations For the Three Months Ended June 30, 2013 (unaudited) | | | | |
|--|--|----------------------------------|---|---------------------|---------------------|
| | Select Medical Corporation (Parent Company Only) | Subsidiary Guarantors | Non- Guarantor Subsidiaries (in thousands) | Eliminations | Consolidated |
| Net operating revenues | \$ 207 | \$ 652,745 | \$ 103,721 | \$ | \$ 756,673 |
| Costs and expenses: | | | | | |
| Cost of services | 557 | 537,048 | 88,125 | | 625,730 |
| General and administrative | 17,853 | 74 | | | 17,927 |
| Bad debt expense | | 7,099 | 1,747 | | 8,846 |
| Depreciation and amortization | 975 | 12,522 | 2,410 | | 15,907 |
| Total costs and expenses | 19,385 | 556,743 | 92,282 | | 668,410 |
| Income (loss) from operations | (19,178) | 96,002 | 11,439 | | 88,263 |
| Other income and expense: | | | | | |
| Intercompany interest and royalty fees | (361) | 355 | 6 | | |
| Intercompany management fees | 62,247 | (57,217) | (5,030) | | |
| Equity in earnings of unconsolidated subsidiaries | | 546 | 22 | | 568 |
| Loss on early retirement of debt | (17,280) | | | | (17,280) |
| Interest expense | (15,427) | (5,447) | (1,030) | | (21,904) |
| Income from operations before income taxes | 10,001 | 34,239 | 5,407 | | 49,647 |
| Income tax expense | 6,555 | 13,018 | 196 | | 19,769 |
| Equity in earnings of subsidiaries | 24,334 | 3,439 | | (27,773)(a) | |
| Net income | 27,780 | 24,660 | 5,211 | (27,773) | 29,878 |
| Less: Net income attributable to non-controlling interests | | | 2,098 | | 2,098 |
| Net income attributable to Select Medical Corporation | \$ 27,780 | \$ 24,660 | \$ 3,113 | \$ (27,773) | \$ 27,780 |

(a) Elimination of equity in earnings of subsidiaries.

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| | Select Medical Corporation Consolidating Statement of Operations For the Six Months Ended June 30, 2013 (unaudited) | | | | |
|--|--|----------------------------------|---|---------------------|---------------------|
| | Select Medical Corporation (Parent Company Only) | Subsidiary Guarantors | Non- Guarantor Subsidiaries (in thousands) | Eliminations | Consolidated |
| Net operating revenues | \$ 310 | \$ 1,296,182 | \$ 210,136 | \$ | \$ 1,506,628 |
| Costs and expenses: | | | | | |
| Cost of services | 1,110 | 1,073,295 | 176,229 | | 1,250,634 |
| General and administrative | 35,219 | 106 | | | 35,325 |
| Bad debt expense | | 14,922 | 3,245 | | 18,167 |
| Depreciation and amortization | 1,945 | 25,025 | 4,739 | | 31,709 |
| Total costs and expenses | 38,274 | 1,113,348 | 184,213 | | 1,335,835 |
| Income (loss) from operations | (37,964) | 182,834 | 25,923 | | 170,793 |
| Other income and expense: | | | | | |
| Intercompany interest and royalty fees | (755) | 741 | 14 | | |
| Intercompany management fees | 81,976 | (72,619) | (9,357) | | |
| Equity in earnings of unconsolidated subsidiaries | | 1,571 | 55 | | 1,626 |
| Loss on early retirement of debt | (17,788) | | | | (17,788) |
| Interest expense | (30,153) | (10,769) | (2,030) | | (42,952) |
| Income (loss) from operations before income taxes | (4,684) | 101,758 | 14,605 | | 111,679 |
| Income tax expense | 1,912 | 40,682 | 215 | | 42,809 |
| Equity in earnings of subsidiaries | 70,984 | 10,121 | | (81,105)(a) | |
| Net income | 64,388 | 71,197 | 14,390 | (81,105) | 68,870 |
| Less: Net income attributable to non-controlling interests | | | 4,482 | | 4,482 |
| Net income attributable to Select Medical Corporation | \$ 64,388 | \$ 71,197 | \$ 9,908 | \$ (81,105) | \$ 64,388 |

(a) Elimination of equity in earnings of subsidiaries.

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Select Medical Corporation
Consolidating Statement of Cash Flows
For the Six Months Ended June 30, 2013
(unaudited)

| | Select Medical Corporation (Parent Company Only) | Subsidiary Guarantors | Non- Guarantor Subsidiaries (in thousands) | Eliminations | Consolidated |
|---|---|--------------------------|---|----------------|--------------|
| Operating activities | | | | | |
| Net income | \$ 64,388 | \$ 71,197 | \$ 14,390 | \$ (81,105)(a) | \$ 68,870 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | | | | |
| Depreciation and amortization | 1,945 | 25,025 | 4,739 | | 31,709 |
| Provision for bad debts | | 14,922 | 3,245 | | 18,167 |
| Equity in earnings of unconsolidated subsidiaries | | (1,571) | (55) | | (1,626) |
| Loss on early retirement of debt | 17,788 | | | | 17,788 |
| Loss from disposal or sale of assets | | 74 | 7 | | 81 |
| Non-cash stock compensation expense | 3,537 | | | | 3,537 |
| Amortization of debt discount and issuance costs | 4,499 | | | | 4,499 |
| Deferred income taxes | 3,192 | | | | 3,192 |
| Changes in operating assets and liabilities, net of effects from acquisition of businesses: | | | | | |
| Equity in earnings of subsidiaries | (70,984) | (10,121) | | 81,105(a) | |
| Accounts receivable | | (70,357) | (13,475) | | (83,832) |
| Other current assets | (2,310) | (5,405) | 1,821 | | (5,894) |
| Other assets | (5,540) | 5,600 | 84 | | 144 |
| Accounts payable | 1,857 | (3,460) | (1,062) | | (2,665) |
| Due to third-party payors | | 4,390 | 827 | | 5,217 |
| Accrued expenses | (19,539) | (6,586) | 1,180 | | (24,945) |
| Income taxes | (6,640) | | | | (6,640) |
| Net cash provided by (used in) operating activities | (7,807) | 23,708 | 11,701 | | 27,602 |
| Investing activities | | | | | |
| Purchases of property and equipment | (1,071) | (23,802) | (3,089) | | (27,962) |
| Investment in businesses, net of distributions | | (28,716) | | | (28,716) |
| Acquisition of businesses, net of cash acquired | | (171) | | | (171) |
| Net cash used in investing activities | (1,071) | (52,689) | (3,089) | | (56,849) |
| Financing activities | | | | | |
| Borrowings on revolving credit facility | 455,000 | | | | 455,000 |
| Payments on revolving credit facility | (480,000) | | | | (480,000) |
| Borrowings on credit facility term loans, net of discount | 298,500 | | | | 298,500 |
| | (592,615) | | | | (592,615) |

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| | | | | |
|---|-----------|----------|----------|-----------|
| Payments on credit facility term loans | | | | |
| Issuance of 6.375% senior notes | 600,000 | | | 600,000 |
| Repurchase of 7 5/8% senior subordinated notes | (70,000) | | | (70,000) |
| Borrowings of other debt | 5,826 | | 1,083 | 6,909 |
| Principal payments on other debt | (4,057) | (223) | (393) | (4,673) |
| Debt issuance costs | (18,583) | | | (18,583) |
| Dividends paid to Holdings | (196,825) | | | (196,825) |
| Proceeds from bank overdrafts | 1,625 | | | 1,625 |
| Intercompany | (20,010) | 27,971 | (7,961) | |
| Distributions to non-controlling interests | | | (1,467) | (1,467) |
| Net cash provided by (used in) financing activities | (21,139) | 27,748 | (8,738) | (2,129) |
| Net decrease in cash and cash equivalents | (30,017) | (1,233) | (126) | (31,376) |
| Cash and cash equivalents at beginning of period | 35,070 | 3,734 | 1,340 | 40,144 |
| Cash and cash equivalents at end of period | \$ 5,053 | \$ 2,501 | \$ 1,214 | \$ 8,768 |

(a) Elimination of equity in earnings of consolidated subsidiaries.

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

You should read this discussion together with our unaudited consolidated financial statements and accompanying notes.

Forward-Looking Statements

This report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws. Statements that are not historical facts, including statements about our beliefs and expectations, are forward-looking statements. Forward-looking statements include statements preceded by, followed by or that include the words may, could, would, should, believe, expect, anticipate, plan, target, project, intend and similar expressions. These statements include, among others, statements regarding our expected business outlook, anticipated financial and operating results, our business strategy and means to implement our strategy, our objectives, the amount and timing of capital expenditures, the likelihood of our success in expanding our business, financing plans, budgets, working capital needs and sources of liquidity.

Forward-looking statements are only predictions and are not guarantees of performance. These statements are based on our management's beliefs and assumptions, which in turn are based on currently available information. Important assumptions relating to the forward-looking statements include, among others, assumptions regarding our services, the expansion of our services, competitive conditions and general economic conditions. These assumptions could prove inaccurate. Forward-looking statements also involve known and unknown risks and uncertainties, which could cause actual results to differ materially from those contained in any forward-looking statement. Many of these factors are beyond our ability to control or predict. Such factors include, but are not limited to, the following:

- changes in government reimbursement for our services due to the implementation of healthcare reform legislation, deficit reduction measures, and/or new payment policies (including, for example, the expiration of the moratorium limiting the full application of the 25 Percent Rule that would reduce our Medicare payments for those patients admitted to a long term acute care hospital from a referring hospital in excess of an applicable percentage admissions threshold) may result in a reduction in net operating revenues, an increase in costs and a reduction in profitability;
- the impact of the Bipartisan Budget Act of 2013, which establishes new payment limits for Medicare patients who do not meet specified criteria, may result in a reduction in net operating revenues and profitability of our long term acute care hospitals;
- the failure of our specialty hospitals to maintain their Medicare certifications may cause our net operating revenues and profitability to decline;
- the failure of our facilities operated as hospitals within hospitals to qualify as hospitals separate from their host hospitals may cause our net operating revenues and profitability to decline;

- a government investigation or assertion that we have violated applicable regulations may result in sanctions or reputational harm and increased costs;

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- acquisitions or joint ventures may prove difficult or unsuccessful, use significant resources or expose us to unforeseen liabilities;
- private third-party payors for our services may undertake future cost containment initiatives that limit our future net operating revenues and profitability;
- the failure to maintain established relationships with the physicians in the areas we serve could reduce our net operating revenues and profitability;
- shortages in qualified nurses or therapists could increase our operating costs significantly;
- competition may limit our ability to grow and result in a decrease in our net operating revenues and profitability;
- the loss of key members of our management team could significantly disrupt our operations;
- the effect of claims asserted against us could subject us to substantial uninsured liabilities; and
- other factors discussed from time to time in our filings with the Securities and Exchange Commission (the SEC), including factors discussed under the heading Risk Factors for the year ended December 31, 2013 contained in our annual report on Form 10-K filed with the SEC on February 25, 2014.

Except as required by applicable law, including the securities laws of the United States and the rules and regulations of the SEC, we are under no obligation to publicly update or revise any forward-looking statements, whether as a result of any new information, future events or otherwise. You should not place undue reliance on our forward-looking statements. Although we believe that the expectations reflected in forward-looking statements are reasonable, we cannot guarantee future results or performance.

