

SELECT MEDICAL HOLDINGS CORP

Form 424B4

September 25, 2009

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Filed Pursuant to Rule 424(b)(4)
File Number 333-152514

30,000,000 Shares

Select Medical Holdings Corporation

Common Stock

This is an initial public offering of shares of common stock of Select Medical Holdings Corporation. We are offering 30,000,000 shares of our common stock.

Prior to this offering, there has been no public market for our common stock. The initial public offering price of our common stock is \$10.00 per share. Our common stock has been approved for listing on the New York Stock Exchange under the symbol SEM.

See Risk Factors beginning on page 14 to read about factors you should consider before buying shares of the common stock.

	Price to Public	Underwriting Discounts and Commissions	Proceeds to Select Medical Holdings Corporation
Per Share	\$ 10.00	\$ 0.60	\$ 9.40
Total	\$ 300,000,000	\$ 18,000,000	\$ 282,000,000

To the extent the underwriters sell more than 30,000,000 shares of common stock, the underwriters have the option to purchase up to an additional 4,500,000 shares from Select Medical Holdings Corporation at the initial public offering price less the underwriting discount.

The underwriters expect to deliver the shares against payment in New York, New York on September 30, 2009.

Neither the Securities and Exchange Commission nor any other regulatory body has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.

Goldman, Sachs & Co.

Morgan Stanley

BofA Merrill Lynch

J.P.Morgan

Wells Fargo Securities

RBC Capital Markets

Prospectus dated September 25, 2009

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You should rely only on the information contained in this prospectus. Neither we nor the underwriters have authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. Neither we nor the underwriters are making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus is accurate only as of the date on the front cover of this prospectus or other date stated in this prospectus. Our business, financial condition, results of operations and prospects may have changed since that date, and we have an obligation to provide updates to this prospectus only to the extent that the information contained in this prospectus becomes materially deficient or misleading after the date on the front cover.

As used in this prospectus, unless the context otherwise indicates, the references to Holdings refer to Select Medical Holdings Corporation, and the references to Select refer to Select Medical Corporation (a wholly-owned subsidiary of Holdings) and references to our company, us, we and our refer to Holdings together with Select and its subsidiaries.

Unless otherwise indicated or the context otherwise requires, financial data in this prospectus reflects the consolidated business and operations of Select Medical Holdings Corporation and its wholly-owned subsidiaries. Except where otherwise indicated, \$ indicates U.S. dollars.

Until October 20, 2009 (25 days after the date of this prospectus), all dealers that buy, sell or trade our common stock, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to the dealers' obligation to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

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PROSPECTUS SUMMARY

The following summary highlights information contained elsewhere in this prospectus and is qualified in its entirety by more detailed information and consolidated financial statements included elsewhere in this prospectus. Because it is a summary, it does not contain all of the information that you should consider before investing in our common stock. You should read this prospectus carefully, including the section entitled Risk Factors and the consolidated financial statements and the related notes to those statements included elsewhere in this prospectus. The information in this prospectus, other than historical financial information, gives effect to a reverse 1 to .30 common stock split, which was completed on September 24, 2009.

Our Business

Overview

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, 2009, we operated 87 long term acute care hospitals and five inpatient rehabilitation facilities in 25 states, and 948 outpatient rehabilitation clinics in 37 states and the District of Columbia. We also provide medical rehabilitation services on a contract basis at nursing homes, hospitals, assisted living and senior care centers, schools and worksites. We began operations in 1997 under the leadership of our current management team, including our co-founders, Rocco A. Ortenzio and Robert A. Ortenzio, who have a combined 68 years of experience in the healthcare industry. Under this leadership, we have grown our business from its founding to a business that generated net operating revenue of \$2,153.4 million for the year ended December 31, 2008.

Business Segments and Strategy

We manage our company through two business segments, our specialty hospital and our outpatient rehabilitation segments, which accounted for approximately 69% and 31%, respectively, of our net operating revenues for the year ended December 31, 2008. Our specialty hospital segment consists of hospitals designed to serve the needs of long term stay acute patients and hospitals designed to serve patients who require intensive inpatient medical rehabilitation. Our outpatient rehabilitation business consists of clinics and contract services that provide physical, occupational and speech rehabilitation services.