Investors should also be aware that while we do, from time to time, communicate with securities analysts, it is against our policy to disclose to securities analysts any material non-public information or other confidential commercial information. Accordingly, stockholders should not assume that we agree with any statement or report issued by any securities analyst irrespective of the content of the statement or report. Thus, to the extent that reports issued by securities analysts contain any projections, forecasts or opinions, such reports are not the responsibility of the Company.

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Overview

We began operations in 1997, and we believe that we are one of the largest operators of both specialty hospitals and outpatient rehabilitation clinics in the United States based on number of facilities. As of June 30, 2014, we operated 112 long term acute care hospitals, or LTCHs, and 15 inpatient rehabilitation facilities, or IRFs, in 28 states, and 1,019 outpatient rehabilitation clinics in 32 states and the District of Columbia. We also provide medical rehabilitation services on a contract basis to nursing homes, hospitals, assisted living and senior care centers, schools and work sites. As of June 30, 2014 we had operations in 44 states and the District of Columbia.

We manage our Company through two business segments, our specialty hospital segment and our outpatient rehabilitation segment. We had net operating revenues of \$1,535.3 million for the six months ended June 30, 2014. Of this total, we earned approximately 73% of our net operating revenues from our specialty hospital segment and approximately 27% from our outpatient rehabilitation segment. Our specialty hospital segment consists of hospitals designed to serve the needs of long term stay acute patients and hospitals designed to serve patients that require intensive medical rehabilitation care. Our outpatient rehabilitation segment consists of clinics and contract therapy locations that provide physical, occupational and speech rehabilitation services.

Significant Events

Dividend Payments

On February 19, 2014, Holdings' board of directors declared a cash dividend of \$0.10 per share. The dividend, totaling \$14.1 million was paid on March 10, 2014 to stockholders of record as of the close of business on March 3, 2014.

On April 30, 2014, Holdings' board of directors declared a cash dividend of \$0.10 per share. The dividend, totaling \$13.1 million was paid on May 28, 2014 to stockholders of record as of the close of business on May 16, 2014.

Stock Repurchase Program

The Company's board of directors has authorized a common stock repurchase program to repurchase up to \$500.0 million worth of shares of its common stock. The program will remain in effect until December 31, 2016, unless extended by the board of directors. During the three months ended June 30, 2014, the Company repurchased a total of 1,285,714 shares of common stock at a total cost of \$18.0 million, or \$14.00 per share. During the six months ended June 30, 2014, the Company repurchased a total of 11,285,714 shares of common stock at a total cost of \$127.5 million, or \$11.30 per share. The shares were repurchased from Welsh, Carson, Anderson & Stowe IX, L.P. and WCAS Capital Partners IV, L.P. See the section titled *Capital Resources* for additional discussion related to our stock repurchase program.

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Financing Transactions

Senior Secured Credit Facilities

On March 4, 2014, Select amended its senior secured credit facilities in order to, among other things:

- convert the remaining series B term loan to a new series D term loan, and lower the interest rate payable on the series D term loan from Adjusted LIBO plus 3.25%, or Alternate Base Rate plus 2.25%, to Adjusted LIBO plus 2.75%, or Alternate Base Rate plus 1.75%;
- set the maturity date of the series D term loan at December 20, 2016;
- convert the remaining series C term loan to a new series E term loan, and lower the interest rate payable on the series E term loan from Adjusted LIBO plus 3.00% (subject to an Adjusted LIBO rate floor of 1.00%), or Alternate Base Rate plus 2.00%, to Adjusted LIBO plus 2.75% (subject to an Adjusted LIBO rate floor of 1.00%), or Alternate Base Rate plus 1.75%;
- set the maturity date of the series E term loan at June 1, 2018;
- beginning with the quarter ending March 31, 2014, increase the quarterly compliance threshold set forth in the leverage ratio financial maintenance covenant to a level of 5.00 to 1.00 from 4.50 to 1.00;
- provide for a prepayment premium of 1.00% if the senior secured credit facilities are amended at any time prior to September 4, 2014 in the case of the series D term loans and March 4, 2015 in the case of the series E term loans and such amendment reduces the yield applicable to such loans; and
- amend the definition of Available Amount in a manner the effect of which was to increase the amount available for investments, restricted payments and the payment of specified indebtedness.

Senior Notes

On March 11, 2014 Select issued \$110.0 million of 6.375% senior notes due June 1, 2021, at 101.50% of the aggregate principal amount resulting in the receipt of gross proceeds of \$111.7 million.

See the section titled *Capital Resources* for additional discussion related to our financing activities.

Budget Control Act of 2011

On April 1, 2013, a federally mandated 2% reduction to Medicare payments (the Sequestration Reduction) was implemented resulting in reductions to both our net operating revenues and income from operations in the six months ended June 30, 2014 of approximately \$15.2 million, of which approximately \$14.4 million was related to our specialty hospitals and \$0.9 million was related to our outpatient rehabilitation segment. For the six months ended June 30, 2013, the Sequestration Reduction reduced our net operating revenues and income from operation by approximately \$9.5 million, of which approximately \$9.1 million was related to our specialty hospitals and \$0.4 million was related to our outpatient rehabilitation segment. See the section titled *Regulatory Changes* *Budget Control Act of 2011* for additional discussion of this regulatory change.

American Taxpayer Relief Act of 2012

On April 1, 2013, the multiple procedure payment reduction (MPPR Reduction) for therapy services was increased from 25% to 50%. For the six months ended June 30, 2014, the MPPR Reduction reduced both our net operating revenues and income from operations by approximately \$4.5 million in our outpatient rehabilitation segment. For the six months ended June 30, 2013, the MPPR Reduction reduced both our net operating revenues and income from operations by approximately \$1.7 million in our outpatient rehabilitation

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segment. See the section titled *Multiple Procedure Payment Reduction* for additional discussion of this regulatory change.

Summary Financial Results

Three Months Ended June 30, 2014

For the three months ended June 30, 2014, our net operating revenues increased 2.1% to \$772.8 million, compared to \$756.7 million for the three months ended June 30, 2013. We had income from operations of \$82.2 million for the three months ended June 30, 2014, compared to \$88.3 million for the three months ended June 30, 2013. Net income attributable to Holdings was \$35.3 million for the three months ended June 30, 2014, compared to \$27.8 million for the three months ended June 30, 2013. Our Adjusted EBITDA for the three months ended June 30, 2014 was \$101.4 million, compared to \$106.0 million for the three months ended June 30, 2013 and our Adjusted EBITDA margin was 13.1% for the three months ended June 30, 2014, compared to 14.0% for the three months ended June 30, 2013. See the section titled *Results of Operations* for a reconciliation of net income to Adjusted EBITDA.

Six Months Ended June 30, 2014

For the six months ended June 30, 2014, our net operating revenues increased 1.9% to \$1,535.3 million compared to \$1,506.6 million for the six months ended June 30, 2013. We had income from operations of \$160.6 million compared to \$170.8 million for the six months ended June 30, 2013. Net income attributable to Holdings was \$68.4 million for the six months ended June 30, 2014, compared to \$62.2 million for the six months ended June 30, 2013. Our Adjusted EBITDA for the six months ended June 30, 2014 decreased 3.8% to \$198.2 million, compared to \$206.0 million for the six months ended June 30, 2013 and our Adjusted EBITDA margin was 12.9% for the six months ended June 30, 2014, compared to 13.7% for the six months ended June 30, 2013. See the section titled *Results of Operations* for a reconciliation of net income to Adjusted EBITDA.

Regulatory Changes

In the past few years, there have been significant regulatory changes that have affected our net operating revenues and, in some cases, caused us to change our operating models and strategies. The following is a discussion of recent regulatory changes that have affected our results of operations in 2014 or may have an effect on our future results of operations. Our Annual Report on Form 10-K for the year ended December 31, 2013 filed with the SEC on February 25, 2014 contains a more detailed discussion of the regulations that affect our business in Part I Business Government Regulations, and the information below should be read in connection with that more detailed discussion.

Budget Control Act of 2011

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The Budget Control Act of 2011 increased the federal debt ceiling in connection with deficit reductions over the next ten years. On April 1, 2013, a 2% reduction to Medicare payments was implemented. For the six months ended June 30, 2014, this has reduced both our net operating revenues and income from operations by approximately \$15.2 million. For the six months ended June 30, 2013, this has reduced both our net operating revenues and income from operations by approximately \$9.5 million.

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Medicare Payment of Long Term Acute Care Hospital Services (LTCH-PPS)

Medicare Payment of Long Term Acute Care Hospitals during Fiscal Year 2014

On August 19, 2013, CMS published the final rule updating policies and payment rates for LTCH-PPS for fiscal year 2014 (affecting discharges and cost reporting periods beginning on or after October 1, 2013 through September 30, 2014). The standard federal rate was set at \$40,607, an increase from the standard federal rate applicable during the period from December 29, 2012 through September 30, 2013 of \$40,398. The update to the standard federal rate for fiscal year 2014 includes a market basket increase of 2.5%, less a productivity adjustment of 0.5%, less a reduction of 0.3% mandated by the Patient Protection and Affordable Care Act, or the PPACA, and less a budget neutrality adjustment of 1.266%, as discussed below. The fixed-loss amount for high cost outlier cases was set at \$13,314, which is a decrease from the fixed-loss amount in the 2013 fiscal year of \$15,408.

Medicare Payment of Long Term Acute Care Hospitals during Fiscal Year 2015

On August 4, 2014, CMS published an advanced copy of the final rule updating policies and payment rates for the LTCH-PPS for fiscal year 2015 (affecting discharges and cost reporting periods beginning on or after October 1, 2014 through September 30, 2015). The standard federal rate is set at \$41,044, an increase from the standard federal rate applicable during fiscal year 2014 of \$40,607. The update to the standard federal rate for fiscal year 2015 includes a market basket increase of 2.9%, less a productivity adjustment of 0.5%, less an additional reduction of 0.2% mandated by the PPACA, and less a budget neutrality adjustment of 1.266%, as discussed below. The fixed-loss amount for high cost outlier cases is set at \$14,972, which is an increase from the fixed-loss amount in the 2014 fiscal year of \$13,314.

25 Percent Rule

The 25 Percent Rule is a downward payment adjustment that applies if the percentage of Medicare patients discharged from LTCHs who were admitted from an individual hospital (regardless of whether the LTCH or LTCH satellite is co-located with the referring hospital) exceeds the applicable percentage admissions thresholds during a particular cost reporting period. The Bipartisan Budget Act of 2013 delays, and in some cases permanently suspends, the application of the 25 Percent Rule. After the expiration of the delay, many of our LTCHs will be subject to a downward payment adjustment for any Medicare patients who were admitted from a co-located or a non-co-located hospital and that exceed the applicable percentage admissions threshold of all Medicare patients discharged from the LTCH during the cost reporting period. This regulatory change will have an adverse financial impact on the net operating revenues and profitability of many of our LTCH hospitals for cost reporting periods beginning on or after July 1, 2016 or October 1, 2016, depending on the specific classification of LTCH.

One-Time Budget Neutrality Adjustment

The regulations governing LTCH-PPS authorizes CMS to make a one-time adjustment to the standard federal rate to correct any significant difference between actual payments and estimated payments for the first year of LTCH-PPS. In the update to the Medicare policies and payment rates for fiscal year 2013, CMS adopted a one-time budget neutrality adjustment that results in a permanent negative adjustment of

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3.75% to the LTCH base rate. CMS is implementing the adjustment over a three-year period by applying a factor of 0.98734 to the standard federal rate in fiscal years 2013, 2014 and 2015.

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Medicare Market Basket Adjustments for Long Term Acute Care Hospitals

The PPACA instituted a market basket payment adjustment to LTCHs. In fiscal year 2014, the market basket update was reduced by 0.3%. Fiscal years 2015 and 2016 the market basket update will be reduced by 0.2%. Finally, in fiscal years 2017-2019, the market basket update will be reduced by 0.75%. The PPACA specifically allows these market basket reductions to result in less than a 0% payment update and payment rates that are less than the prior year.

Moratorium on New LTCHs and New LTCH Beds

The Bipartisan Budget Act of 2013 reinstated a moratorium on the establishment and classification of new LTCHs or LTCH satellite facilities, and on the increase of LTCH beds in existing LTCHs or satellite facilities, beginning January 1, 2015 through September 30, 2017. The Protecting Access to Medicare Act of 2014 advanced the commencement date of the new moratorium from January 1, 2015 to April 1, 2014. The Protecting Access to Medicare Act of 2014 includes exceptions to the moratorium that are applicable to the establishment and classification of new LTCHs or LTCH satellite facilities currently under development. The new moratorium will not apply to LTCHs or LTCH satellite facilities that: (1) began their qualifying period to become an LTCH on or before April 1, 2014; (2) have a binding written agreement as of April 1, 2014 with an unrelated party for construction, renovation, or lease for an LTCH and have expended, before April 1, 2014, at least 10% of the estimated cost of the project (or, if less, \$2,500,000); or (3) have obtained a certificate of need on or before April 1, 2014.

Termination of the 5 Percent Readmissions Policy

CMS is eliminating the 5 percent readmissions policy for patients discharged on or after October 1, 2014. Under this policy, readmissions from co-located providers in excess of 5 percent are paid a single LTCH payment rather than two payments (one for both the admission and readmission). In eliminating this policy, CMS indicated that the new statutory revisions to the LTCH-PPS, which will be implemented for discharges beginning on or after October 1, 2015 (establishing clinical criteria for standard LTCH-PPS payments) will negate the need for the 5 percent policy.

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Medicare Payment of Inpatient Rehabilitation Facility Services (IRF-PPS)

Medicare Payment of Inpatient Rehabilitation Facilities during Fiscal Year 2014

On August 6, 2013, CMS published the final rule updating policies and payment rates for IRF-PPS for fiscal year 2014 (affecting discharges and cost reporting periods beginning on or after October 1, 2013 through September 30, 2014). The standard payment conversion factor for discharges for fiscal year 2014 is \$14,846, which is an increase from the fiscal year 2013 standard payment conversion factor of \$14,343. The update to the standard payment conversion factor for fiscal year 2014 includes a market basket increase of 2.6%, less a productivity adjustment of 0.5%, less an additional reduction of 0.3% as mandated by the PPACA. CMS decreased the outlier threshold amount for fiscal year 2014 to \$9,272 from \$10,466 established in the final rule for fiscal year 2013.

Medicare Payment of Inpatient Rehabilitation Facilities during Fiscal Year 2015

On July 31, 2014, CMS published an advanced copy of the final rule updating policies and payment rates for the IRF-PPS for fiscal year 2015 (affecting discharges and cost reporting periods beginning on or after October 1, 2014 through September 30, 2015). The standard payment conversion factor for discharges for fiscal year 2015 is \$15,198, which is an increase from the fiscal year 2014 standard payment conversion factor of \$14,846. The update to the standard payment conversion factor for fiscal year 2015 includes a market basket increase of 2.9%, less a productivity adjustment of 0.5%, less an additional reduction of 0.2% as mandated by the PPACA. CMS decreased the outlier threshold amount for fiscal year 2015 to \$8,848, from \$9,272 established in the final rule for fiscal year 2014.

Classification Criteria for Inpatient Rehabilitation Facilities

In order to be excluded from the hospital inpatient PPS and be paid at the higher IRF-PPS rates, an inpatient hospital must demonstrate that at least 60 percent of its patients meet the criteria specified in the regulations, including the need for intensive inpatient rehabilitation services for one or more of the 13 listed conditions, representing a presumptive need for intensive inpatient rehabilitation. Compliance is demonstrated through either medical review or the presumptive method, in which a patient's diagnosis codes are compared to a presumptive compliance list.

CMS has announced that it will remove a number of diagnosis codes from the presumptive compliance list including diagnosis codes in the following categories: non-specific diagnosis codes, arthritis diagnosis codes, unilateral upper extremity amputations diagnosis, amputation status codes, prosthetic fitting and adjustment codes, some congenital anomalies diagnosis codes, and other miscellaneous diagnosis codes. According to CMS, these conditions do not demonstrate the need for intensive inpatient rehabilitation services in the absence of additional facts that would have to be pulled from a patient's medical record. These diagnosis codes are scheduled to be removed from the presumptive compliance list beginning October 1, 2015.

Medicare Market Basket Adjustments for Inpatient Rehabilitation Facilities

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The PPACA instituted a market basket payment adjustment for IRFs. For fiscal year 2014, the reduction is 0.3%. For fiscal years 2015 and 2016, the reduction is 0.2%. For fiscal years 2017 - 2019, the reduction is 0.75%. The PPACA specifically allows these market basket reductions to result in less than a 0% payment update and payment rates that are less than the prior year.

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Medicare Payment of Outpatient Rehabilitation Services

Medicare Physician Fee Schedule and Sustainable Growth Rate Update

The Medicare program reimburses outpatient rehabilitation providers based on the Medicare physician fee schedule. The Medicare physician fee schedule rates are automatically updated annually based on the sustainable growth rate (SGR) formula, contained in legislation. The SGR formula has resulted in automatic reductions in rates in every year since 2002; however, for each year through April 1, 2015 CMS or Congress has taken action to prevent the SGR formula reductions. On December 10, 2013, CMS estimated a 20.1% reduction in the Medicare physician fee schedule payment rates for calendar year 2014 as a result of the SGR formula. The Bipartisan Budget Act of 2013 prevented the 20.1% reduction for services provided through March 31, 2014. The Protecting Access to Medicare Act (PAMA) of 2014 temporarily blocks this reduction through March 31, 2015 and replaces it with a 0.5% payment increase for services provided through December 31, 2014 and a 0% payment update from January 1, 2015 through March 31, 2015. Automatic reductions in the Medicare physician fee schedule payment rates will commence on April 1, 2015, unless Congress again takes legislative action to prevent the SGR formula reductions from going into effect. On July 3, 2014, CMS released the proposed 2015 Medicare Physician Fee Schedule Rule. CMS estimates a 20.9% reduction in the Medicare physician fee schedule payment rates beginning April 1, 2015, unless Congress again takes legislative action to prevent the SGR formula reductions from going into effect. If the 20.9% cut is averted by Congress, the projected impact of other changes in the rule on outpatient physical therapy services in aggregate would be a positive 1% in 2015. The PAMA also amended the law to expand the categories of services that CMS is directed to examine for the purpose of identifying potentially misvalued codes. The proposed 2015 Medicare Physician Fee Schedule Rule listed several CPT codes billed by physical therapists that CMS intends to review to ensure they remain accurately valued.

Therapy Caps

Beginning on January 1, 1999, the Balanced Budget Act of 1997 subjected certain outpatient therapy providers reimbursed under the Medicare physician fee schedule to annual limits for therapy expenses. Effective January 1, 2014, the annual limit on outpatient therapy services is \$1,920 for combined physical and speech language pathology services and \$1,920 for occupational therapy services. The per beneficiary caps were \$1,900 for calendar year 2013.

The annual limits for therapy expenses historically did not apply to services furnished and billed by outpatient hospital departments. However, the Protecting Access to Medicare Act of 2014, and prior legislation, extended the annual limits on therapy expenses and the manual medical review thresholds to services furnished in hospital outpatient department settings through March 31, 2015. The application of annual limits to hospital outpatient department settings will sunset on March 31, 2015 unless Congress extends it.

In the Deficit Reduction Act of 2005, Congress implemented an exceptions process to the annual limit for therapy expenses. Under this process, a Medicare enrollee (or person acting on behalf of the Medicare enrollee) is able to request an exception from the therapy caps if the provision of therapy services was deemed to be medically necessary. Therapy cap exceptions have been available automatically for certain conditions and on a case-by-case basis upon submission of documentation of medical necessity. The Protecting Access to Medicare Act of 2014 extends the exceptions process for outpatient therapy caps through March 31, 2015. Unless Congress extends the exceptions process, the therapy caps will apply to all outpatient therapy services beginning April 1, 2015, except those services furnished and billed by outpatient hospital departments.

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Multiple Procedure Payment Reduction

CMS adopted a multiple procedure payment reduction for therapy services in the final update to the Medicare physician fee schedule for calendar year 2011. This multiple procedure payment reduction policy became effective January 1, 2011 and applies to all outpatient therapy services paid under Medicare Part B. The multiple procedure payment reduction policy applies across all therapy disciplines – occupational therapy, physical therapy and speech-language pathology. Under the policy, the Medicare program pays 100% of the practice expense component of the therapy procedure or unit of service with the highest Relative Value Unit, and then reduces the payment for the practice expense component for the second and subsequent therapy procedures or units of service furnished during the same day for the same patient, regardless of whether those therapy services are furnished in separate sessions. In 2011 and 2012, the second and subsequent therapy service furnished during the same day for the same patient was reduced by 20% in office and other non-institutional settings and by 25% in institutional settings. The American Taxpayer Relief Act of 2012 increased the payment reduction in either setting to 50% effective April 1, 2013 for all outpatient therapy services. Our outpatient rehabilitation therapy services are primarily offered in institutional settings and, as such, were subject to the applicable 25% payment reduction in the practice expense component for the second and subsequent therapy services furnished by us to the same patient on the same day until April 1, 2013 when the payment reduction was increased to 50%.

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The following tables set forth operating statistics for our specialty hospitals and our outpatient rehabilitation clinics for each of the periods presented. The data in the tables reflect the changes in the number of specialty hospitals and outpatient rehabilitation clinics we operate that resulted from acquisitions, start-up activities, closures and sales. The operating statistics reflect data for the period of time these operations were managed by us.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-----------|------------------------------|-----------|
| | 2013 | 2014 | 2013 | 2014 |
| Specialty hospital data(1): | | | | |
| Number of hospitals owned - start of period | 116 | 117 | 116 | 115 |
| Number of hospitals acquired | 1 | | 1 | |
| Number of hospital start-ups | | 2 | | 4 |
| Number of hospitals closed/sold | (1) | | (1) | |
| Number of hospitals owned - end of period | 116 | 119 | 116 | 119 |
| Number of hospitals managed - end of period | 7 | 8 | 7 | 8 |
| Total number of hospitals (all) - end of period | 123 | 127 | 123 | 127 |
| Long term acute care hospitals | 109 | 112 | 109 | 112 |
| Rehabilitation hospitals | 14 | 15 | 14 | 15 |
| Available licensed beds (2) | 5,181 | 5,303 | 5,181 | 5,303 |
| Admissions (2) | 14,106 | 13,796 | 27,962 | 27,737 |
| Patient days (2) | 341,655 | 330,378 | 681,037 | 671,929 |
| Average length of stay (days) (2) | 24 | 24 | 25 | 24 |
| Net revenue per patient day (2)(3) | \$ 1,532 | \$ 1,562 | \$ 1,538 | \$ 1,550 |
| Occupancy rate (2) | 73% | 69% | 73% | 71% |
| Percent patient days - Medicare (2) | 64% | 63% | 64% | 63% |
| Outpatient rehabilitation data: | | | | |
| Number of clinics owned - start of period | 871 | 900 | 867 | 885 |
| Number of clinics acquired | | 2 | | 12 |
| Number of clinic start-ups | 7 | 4 | 11 | 9 |
| Number of clinics closed/sold | (6) | (5) | (6) | (5) |
| Number of clinics owned - end of period | 872 | 901 | 872 | 901 |
| Number of clinics managed - end of period | 116 | 118 | 116 | 118 |
| Total number of clinics (all) - end of period | 988 | 1,019 | 988 | 1,019 |
| Number of visits (2) | 1,217,598 | 1,289,782 | 2,380,221 | 2,464,572 |
| Net revenue per visit (2)(4) | \$ 103 | \$ 103 | \$ 104 | \$ 104 |

(1) Specialty hospitals consist of long term acute care hospitals and inpatient rehabilitation facilities.