Specialty Hospitals

The key elements of our specialty hospital strategy are to:

Focus on Specialized Inpatient Services. We serve highly acute patients and patients with debilitating injuries that cannot be adequately cared for in a less medically intensive environment, such as a skilled nursing facility. Generally, patients in our specialty hospitals require longer stays and higher levels of clinical care than patients treated in general acute care hospitals. Our patients' average length of stay in our specialty hospitals was 24 days for the six months ended June 30, 2009.

Provide High Quality Care and Service. We believe that our specialty hospitals serve a critical role in comprehensive healthcare delivery. Through our specialized treatment programs and staffing models, we treat patients with acute, complex and specialized medical needs who are typically referred to us by general acute care hospitals. Our specialized treatment programs focus on specific patient needs and medical conditions such

as ventilator weaning programs, wound care protocols and rehabilitation programs for brain trauma and spinal cord injuries. Our responsive staffing models ensure that patients have the appropriate clinical resources over the course of their stay. We believe that we are recognized for providing quality care and service, as evidenced by accreditation by The Joint Commission and the Commission on Accreditation of Rehabilitation Facilities. We also believe we develop brand loyalty in the local areas we serve allowing us to strengthen our relationships with physicians and other referral sources and drive additional patient volume to our hospitals.

Reduce Operating Costs. We continually seek to improve operating efficiency and reduce costs at our hospitals by standardizing operations and centralizing key administrative functions. These initiatives include optimizing staffing based on our occupancy and the clinical needs of our patients, centralizing

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administrative functions, standardizing management information systems and participating in group purchasing arrangements.

Increase Higher Margin Commercial Volume. With reimbursement rates from commercial insurers typically higher than the federal Medicare program, we have focused on continued expansion of our relationships with commercial insurers to increase our volume of patients with commercial insurance in our specialty hospitals. Although the level of care we provide is complex and staff intensive, we typically have lower relative operating expenses than a general acute care hospital because we provide a much narrower range of patient services at our hospitals. We believe that commercial payors seek to contract with our hospitals because we offer patients high quality, cost-effective care at more attractive rates than general acute care hospitals.

Develop New Inpatient Rehabilitation Facilities. By leveraging the experience of our senior management and dedicated development team, we intend to pursue new inpatient rehabilitation hospital development opportunities.

Pursue Opportunistic Acquisitions. In addition to our development initiatives, we may grow our network of specialty hospitals through opportunistic acquisitions. Our immediate focus is on acquisitions of inpatient rehabilitation facilities, although we will still consider acquisitions of long term acute care hospitals if they are at attractive valuations.

Outpatient Rehabilitation

The key elements of our outpatient rehabilitation strategy are to:

Provide High Quality Care and Service. We are focused on providing a high level of service to our patients throughout their entire course of treatment. This high quality of care and service allows us to strengthen our relationships with referring physicians, employers and health insurers and drive additional patient volume.

Increase Market Share. We strive to establish a leading presence within the local areas we serve. This allows us to realize economies of scale, heightened brand loyalty, workforce continuity and increased leverage when negotiating payor contracts.

Expand Rehabilitation Programs and Services. Through our local clinical directors of operations and clinic managers within their service areas, we assess the healthcare needs of the areas we serve. Based on these assessments, we implement additional programs and services specifically targeted to meet demand in the local community.

Optimize the Profitability of Our Payor Contracts. We rigorously review payor contracts up for renewal and potential new payor contracts to optimize our profitability. We believe that our size and our strong reputation enables us to negotiate favorable outpatient contracts with commercial insurers.

Maintain Strong Employee Relations. We seek to retain, motivate and educate our employees whose relationships with referral sources are key to our success.