(2) Data excludes specialty hospitals and outpatient clinics managed by the Company.

(3) Net revenue per patient day is calculated by dividing specialty hospital direct patient service revenues by the total number of patient days.

(4) Net revenue per visit is calculated by dividing outpatient rehabilitation clinic direct patient service revenue by the total number of visits. For purposes of this computation, outpatient rehabilitation direct patient service clinic revenue does not include contract services revenue.

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The following table outlines, for the periods indicated, selected operating data as a percentage of net operating revenues:

| | Select Medical Holdings Corporation Three Months Ended June 30, | | Select Medical Corporation Three Months Ended June 30, | |
|--|---|--------|--|--------|
| | 2013 | 2014 | 2013 | 2014 |
| Net operating revenues | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of services(1) | 82.7 | 83.2 | 82.7 | 83.2 |
| General and administrative | 2.3 | 2.5 | 2.3 | 2.5 |
| Bad debt expense | 1.2 | 1.5 | 1.2 | 1.5 |
| Depreciation and amortization | 2.1 | 2.2 | 2.1 | 2.2 |
| Income from operations | 11.7 | 10.6 | 11.7 | 10.6 |
| Loss on early retirement of debt | (2.3) | | (2.3) | |
| Equity in earnings of unconsolidated subsidiaries | 0.1 | 0.2 | 0.1 | 0.2 |
| Interest expense | (2.9) | (2.8) | (2.9) | (2.8) |
| Income before income taxes | 6.6 | 8.0 | 6.6 | 8.0 |
| Income tax expense | 2.6 | 3.1 | 2.6 | 3.1 |
| Net income | 4.0 | 4.9 | 4.0 | 4.9 |
| Net income attributable to non-controlling interests | 0.3 | 0.3 | 0.3 | 0.3 |
| Net income attributable to Holdings and Select | 3.7% | 4.6% | 3.7% | 4.6% |

| | Select Medical Holdings Corporation Six Months Ended June 30, | | Select Medical Corporation Six Months Ended June 30, | |
|--|---|--------|--|--------|
| | 2013 | 2014 | 2013 | 2014 |
| Net operating revenues | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of services(1) | 83.0 | 83.5 | 83.0 | 83.5 |
| General and administrative | 2.4 | 2.4 | 2.4 | 2.4 |
| Bad debt expense | 1.2 | 1.4 | 1.2 | 1.4 |
| Depreciation and amortization | 2.1 | 2.2 | 2.1 | 2.2 |
| Income from operations | 11.3 | 10.5 | 11.3 | 10.5 |
| Loss on early retirement of debt | (1.2) | (0.2) | (1.2) | (0.2) |
| Equity in earnings of unconsolidated subsidiaries | 0.1 | 0.2 | 0.1 | 0.2 |
| Interest expense | (3.0) | (2.8) | (2.8) | (2.8) |
| Income before income taxes | 7.2 | 7.7 | 7.4 | 7.7 |
| Income tax expense | 2.8 | 3.0 | 2.8 | 3.0 |
| Net income | 4.4 | 4.7 | 4.6 | 4.7 |
| Net income attributable to non-controlling interests | 0.3 | 0.2 | 0.3 | 0.2 |
| Net income attributable to Holdings and Select | 4.1% | 4.5% | 4.3% | 4.5% |

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The following tables summarize selected financial data by business segment, for the periods indicated:

| | Select Medical Holdings Corporation Three Months Ended June 30, | | | Select Medical Corporation Three Months Ended June 30, | | |
|---|--|--------------|-------------|---|--------------|-------------|
| | 2013 (in thousands) | 2014 | % Change | 2013 (in thousands) | 2014 | % Change |
| Net operating revenues: | | | | | | |
| Specialty hospitals | \$ 559,386 | \$ 557,833 | (0.3)% | \$ 559,386 | \$ 557,833 | (0.3)% |
| Outpatient rehabilitation | 197,080 | 214,798 | 9.0 | 197,080 | 214,798 | 9.0 |
| Other(2) | 207 | 131 | (36.7) | 207 | 131 | (36.7) |
| Total company | \$ 756,673 | \$ 772,762 | 2.1% | \$ 756,673 | \$ 772,762 | 2.1% |
| Income (loss) from operations: | | | | | | |
| Specialty hospitals | \$ 84,461 | \$ 75,621 | (10.5)% | \$ 84,461 | \$ 75,621 | (10.5)% |
| Outpatient rehabilitation | 23,053 | 27,207 | 18.0 | 23,053 | 27,207 | 18.0 |
| Other(2) | (19,251) | (20,635) | (7.2) | (19,251) | (20,635) | (7.2) |
| Total company | \$ 88,263 | \$ 82,193 | (6.9)% | \$ 88,263 | \$ 82,193 | (6.9)% |
| Adjusted EBITDA:(3) | | | | | | |
| Specialty hospitals | \$ 96,393 | \$ 88,688 | (8.0)% | \$ 96,393 | \$ 88,688 | (8.0)% |
| Outpatient rehabilitation | 26,054 | 30,432 | 16.8 | 26,054 | 30,432 | 16.8 |
| Other(2) | (16,489) | (17,766) | (7.7) | (16,489) | (17,766) | (7.7) |
| Total company | \$ 105,958 | \$ 101,354 | (4.3)% | \$ 105,958 | \$ 101,354 | (4.3)% |
| Adjusted EBITDA margin:(3) | | | | | | |
| Specialty hospitals | 17.2% | 15.9% | | 17.2% | 15.9% | |
| Outpatient rehabilitation | 13.2 | 14.2 | | 13.2 | 14.2 | |
| Other(2) | N/M | N/M | | N/M | N/M | |
| Total company | 14.0% | 13.1% | | 14.0% | 13.1% | |
| Total assets: | | | | | | |
| Specialty hospitals | \$ 2,229,458 | \$ 2,271,256 | | \$ 2,229,458 | \$ 2,271,256 | |
| Outpatient rehabilitation | 445,411 | 532,529 | | 445,411 | 532,529 | |
| Other(2) | 170,186 | 99,986 | | 170,186 | 99,986 | |
| Total company | \$ 2,845,055 | \$ 2,903,771 | | \$ 2,845,055 | \$ 2,903,771 | |
| Purchases of property and equipment: | | | | | | |
| Specialty hospitals | \$ 10,203 | \$ 19,800 | | \$ 10,203 | \$ 19,800 | |
| Outpatient rehabilitation | 2,999 | 2,546 | | 2,999 | 2,546 | |
| Other(2) | 761 | 848 | | 761 | 848 | |
| Total company | \$ 13,963 | \$ 23,194 | | \$ 13,963 | \$ 23,194 | |

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| | Select Medical Holdings Corporation Six Months Ended June 30, | | | Select Medical Corporation Six Months Ended June 30, | | |
|---|--|---------------------|---------------|---|---------------------|---------------|
| | 2013 (in thousands) | 2014 | % Change | 2013 (in thousands) | 2014 | % Change |
| Net operating revenues: | | | | | | |
| Specialty hospitals | \$ 1,117,137 | \$ 1,122,458 | 0.5% | \$ 1,117,137 | \$ 1,122,458 | 0.5% |
| Outpatient rehabilitation | 389,181 | 412,648 | 6.0 | 389,181 | 412,648 | 6.0 |
| Other(2) | 310 | 234 | (24.5) | 310 | 234 | (24.5) |
| Total company | \$ 1,506,628 | \$ 1,535,340 | 1.9% | \$ 1,506,628 | \$ 1,535,340 | 1.9% |
| Income (loss) from operations: | | | | | | |
| Specialty hospitals | \$ 165,946 | \$ 155,676 | (6.2)% | \$ 165,946 | \$ 155,676 | (6.2)% |
| Outpatient rehabilitation | 42,917 | 44,984 | 4.8 | 42,917 | 44,984 | 4.8 |
| Other(2) | (38,070) | (40,023) | (5.1) | (38,070) | (40,023) | (5.1) |
| Total company | \$ 170,793 | \$ 160,637 | (5.9)% | \$ 170,793 | \$ 160,637 | (5.9)% |
| Adjusted EBITDA:(3) | | | | | | |
| Specialty hospitals | \$ 189,740 | \$ 180,838 | (4.7)% | \$ 189,740 | \$ 180,838 | (4.7)% |
| Outpatient rehabilitation | 48,887 | 51,421 | 5.2 | 48,887 | 51,421 | 5.2 |
| Other(2) | (32,588) | (34,077) | (4.6) | (32,588) | (34,077) | (4.6) |
| Total company | \$ 206,039 | \$ 198,182 | (3.8)% | \$ 206,039 | \$ 198,182 | (3.8)% |
| Adjusted EBITDA margins:(3) | | | | | | |
| Specialty hospitals | 17.0% | 16.1% | | 17.0% | 16.1% | |
| Outpatient rehabilitation | 12.6 | 12.5 | | 12.6 | 12.5 | |
| Other(2) | N/M | N/M | | N/M | N/M | |
| Total company | 13.7% | 12.9% | | 13.7% | 12.9% | |
| Total assets: | | | | | | |
| Specialty hospitals | \$ 2,229,458 | \$ 2,271,256 | | \$ 2,229,458 | \$ 2,271,256 | |
| Outpatient rehabilitation | 445,411 | 532,529 | | 445,411 | 532,529 | |
| Other(2) | 170,186 | 99,986 | | 170,186 | 99,986 | |
| Total company | \$ 2,845,055 | \$ 2,903,771 | | \$ 2,845,055 | \$ 2,903,771 | |
| Purchases of property and equipment: | | | | | | |
| Specialty hospitals | \$ 21,100 | \$ 41,298 | | \$ 21,100 | \$ 41,298 | |
| Outpatient rehabilitation | 5,844 | 6,176 | | 5,844 | 6,176 | |
| Other(2) | 1,018 | 3,019 | | 1,018 | 3,019 | |
| Total company | \$ 27,962 | \$ 50,493 | | \$ 27,962 | \$ 50,493 | |

N/M Not Meaningful.

- (1) Cost of services includes salaries, wages and benefits, operating supplies, lease and rent expense and other operating costs.
- (2) Other includes our corporate services and certain other non-consolidating joint ventures and minority investments in other healthcare related businesses.

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(3) We define Adjusted EBITDA as net income before interest, income taxes, depreciation and amortization, gain (loss) on early retirement of debt, stock compensation expense, equity in earnings (losses) of unconsolidated subsidiaries, and other income (expense). We believe that the presentation of Adjusted EBITDA is important to investors because Adjusted EBITDA is commonly used as an analytical indicator of performance by investors within the healthcare industry. Adjusted EBITDA is used by management to evaluate financial performance and determine resource allocation for each of our operating units. Adjusted EBITDA is not a measure of financial performance under generally accepted accounting principles. Items excluded from Adjusted EBITDA are significant components in understanding and assessing financial performance. Adjusted EBITDA should not be considered in isolation or as an alternative to, or substitute for, net income, cash flows generated by operations, investing or financing activities, or other financial statement data presented in the consolidated financial statements as indicators of financial performance or liquidity. Because Adjusted EBITDA is not a measurement determined in accordance with generally accepted accounting principles and is thus susceptible to varying calculations, Adjusted EBITDA as presented may not be comparable to other similarly titled measures of other companies.

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Following is a reconciliation of net income to Adjusted EBITDA as utilized by us in reporting our segment performance:

| | Select Medical Holdings Corporation | | Select Medical Corporation | |
|---|-------------------------------------|------------|-----------------------------|------------|
| | Three Months Ended June 30, | | Three Months Ended June 30, | |
| | 2013 | 2014 | 2013 | 2014 |
| | (in thousands) | | (in thousands) | |
| Net income | \$ 29,878 | \$ 37,994 | \$ 29,878 | \$ 37,994 |
| Income tax expense | 19,769 | 23,775 | 19,769 | 23,775 |
| Interest expense | 21,904 | 21,663 | 21,904 | 21,663 |
| Loss on early retirement of debt | 17,280 | | 17,280 | |
| Equity in earnings of unconsolidated subsidiaries | (568) | (1,239) | (568) | (1,239) |
| Stock compensation expense: | | | | |
| Included in general and administrative | 1,231 | 1,480 | 1,231 | 1,480 |
| Included in cost of services | 557 | 485 | 557 | 485 |
| Depreciation and amortization | 15,907 | 17,196 | 15,907 | 17,196 |
| Adjusted EBITDA | \$ 105,958 | \$ 101,354 | \$ 105,958 | \$ 101,354 |

| | Select Medical Holdings Corporation | | Select Medical Corporation | |
|---|-------------------------------------|------------|----------------------------|------------|
| | Six Months Ended June 30, | | Six Months Ended June 30, | |
| | 2013 | 2014 | 2013 | 2014 |
| | (in thousands) | | (in thousands) | |
| Net income | \$ 66,680 | \$ 72,361 | \$ 68,870 | \$ 72,361 |
| Income tax expense | 41,630 | 45,867 | 42,809 | 45,867 |
| Interest expense | 45,362 | 42,279 | 42,952 | 42,279 |
| Loss on early retirement of debt | 18,747 | 2,277 | 17,788 | 2,277 |
| Equity in earnings of unconsolidated subsidiaries | (1,626) | (2,147) | (1,626) | (2,147) |
| Stock compensation expense: | | | | |
| Included in general and administrative | 2,427 | 3,190 | 2,427 | 3,190 |
| Included in cost of services | 1,110 | 930 | 1,110 | 930 |
| Depreciation and amortization | 31,709 | 33,425 | 31,709 | 33,425 |
| Adjusted EBITDA | \$ 206,039 | \$ 198,182 | \$ 206,039 | \$ 198,182 |

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Three Months Ended June 30, 2014 Compared to Three Months Ended June 30, 2013

In the following discussion, we discuss our results of operations related to net operating revenues, operating expenses, Adjusted EBITDA, income from operations, equity in earnings of unconsolidated subsidiaries, loss on early retirement of debt, interest expense, income taxes and non-controlling interest, which are the same for Holdings and Select for both the three month periods ended June 30, 2014 and 2013.

Net Operating Revenues

Our net operating revenues increased by 2.1% to \$772.8 million for the three months ended June 30, 2014 compared to \$756.7 million for the three months ended June 30, 2013. The effects of the Sequestration Reduction and the MPPR Reduction are reflected in our results for both of the three month periods ended June 30, 2014 and June 30, 2013.

Specialty Hospitals. Our specialty hospital net operating revenues decreased by 0.3% to \$557.8 million for the three months ended June 30, 2014 compared to \$559.4 million for the three months ended June 30, 2013. Net operating revenues in our specialty hospital segment are comprised primarily of the revenues associated with performing patient services in our hospitals and revenues from contracted labor services provided to certain of our non-consolidated joint ventures. The decline in net operating revenues is due principally to a reduction in patient services revenues, offset in part by increases in contracted labor services. Patient services revenues decreased primarily due to a decrease in patient days, offset in part by an increase in our average net revenue per patient day. Our patient days decreased 3.3% to 330,378 days for the three months ended June 30, 2014 as compared to the three months ended June 30, 2013. Our occupancy percentage was 69% for the three months ended June 30, 2014 compared to 73% for the three months ended June 30, 2013. Our average net revenue per patient day increased to \$1,562 for the three months ended June 30, 2014 compared to \$1,532 for the three months ended June 30, 2013.

Outpatient Rehabilitation. Our outpatient rehabilitation segment net operating revenues increased 9.0% to \$214.8 million for the three months ended June 30, 2014 compared to \$197.1 million for the three months ended June 30, 2013. This increase resulted from a growth in patient visits and the expansion of contracted management services in our outpatient rehabilitation clinic business and growth in our contract therapy business. The net operating revenues generated in our outpatient rehabilitation clinic business for the three months ended June 30, 2014 increased 7.0% compared to the three months ended June 30, 2013. Growth in our outpatient rehabilitation clinic business net operating revenues was principally due to a 5.9% increase in visits to 1,289,782 at our owned clinics and additional contracted management service revenue at our managed clinics for the three months ended June 30, 2014 compared to the three months ended June 30, 2013. The growth in visits resulted from an increase in the visits at our existing clinics and the addition of new clinics. Net revenue per visit in our owned outpatient rehabilitation clinics was \$103 for both the three months ended June 30, 2014 and 2013. Our contract therapy business experienced an increase in net operating revenues of \$7.2 million compared to the three months ended June 30, 2013, which principally resulted from new contracts and expansion of services of existing contracts, which more than offset reductions from terminated contracts.

Operating Expenses

Our operating expenses include our cost of services, general and administrative expense and bad debt expense. Our operating expenses increased by \$20.9 million to \$673.4 million, or 87.2% of net operating revenues for the three months ended June 30, 2014 compared to \$652.5 million, or 86.2% of net operating revenues for the three months ended June 30, 2013. Our cost of services, a major component of which is

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labor expense, was \$642.9 million, or 83.2% of net operating revenues for the three months ended June 30, 2014 compared to \$625.7 million, or 82.7% of net operating revenues for the three months ended June 30, 2013. Our cost of services increased as a result of incremental start-up costs associated with new and recently expanded specialty hospitals, increases in contract management services provided to our joint ventures, and growth in services provided by our outpatient rehabilitation segment. These increases in cost of services were offset in part, by a decrease in cost of services in our specialty hospitals due to the decline in patient days during the three months ended June 30, 2014 compared to the three months ended June 30, 2013. Cost of services as a percentage of net operating revenues increased primarily as a result of the incremental start-up costs associated with new and recently expanded specialty hospitals. We also experienced an increase in the cost of services as a percent of revenue in our specialty hospitals, which was offset by a decrease in the cost of services as a percent of revenue in our outpatient rehabilitation segment for the three months ended June 30, 2014 compared to the three months ended June 30, 2013.

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Facility rent expense, a component of cost of services, was \$32.1 million for the three months ended June 30, 2014 compared to \$30.9 million for the three months ended June 30, 2013. Our general and administrative expenses were 2.5% of net operating revenues or \$19.4 million for the three months ended June 30, 2014 compared to 2.3% of net operating revenues or \$17.9 million for the three months ended June 30, 2013. The growth in general and administrative expenses as a percentage of net operating revenues resulted primarily from increased compensation costs. Our bad debt expense was \$11.1 million or 1.5% of net operating revenues for the three months ended June 30, 2014 compared to \$8.8 million or 1.2% of net operating revenues for the three months ended June 30, 2013. The increase in bad debt expense occurred in our specialty hospital segment.

Adjusted EBITDA

Specialty Hospitals. Adjusted EBITDA for our specialty hospitals decreased 8.0% to \$88.7 million for the three months ended June 30, 2014 compared to \$96.4 million for the three months ended June 30, 2013. Our Adjusted EBITDA margin for the segment decreased to 15.9% for the three months ended June 30, 2014 from 17.2% for the three months ended June 30, 2013. The decrease in Adjusted EBITDA and Adjusted EBITDA margin for our specialty hospitals was principally the result of a decline in patient services revenues as discussed above under *Net Operating Revenues*, incremental start-up costs associated with new and recently expanded specialty hospitals and an increase in bad debt expense, discussed above under *Operating Expenses*.

Outpatient Rehabilitation. Our Adjusted EBITDA for our outpatient rehabilitation segment increased 16.8% to \$30.4 million, for the three months ended June 30, 2014 compared to \$26.1 million for the three months ended June 30, 2013. Our Adjusted EBITDA margin for the outpatient rehabilitation segment increased to 14.2% for the three months ended June 30, 2014 from 13.2% for the three months ended June 30, 2013. The Adjusted EBITDA in our outpatient rehabilitation clinics increased by \$2.8 million for the three months ended June 30, 2014 compared to the three months ended June 30, 2013. Our Adjusted EBITDA margin for our outpatient rehabilitation clinics was 15.8% for the three months ended June 30, 2014 compared to 15.1% for the three months ended June 30, 2013. The increase in Adjusted EBITDA and Adjusted EBITDA margin for our outpatient rehabilitation clinics was principally the result of growth in our net operating revenues. Our contract therapy business experienced an increase in Adjusted EBITDA of \$1.6 million compared to the three months ended June 30, 2013, which principally resulted from revenue growth as discussed above under *Net Operating Revenues*.

Other. The Adjusted EBITDA loss was \$17.8 million for the three months ended June 30, 2014 compared to an Adjusted EBITDA loss of \$16.5 million for the three months ended June 30, 2013, and resulted from the increase in our general and administrative expenses.

Income from Operations

For the three months ended June 30, 2014, we had income from operations of \$82.2 million compared to \$88.3 million for the three months ended June 30, 2013. The decrease in our income from operations resulted principally from a decline in patient services revenues, as discussed above under *Net Operating Revenues*, incremental start-up costs associated with new and recently expanded specialty hospitals, an increase in general and administrative expenses, and an increase in bad debt expense, as discussed above under *Operating Expenses*.

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Loss on Early Retirement of Debt

On May 28, 2013, we repaid a portion of Select's original term loan and series A term loan under its senior secured credit facilities, and on June 3, 2013, we amended Select's existing senior secured credit facilities. During the three months ended June 30, 2013, we recognized a loss of \$17.3 million for unamortized debt issuance costs, unamortized original issue discount and certain debt issuance costs associated with these refinancing activities.

Equity in Earnings of Unconsolidated Subsidiaries

For the three months ended June 30, 2014, we had equity in earnings of unconsolidated subsidiaries of \$1.2 million compared to equity in earnings of unconsolidated subsidiaries of \$0.6 million for the three months ended June 30, 2013. The principal increase in our equity in earnings of unconsolidated subsidiaries resulted from our Baylor Institute for Rehabilitation (BIR) and Ohio Health investments.

Interest Expense

Interest expense was \$21.7 million for the three months ended June 30, 2014 compared to \$21.9 million for the three months ended June 30, 2013. The decrease in interest expense was principally due to lower average interest rates on borrowings during the three months ended June 30, 2014.

Income Taxes

We recorded income tax expense of \$23.8 million for the three months ended June 30, 2014. The expense represented an effective tax rate of 38.5%. We recorded income tax expense of \$19.8 million for the three months ended June 30, 2013. The expense represented an effective tax rate of 39.8%. Select is part of the consolidated federal tax return for Holdings.

Our quarterly effective income tax rate is derived from our full year estimated effective income tax rate and can be impacted by discreet items and quarterly changes in our full year tax provision estimate. See our following discussion of *Income Taxes* for the six months ended June 30, 2014 compared to the six months ended June 30, 2013 for additional information.

Non-controlling Interests

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Non-controlling interests in consolidated earnings were \$2.7 million for the three months ended June 30, 2014 compared to \$2.1 million for the three months ended June 30, 2013. These amounts represent the minority owner's share of income and losses for these consolidated entities.

Six Months Ended June 30, 2014 Compared to Six Months Ended June 30, 2013

In the following section, we discuss our results of operations related to net operating revenues, operating expenses, Adjusted EBITDA, income from operations, equity in earnings of unconsolidated subsidiaries and non-controlling interest. These are the same for Holdings and Select. In addition, we discuss separately for Holdings and Select, changes related to loss on early retirement of debt, interest expense and income taxes.

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Net Operating Revenues

Our net operating revenues increased by 1.9% to \$1,535.3 million for the six months ended June 30, 2014 compared to \$1,506.6 million for the six months ended June 30, 2013.

Specialty Hospitals. Our specialty hospital net operating revenues increased by 0.5% to \$1,122.5 million for the six months ended June 30, 2014 compared to \$1,117.1 million for the six months ended June 30, 2013. The increase in our net operating revenues is due principally to the expansion of contracted labor services provided to certain of our non-consolidated joint ventures, offset in part by a decline in our patient services revenues due to both a decrease in patient days and the impact of the Sequestration Reduction. Our patient days decreased 1.3% to 671,929 days for the six months ended June 30, 2014 as compared to the six months ended June 30, 2013. Our occupancy percentage was 71% for the six months ended June 30, 2014 compared to 73% for the six months ended June 30, 2013. Our average net revenue per patient day increased to \$1,550 for the six months ended June 30, 2014 compared to \$1,538 for the six months ended June 30, 2013, despite a reduction in our Medicare net operating revenue due to the Sequestration Reduction of \$14.4 million for the six months ended June 30, 2014 compared to \$9.1 million for the six months ended June 30, 2013.

Outpatient Rehabilitation. Our outpatient rehabilitation segment net operating revenues increased 6.0% to \$412.6 million for the six months ended June 30, 2014 compared to \$389.2 million for the six months ended June 30, 2013. This increase resulted from a growth in patient visits and the expansion of contracted management services in our outpatient rehabilitation clinic business and growth in our contract therapy business. The net operating revenues generated by our outpatient rehabilitation clinics for the six months ended June 30, 2014 increased 4.6% compared to the six months ended June 30, 2013. Our growth was principally due to a 3.5% increase in visits to 2,464,572 at our owned clinics and additional contracted management service revenue at our managed clinics for the six months ended June 30, 2014 compared to the six months ended June 30, 2013. Net revenue per visit in our owned outpatient rehabilitation clinics was \$104 for both the six months ended June 30, 2014 and 2013. Our contract therapy business experienced an increase in net operating revenues of \$9.8 million compared to the six months ended June 30, 2013, which principally resulted from new contracts and expansion of services of existing contracts, which more than offset reductions from terminated contracts. Growth at our outpatient rehabilitation segment was offset in part by a reduction in our net operating revenues caused by the Sequestration Reduction of \$0.9 million and the MPPR Reduction of \$4.5 million for the six months ended June 30, 2014 compared to a Sequestration Reduction of \$0.4 million and the MPPR Reduction of \$1.7 million for the six months ended June 30, 2013.

Operating Expenses

Our operating expenses include our cost of services, general and administrative expense and bad debt expense. Our operating expenses increased by \$37.2 million to \$1,341.3 million, or 87.3% of net operating revenues for the six months ended June 30, 2014 compared to \$1,304.1 million, or 86.6% of net operating revenues for the six months ended June 30, 2013. We experienced increases in cost of services in both our specialty hospital and outpatient rehabilitation segments. Our cost of services, a major component of which is labor expense, was \$1,281.6 million, or 83.5% of net operating revenues for the six months ended June 30, 2014 compared to \$1,250.6 million, or 83.0% of net operating revenues for the six months ended June 30, 2013. The principal causes of the increases in cost of services as a percentage of net operating revenues resulted from the decrease in patient services revenues in our specialty hospital segment as discussed above under *Net Operating Revenues*, an increase in labor costs to provide contracted services to certain of our non-consolidated joint ventures, and incremental start-up costs associated with new and recently expanded specialty hospitals. Facility rent expense, a component of cost of services, was \$63.7 million for the six months ended June 30, 2014 compared to \$61.3 million for the six months ended June 30, 2013. General and administrative

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expenses were \$37.5 million for the six months ended June 30, 2014 compared to \$35.3 million for the six months ended June 30, 2013 and as a percentage of net operating revenues were 2.4% for both the six months ended June 30, 2014 and 2013. Our bad debt expense was \$22.1 million or 1.4% of net operating revenues for the six months ended June 30, 2014 compared to \$18.2 million or 1.2% of net operating revenues for the six months ended June 30, 2013. The increase in bad debt expense occurred in our specialty hospital segment.

Adjusted EBITDA

Specialty Hospitals. Adjusted EBITDA for our specialty hospitals decreased 4.7% to \$180.8 million for the six months ended June 30, 2014 compared to \$189.7 million for the six months ended June 30, 2013. Our Adjusted EBITDA margin for the segment decreased to 16.1% for the six months ended June 30, 2014 from 17.0% for the six months ended June 30, 2013. The decrease in Adjusted EBITDA and Adjusted EBITDA margin for our specialty hospitals was principally the result of a decline in patient services revenues as discussed above under *Net Operating Revenues*, incremental start-up costs associated with new and recently expanded specialty hospitals and an increase in bad debt expense, discussed above under *Operating Expenses*.

Outpatient Rehabilitation. Our Adjusted EBITDA for our outpatient rehabilitation segment increased 5.2% to \$51.4 million, for the six months ended June 30, 2014 compared to \$48.9 million for the six months ended June 30, 2013. Our Adjusted EBITDA margin for the outpatient rehabilitation segment was 12.5% for the six months ended June 30, 2014 compared to 12.6% for the six months ended June 30, 2013. The Adjusted EBITDA in our outpatient rehabilitation clinics increased by \$0.6 million for the six months ended June 30, 2014 compared to the six months ended June 30, 2013. Our Adjusted EBITDA margin for our outpatient rehabilitation clinics was 13.8% for the six months ended June 30, 2014 compared to 14.2% for the six months ended June 30, 2013. The decrease in Adjusted EBITDA margin for our outpatient rehabilitation clinics was principally the result of lost net operating revenues caused by the Sequestration Reduction and the MPPR Reduction, which reductions were accompanied by no relative offsetting reduction in costs as discussed above under *Net Operating Revenues*. Our contract therapy business experienced an increase in Adjusted EBITDA of \$2.0 million compared to the six months ended June 30, 2013, which principally resulted from revenue growth as discussed above under *Net Operating Revenues*.

Other. The Adjusted EBITDA loss was \$34.1 million for the six months ended June 30, 2014 compared to an Adjusted EBITDA loss of \$32.6 million for the six months ended June 30, 2013, and resulted from the increase in our general and administrative expenses.

Income from Operations

For the six months ended June 30, 2014, we had income from operations of \$160.6 million compared to \$170.8 million for the six months ended June 30, 2013. The decrease in our income from operations resulted principally from a decline in patient services revenues in our specialty hospital segment, as discussed above under *Net Operating Revenues*, incremental start-up costs associated with new and recently expanded specialty hospitals and an increase in bad debt expense, discussed above under *Operating Expenses*.

Loss on Early Retirement of Debt

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Select Medical Corporation. On March 4, 2014, we amended Select's term loans under its senior secured credit facilities. During the six months ended June 30, 2014, we recognized a loss of \$2.3 million for unamortized debt issuance costs, unamortized original issue discount and certain fees incurred related to term loan modifications.

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On May 28, 2013, we repaid a portion of Select's original term loan and series A term loan under its senior secured credit facilities, and on June 3, 2013, we amended Select's existing senior secured credit facilities. During the six months ended June 30, 2013, we recognized a loss of \$17.3 million for unamortized debt issuance costs, unamortized original issue discount and certain debt issuance costs associated with these refinancing activities.

On March 22, 2013, we redeemed Select's 7 5/8% senior subordinated notes due 2015. During the six months ended June 30, 2013, we recognized a loss on early retirement of debt of \$0.5 million for unamortized debt issuance costs associated with Select's redemption of its 7 5/8% senior subordinated notes due 2015.

Select Medical Holdings Corporation. On March 4, 2014, we amended Select's term loans under its senior secured credit facilities. During the six months ended June 30, 2014, we recognized a loss of \$2.3 million for unamortized debt issuance costs, unamortized original issue discount and certain fees incurred related to term loan modifications.

On May 28, 2013, we repaid a portion of Select's original term loan and series A term loan under its senior secured credit facilities, and on June 3, 2013, we amended Select's existing senior secured credit facilities. During the six months ended June 30, 2013, we recognized a loss of \$17.3 million for unamortized debt issuance costs, unamortized original issue discount and certain debt issuance costs associated with these refinancing activities.

On March 22, 2013, we redeemed Select's 7 5/8% senior subordinated notes due 2015 and redeemed Holdings' senior floating rate notes due 2015. During the six months ended June 30, 2013, we recognized a loss on early retirement of debt of \$1.5 million for unamortized debt issuance costs of which approximately \$0.5 million was associated with Select's redemption of its 7 5/8% senior subordinated notes due 2015 and approximately \$1.0 million was associated with Holdings' redemption of its senior floating rate notes due 2015.

Equity in Earnings of Unconsolidated Subsidiaries

For the six months ended June 30, 2014, we had equity in earnings of unconsolidated subsidiaries of \$2.1 million compared to equity in earnings of unconsolidated subsidiaries of \$1.6 million for the six months ended June 30, 2013. The principal increase in our equity in earnings of unconsolidated subsidiaries resulted from the earnings associated with our BIR and Ohio Health investments.

Interest Expense

Select Medical Corporation. Interest expense was \$42.3 million for the six months ended June 30, 2014 compared to \$43.0 million for the six months ended June 30, 2013. The decrease in interest expense was principally due to lower interest rates on borrowings during the six months ended June 30, 2014.

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Select Medical Holdings Corporation. Interest expense was \$42.3 million for the six months ended June 30, 2014 compared to \$45.4 million for the six months ended June 30, 2013. The decrease in interest expense was principally due to lower interest rates on borrowings during the six months ended June 30, 2014.

Income Taxes

Select Medical Corporation. We recorded income tax expense of \$45.9 million for the six months ended June 30, 2014. The expense represented an effective tax rate of 38.8%. We recorded income tax expense of

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\$42.8 million for the six months ended June 30, 2013. The expense represented an effective tax rate of 38.3%. Select is part of the consolidated federal tax return for Holdings. We allocate income taxes between Select and Holdings for purposes of financial statement presentation. Because Holdings is a passive investment company incorporated in Delaware, it does not incur any state income tax expense or benefit on its specific income or loss and, as such, receives a tax allocation equal to the federal statutory rate of 35% on its specific income or loss. Based upon the relative size of Holdings' income or loss, this can cause the effective tax rate for Select to differ from the effective tax rate for the consolidated company.

Select Medical Holdings Corporation. We recorded income tax expense of \$45.9 million for the six months ended June 30, 2014, which represented an effective tax rate of 38.8%. We recorded income tax expense of \$41.6 million for the six months ended June 30, 2013, which represented an effective tax rate of 38.4%. The increase in the effective tax rate has resulted from a decrease in earnings of our consolidated subsidiaries where we have less than a 100% ownership interest that are taxed as pass-through entities in which we only record income taxes on our share of the income.

Non-controlling Interests

Non-controlling interests in consolidated earnings were \$4.0 million for the six months ended June 30, 2014 and \$4.5 million for the six months ended June 30, 2013. These amounts represent the minority owner's share of income and losses for these consolidated entities.

Liquidity and Capital Resources***Cash Flows for the Six Months Ended June 30, 2014 and Six Months Ended June 30, 2013***

| | Select Medical Holdings Corporation Six Months Ended June 30, | | | Select Medical Corporation Six Months Ended June 30, | | | | |
|---|---|----------|------|--|----|----------|----|----------|
| | 2013 | | 2014 | 2013 | | 2014 | | |
| | (in thousands) | | | (in thousands) | | | | |
| Cash provided by operating activities | \$ | 22,023 | \$ | 42,169 | \$ | 27,602 | \$ | 42,169 |
| Cash used in investing activities | | (56,849) | | (51,122) | | (56,849) | | (51,122) |
| Cash provided by (used in) financing activities | | 3,450 | | 7,774 | | (2,129) | | 7,774 |
| Decrease in cash and equivalents | | (31,376) | | (1,179) | | (31,376) | | (1,179) |
| Cash and equivalents at beginning of period | | 40,144 | | 4,319 | | 40,144 | | 4,319 |
| Cash and equivalents at end of period | \$ | 8,768 | \$ | 3,140 | \$ | 8,768 | \$ | 3,140 |

Operating activities for Holdings and Select provided \$42.2 million of cash flows for the six months ended June 30, 2014. Operating activities for Holdings provided \$22.0 million and for Select provided \$27.6 million of cash flows for the six months ended June 30, 2013. For the six months ended June 30, 2013, the operating cash flows of Select exceeded the operating cash flows of Holdings by \$5.6 million principally due to interest payments on Holdings' indebtedness. The increase in operating cash flows for both Holdings and Select in the six months ended June 30, 2014 compared to the six months ended June 30, 2013 is principally due to the change in accounts payable and accrued expenses.

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Investing activities used \$51.1 million of cash flow for the six months ended June 30, 2014. The principal use of cash was for purchases of property, plant and equipment. Investing activities used \$56.8 million of cash flow for the six months ended June 30, 2013, which included \$28.0 million related to the purchase of property and equipment and \$28.7 million related principally to investments in unconsolidated businesses.

Financing activities for Select provided \$7.8 million of cash flow for the six months ended June 30, 2014. Cash was provided by \$90.0 million in net borrowings on our revolving credit facility, \$111.7 million from the issuance of additional 6.375% senior notes due June 1, 2021, offset in part by a \$34.0 million mandatory prepayment of term loans under our senior secured credit facility and \$154.7 million of dividends paid to Holdings in the aggregate that were used to repurchase shares of common stock and pay dividends to common stockholders.

Financing activities for Select used \$2.1 million of cash flow for the six months ended June 30, 2013. Refinancing activities provided Select \$600.0 million of proceeds from the 6.375% senior notes and \$298.5 million in term loan proceeds under the senior secured credit facility that was used in part to redeem \$70.0 million principal amount of Select's 7 5/8% senior subordinated notes, pay \$18.6 million of debt issuance costs related to the refinancing activities, and pay \$196.8 million in dividends to Holdings for the purpose of repurchasing \$167.3 million of its senior floating rate notes, payment of \$14.0 million of dividends to common stockholders, repurchase of \$10.0 million of common stock and paying \$5.6 million of interest payments on Holdings' indebtedness. Additionally, we made \$25.0 million of net repayments on our revolving loans under our senior secured credit facility in the six months ended June 30, 2013.

The difference in cash flows provided by financing activities of Holdings compared to Select of \$5.6 million for the six months ended June 30, 2013 related to dividends paid by Select to Holdings to service Holdings' interest obligations related to its indebtedness.

Capital Resources

Working capital - We had net working capital of \$161.3 million at June 30, 2014 compared to net working capital of \$82.9 million at December 31, 2013. The increase in net working capital is primarily due to an increase in our Medicare accounts receivable. Our days sales outstanding were 53 days at June 30, 2014 compared to 48 days at December 31, 2013 and 51 days at June 30, 2013. The increase in our days sales outstanding between December 31, 2013 and June 30, 2014 is primarily related to the timing of payments we receive from Medicare.

Senior secured credit facilities - On March 4, 2014, Select made a principal prepayment of \$34.0 million associated with our term loans in accordance with the provision in our senior secured credit facilities agreement that requires mandatory prepayments of term loans resulting from excess cash flow as defined in the senior secured credit facilities.

On March 4, 2014, Select amended its senior secured credit facilities in order to, among other things:

- convert the remaining series B term loan to a new series D term loan, and lower the interest rate payable on the series D term loan from Adjusted LIBO plus 3.25%, or Alternate Base Rate plus 2.25%, to Adjusted LIBO plus 2.75%, or Alternate Base Rate plus 1.75%;

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- set the maturity date of the series D term loan at December 20, 2016;
- convert the remaining series C term loan to a new series E term loan, and lower the interest rate payable on the series E term loan from Adjusted LIBO plus 3.00% (subject to an Adjusted LIBO rate floor of

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1.00%), or Alternate Base Rate plus 2.00%, to Adjusted LIBO plus 2.75% (subject to an Adjusted LIBO rate floor of 1.00%), or Alternate Base Rate plus 1.75%;

- set the maturity date of the series E term loan at June 1, 2018;
- beginning with the quarter ending March 31, 2014, increase the quarterly compliance threshold set forth in the leverage ratio financial maintenance covenant to a level of 5.00 to 1.00 from 4.50 to 1.00;
- provide for a prepayment premium of 1.00% if the senior secured credit facilities are amended at any time prior to September 4, 2014 in the case of the series D term loans and March 4, 2015 in the case of the series E term loans and such amendment reduces the yield applicable to such loans; and
- amend the definition of Available Amount in a manner the effect of which was to increase the amount available for investments, restricted payments and the payment of specified indebtedness.

At June 30, 2014, our senior secured credit facilities consist of:

- a \$300.0 million, revolving credit facility, \$293.3 million of which matures on March 1, 2018 and the remaining \$6.7 million maturing on June 1, 2016, including a \$75.0 million sublimit for the issuance of standby letters of credit and a \$25.0 million sublimit for swingline loans;
- a \$284.6 million series D term loan, maturing on December 20, 2016; and
- a \$495.6 million series E term loan, maturing on June 1, 2018.

Beginning on March 31, 2015 the principal amount will amortize as follows:

- the series D term loan has quarterly principal repayment requirements of \$0.7 million until maturity, at which time the remaining balance of \$279.5 million is due on December 20, 2016; and
- the series E term loan has quarterly principal repayment requirements of \$1.3 million until maturity, at which time the remaining balance of \$479.2 million is due on June 1, 2018.

At June 30, 2014, we had outstanding borrowings of \$780.2 million (excluding unamortized original issue discounts of \$4.8 million) under the term loans and borrowings of \$110.0 million (excluding letters of credit) under the revolving loan portion of our senior secured credit facilities. We had \$147.7 million of availability under our revolving credit facility (after giving effect to \$42.3 million of outstanding letters of credit) at June 30, 2014.

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The applicable margin percentage for borrowings under our revolving loan is subject to change based upon the ratio of Select's leverage ratio (as defined in our senior secured credit facility). The applicable interest rate for revolving loans as of June 30, 2014 was (1) Alternate Base plus 2.75% for alternate base rate loans and (2) LIBO plus 3.75% for adjusted LIBO rate loans.

Our senior secured credit facility requires Select to maintain certain leverage ratios (as defined in our senior secured credit facility). For the four consecutive fiscal quarters ended June 30, 2014, Select was required to maintain its leverage ratio (its ratio of total indebtedness to consolidated EBITDA) at less than 5.00 to 1.00. Select's leverage ratio was 4.47 to 1.00 as of June 30, 2014.

6.375% Senior Notes due 2021 - On March 11, 2014, Select issued and sold \$110.0 million aggregate principal amount of additional 6.375% senior notes due June 1, 2021, at 101.50% of the aggregate principal amount resulting in gross proceeds of \$111.7 million. The notes were issued as Additional Notes under the indenture pursuant to which it previously issued \$600.0 million of 6.375% senior notes due June 1, 2021.

Stock Repurchase Program - Holdings' board of directors has authorized a common stock repurchase program to repurchase up to \$500.0 million worth of shares of its common stock. The program will remain in

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effect until December 31, 2016, unless extended by the board of directors. Stock repurchases under this program may be made in the open market or through privately negotiated transactions, and at times and in such amounts as Holdings deems appropriate. Holdings is funding this program with cash on hand and borrowings under Select's revolving credit facility. Holdings repurchased a total of 11,285,714 shares at a total cost of \$127.5 million, or \$11.30 per share, during the six months ended June 30, 2014. Since the inception of the program through June 30, 2014, Holdings has repurchased 34,891,794 shares at a cost of approximately \$301.1 million, or \$8.63 per share, which includes transaction costs.

Liquidity - We believe our internally generated cash flows and borrowing capacity under our senior secured credit facility will be sufficient to finance operations over the next twelve months. We may from time to time seek to retire or purchase our outstanding debt through cash purchases and/or exchanges for equity securities, in open market purchases, privately negotiated transactions, tender offers or otherwise. Such repurchases or exchanges, if any, may be funded from operating cash flows or other sources and will depend on prevailing market conditions, our liquidity requirements, contractual restrictions and other factors. The amounts involved may be material.

Use of Capital Resources - We may from time to time pursue opportunities to develop new joint venture relationships with significant health systems and other healthcare providers, and from time to time we may also develop new inpatient rehabilitation hospitals. We are currently adding new LTCHs, although the Bipartisan Budget Act of 2013 reinstated a moratorium on new LTCHs and new LTCH beds. See section titled *Moratorium on New LTCHs and New LTACH Beds* under Regulatory Changes. We also intend to open new outpatient rehabilitation clinics in local areas that we currently serve where we can benefit from existing referral relationships and brand awareness to produce incremental growth. In addition to our development activities, we may grow our network of specialty hospitals through opportunistic acquisitions.

Dividend

On August 6, 2014, Holdings' board of directors declared a cash dividend of \$0.10 per share. The dividend will be payable on or about August 29, 2014 to stockholders of record as of the close of business on August 20, 2014.

Effects of inflation and changing prices

We derive a substantial portion of our revenues from the Medicare program. We have been, and could be in the future, affected by the continuing efforts of governmental and private third party payors to contain healthcare costs by limiting or reducing reimbursement payments.

Additionally, reimbursement payments under governmental and private third party payor programs may not increase to sufficiently cover increasing costs. Medicare reimbursement in long term acute care hospitals and inpatient rehabilitation facilities are subject to fixed payments under the Medicare prospective payment systems. In accordance with Medicare laws, CMS makes annual adjustments to Medicare payments under what is commonly known as a market basket update. Generally, these rates are adjusted for inflation. However, these adjustments may not reflect the actual increase in the costs of providing healthcare services and may be reduced by CMS for other adjustments.

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The healthcare industry is labor intensive and the Company's largest expenses are labor related costs. Wages and other expenses increase during periods of inflation and when labor shortages occur in the marketplace. While we believe the current economic climate may help to moderate wage increases in the near term, there can be no guarantee we will not experience increases in the cost of labor, as the need for clinical healthcare

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professionals is expected to grow. In addition, suppliers pass along rising costs to us in the form of higher prices. We have little or no ability to pass on these increased costs associated with providing services due to federal laws that establish fixed reimbursement rates.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which supersedes most of the current revenue recognition requirements. The core principle of the new guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. New disclosures about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers are also required. This guidance is effective in the first quarter of 2017 and early application is not permitted. Entities must adopt the new guidance using one of two retrospective application methods. We are currently evaluating the standard to determine the impact of its adoption on the consolidated financial statements.

In April 2014, the FASB issued ASU No. 2014-08, Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity, which changes the criteria for determining which disposals can be presented as discontinued operations and modifies the related disclosure requirements. Under the new guidance, a discontinued operation is defined as a disposal of a component or group of components that represents a strategic shift that has, or will have, a major effect on an entity's operations and financial results. The revised guidance is effective for annual fiscal periods beginning after December 15, 2014. Early adoption is permitted and we intend to prospectively adopt ASU No. 2014-08, as applicable.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Quantitative and Qualitative Disclosures about Market Risk

We are subject to interest rate risk in connection with our long-term indebtedness. Our principal interest rate exposure relates to the loans outstanding under our senior secured credit facility. As of June 30, 2014, we had \$780.2 million (excluding unamortized original issue discount) in term loans outstanding under our senior secured credit facility and \$110.0 million in revolving loans outstanding under our senior secured credit facility, which bear interest at variable rates. Each eighth point change in interest rates on the variable rate portion of our long-term indebtedness would result in a \$1.1 million annual change in interest expense. However, because the variable interest rate for an aggregate \$495.6 million in series E term loan is subject to an Adjusted LIBO Rate floor of 1.00% until the Adjusted LIBO Rate exceeds 1.00%, our interest rate on this indebtedness is currently effectively fixed at 3.75%.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

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We carried out an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934) as of the end of the period covered in this report. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures, including the accumulation and communication of disclosure to our principal executive officer and principal financial officer as appropriate to allow timely decisions regarding disclosure, are effective as of June 30, 2014 to provide reasonable assurance that material information required to be included in our periodic SEC reports is recorded, processed, summarized and reported within the time periods specified in the relevant SEC rules and forms.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Securities Exchange Act of 1934) identified in connection with the evaluation required by Rule 13a-15(d) of the Securities Exchange Act of 1934 that occurred during the second quarter ended June 30, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations on Effectiveness of Controls

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system will be met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there is only reasonable assurance that our controls will succeed in achieving their goals under all potential future conditions.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Litigation

The Company is a party to various legal actions, proceedings and claims (some of which are not insured), and regulatory and other governmental audits and investigations in the ordinary course of its business. The Company cannot predict the ultimate outcome of pending litigation, proceedings and regulatory and other governmental audits and investigations. These matters could potentially subject the Company to sanctions, damages, recoupments, fines and other penalties. The Department of Justice, Centers for Medicare & Medicaid Services (CMS) or other federal and state enforcement and regulatory agencies may conduct additional investigations related to the Company s businesses in the future that may, either individually or in the aggregate, have a material adverse effect on the Company s business, financial position, results of operations and liquidity.

To address claims arising out of the operations of the Company s specialty hospitals and outpatient rehabilitation facilities, the Company maintains professional malpractice liability insurance and general liability insurance, subject to self-insured retention of \$2.0 million per medical incident for professional liability claims and \$2.0 million per occurrence for general liability claims. The Company also maintains umbrella liability insurance covering claims which, due to their nature or amount, are not covered by or not fully covered by the Company s other insurance policies. These insurance policies also do not generally cover punitive damages and are subject to various deductibles and policy limits. Significant legal actions, as well as the cost and possible lack of available insurance, could subject the Company to substantial uninsured liabilities. In the Company s opinion, the outcome of these actions, individually or in the aggregate, will not have a material adverse effect on its financial position, results of operations, or cash flows.

Healthcare providers are subject to lawsuits under the qui tam provisions of the federal False Claims Act. Qui tam lawsuits typically remain under seal (hence, usually unknown to the defendant) for some time while the government decides whether or not to intervene on behalf of a private qui tam plaintiff (known as a relator) and take the lead in the litigation. These lawsuits can involve significant monetary damages and penalties and award bounties to private plaintiffs who successfully bring the suits. The Company has been a defendant in these cases in the past, and may be named as a defendant in similar cases from time to time in the future.

On January 8, 2013, a federal magistrate judge unsealed an Amended Complaint in United States of America and the State of Indiana, ex rel. Doe I, Doe II and Doe III v. Select Medical Corporation, Select Specialty Hospital-Evansville, Evansville Physician Investment Corporation, Dr. Richard Sloan and Dr. Jeffrey Selby. The Amended Complaint, which was served on the Company on February 15, 2013, is a civil action filed under seal on September 28, 2012 in the United States District Court for the Southern District of Indiana by private plaintiff-relators on behalf of the United States and the state of Indiana under the federal False Claims Act and Indiana False Claims and Whistleblower Protection Act. Although the Amended Complaint identifies the relators by fictitious pseudonyms, on March 28, 2013, the relators filed a Notice identifying themselves as the former CEO at the Company s long term acute care hospital in Evansville, Indiana (SSH-Evansville) and two former case managers at SSH-Evansville. The named defendants include the Company, SSH-Evansville, and two physicians who have practiced at SSH-Evansville. On March 26, 2013, the defendants, relators and the United States filed a joint motion seeking a stay of the proceedings, in which the United States notified the court that its investigation has not been completed and therefore it is not yet able to decide whether or not to intervene, and on March 29, 2013, the magistrate judge granted the motion and stayed all deadlines in the case for 90 days. The court has subsequently granted additional

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motions filed by the United States to continue the stay, and the current stay extends through September 15, 2014.

In January 2014, representatives of the United States Attorney's Office for the Southern District of Indiana and the Office of Attorney General for the State of Indiana informed the Company that, while they have not yet decided whether to intervene in the case, their investigation is continuing concerning allegations that SSH-Evansville admitted patients for whom long-term acute care was not medically necessary, up-coded diagnoses at admission, discharged patients too early or held patients too long, readmitted patients discharged to short-stay acute care hospitals only after nine days to enable billing for two admissions, and allowed unnecessary bronchoscopies to be performed. The Company is involved in ongoing discussions with the government regarding this matter.

As previously disclosed, beginning in April 2012, the Company and SSH-Evansville have received various subpoenas and demands for documents relating to SSH-Evansville, including a request for information and subpoenas from the Office of Inspector General of the U.S. Department of Health and Human Services and subpoenas from the Office of Attorney General for the State of Indiana, and the Evansville (Indiana) Police Department has executed a search warrant at SSH-Evansville. The Company has produced and will continue to produce documents in response to, and intends to fully cooperate with, these governmental investigations. At this time, the Company is unable to predict the timing and outcome of this matter.

On July 22, 2014, the United States District Court for the Western District of Wisconsin unsealed a *qui tam* Complaint in United States of America and State of Wisconsin ex rel. Todd Schmadl v. Select Medical Holdings Corporation and Select Specialty Hospital - Madison, Inc. The Complaint was unsealed after the United States notified the Court on July 21, 2014, that the United States and the State of Wisconsin have decided not to intervene in the case. The Complaint, which has not yet been served on the Company, is a civil action that was filed under seal on July 17, 2013, on behalf of the United States and the State of Wisconsin by a nurse formerly employed at the Company's long term acute care hospital in Madison. The Complaint alleges violations of the federal False Claims Act and the Wisconsin False Claims for Medical Assistance Act based on inadequate medical care; billing for services that were not performed, were performed by unqualified personnel or were unnecessary; manipulation of patient lengths of stay and readmissions; and providing substandard care at the hospital. The Company intends to vigorously defend this action if the relator pursues it, but at this time the Company is unable to predict the timing and outcome of this matter.

ITEM 1A. RISK FACTORS

There have been no material changes from our risk factors as previously reported in our Annual Report on Form 10-K for the year ended December 31, 2013.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Purchases of Equity Securities by the Issuer

The board of directors of Holdings has authorized a common stock repurchase program to repurchase up to \$500.0 million worth of shares of its common stock. The program will remain in effect until December 31, 2016, unless extended by the board of directors. Stock repurchases under

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this program may be made in the open market or through privately negotiated transactions, and at times and in such amounts as the Company deems appropriate. Holdings is funding this program with cash on hand and borrowings under Select's revolving credit facility. Holdings repurchased 11,285,714 shares at a cost of \$127.5 million during the six months ended June 30, 2014.

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The following table sets forth the monthly purchases made under this program during the three months ended June 30, 2014:

| Period | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs |
|---------------------------------|---|---|---|---|
| April 1, 2014 to April 30, 2014 | | | | \$ 216,871,503 |
| May 1, 2014 to May 31, 2014 | 1,285,714 | \$ 14.00 | 1,285,714 | \$ 198,871,507 |
| June 1, 2014 to June 30, 2014 | | | | \$ 198,871,507 |
| Total | 1,285,714 | \$ 14.00 | 1,285,714 | \$ 198,871,507 |

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

The exhibits to this report are listed in the Exhibit Index appearing on page 62 hereof.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrants have duly caused this Report to be signed on their behalf by the undersigned, thereunto duly authorized.

SELECT MEDICAL CORPORATION

By: /s/ Martin F. Jackson
Martin F. Jackson
Executive Vice President and Chief Financial
Officer
(Duly Authorized Officer)

By: /s/ Scott A. Romberger
Scott A. Romberger
Senior Vice President, Chief Accounting Officer
and Controller
(Principal Accounting Officer)

Dated: August 7, 2014

SELECT MEDICAL HOLDINGS CORPORATION

By: /s/ Martin F. Jackson
Martin F. Jackson
Executive Vice President and Chief Financial
Officer
(Duly Authorized Officer)

By: /s/ Scott A. Romberger
Scott A. Romberger
Senior Vice President, Chief Accounting Officer
and Controller
(Principal Accounting Officer)

Dated: August 7, 2014

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EXHIBIT INDEX

| Exhibit | Description |
|----------------|---|
| 10.1 | Stock Purchase Agreement, dated May 5, 2014, by and among Select Medical Holdings Corporation, Welsh, Carson, Anderson & Stowe IX, L.P. and WCAS Capital Partners IV, L.P. |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Executive Vice President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer, and Executive Vice President and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101 | The following financial information from the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2014 formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Statements of Operations for the three and six months ended June 30, 2014 and 2013, (ii) Consolidated Balance Sheets as June 30, 2014 and December 31, 2013, (iii) Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013, (iv) Consolidated Statements of Changes in Equity and Income for the six months ended June 30, 2014 and (v) Notes to Consolidated Financial Statements.* |

* XBRL information is furnished and not filed herewith, is not part of a registration statement or prospectus for purposes of section 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these sections.