Pursue Opportunistic Acquisitions. We may grow our network of outpatient rehabilitation facilities through opportunistic acquisitions. We significantly expanded our network with the 2007 acquisition of the outpatient rehabilitation division of HealthSouth Corporation, consisting of 569 clinics in 35 states and the District of Columbia, including 18 states in which we did not previously have outpatient rehabilitation facilities. We believe our size and centralized infrastructure allow us to take advantage of operational efficiencies and

increase margins at acquired facilities.

Our Competitive Strengths

We believe that the success of our business model is based on a number of competitive strengths, including:

Leading Operator in Distinct but Complementary Lines of Business. We believe that we are a leading operator in each of our principal business segments, based on number of facilities in the United States. Our leadership position and reputation as a high quality, cost-effective health care provider in each of our

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business segments allows us to attract patients and employees, aids us in our marketing efforts to payors and referral sources and helps us negotiate payor contracts.

Proven Financial Performance and Strong Cash Flow. We have established a track record of improving the financial performance of our facilities due to our disciplined approach to revenue growth, expense management and an intense focus on free cash flow generation.

Significant Scale. By building significant scale in each of our business segments, we have been able to leverage our operating costs by centralizing administrative functions at our corporate office. As a result, we have been able to minimize our general and administrative expense as a percentage of revenues, which was 2.3% for the six months ended June 30, 2009.

Well-Positioned to Capitalize on Consolidation Opportunities. We believe that we are well-positioned to capitalize on consolidation opportunities within each of our business segments and selectively augment our internal growth. With our geographically diversified portfolio of facilities in the United States, we believe that our footprint provides us with a wide-ranging perspective on multiple potential acquisition opportunities.

Experience in Successfully Completing and Integrating Acquisitions. From our inception in 1997 through June 30, 2009, we completed six significant acquisitions for approximately \$894.8 million in aggregate consideration. We believe that we have improved the operating performance of these facilities over time by applying our standard operating practices and by realizing efficiencies from our centralized operations and management.

Experienced and Proven Management Team. Prior to co-founding our company with our current Chief Executive Officer, our Executive Chairman founded and operated three other healthcare companies focused on inpatient and outpatient rehabilitation services. In addition, our four senior operations executives have an average of over 31 years of experience in the healthcare industry, including extensive experience working together for our company and for past companies focused on operating acute rehabilitation hospitals and outpatient rehabilitation facilities.

Industry

In the United States, spending on healthcare was expected to be 16.6% of the gross domestic product in 2008, according to the Centers for Medicare & Medicaid Services. An important factor driving healthcare spending is increased consumption of services due to the aging of the population. The number of individuals age 65 and older has grown 1.2% compounded annually over the past 20 years and is expected to grow 2.9% compounded annually over the next 20 years, approximately three times faster than the overall population, according to the U.S. Census Bureau. We believe that an increasing number of individuals age 65 and older will drive demand for our specialized medical services.

For individuals age 65 and older, the primary source of health insurance is the federal Medicare program. Medicare utilizes distinct payment methodologies for services provided in long term acute care hospitals, inpatient rehabilitation facilities and outpatient rehabilitation clinics. In the federal fiscal year 2007, Medicare payments for long term acute care hospital services accounted for 1.0% of overall Medicare outlays and Medicare payments for inpatient rehabilitation services accounted for 1.4%, according to the Medicare Payment Advisory Commission.

Risk Factors

Before you invest in our shares, you should carefully consider all of the information in this prospectus, including matters set forth under the heading Risk Factors, such as:

Highly regulated industry. The healthcare services industry is subject to extensive federal, state and local laws and regulations. We conduct business in a heavily regulated industry and changes in regulations, new interpretations of existing regulations or violations of regulations could have a material adverse effect on our business, financial condition and results of operations.

Reliance on Medicare reimbursement. Approximately 46% and 47% of our net operating revenues for the year ended December 31, 2008 and the six months ended June 30, 2009, respectively, came from the highly regulated federal Medicare program. President Obama has proposed comprehensive reforms to the

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healthcare system, including changes to the methods for, and amounts of, Medicare reimbursement. If these or other changes are made to the rates or methods of government reimbursements for our services, our business, financial condition and results of operations could decline.

Changes in federal regulations applicable to hospitals within hospitals. At June 30, 2009, 65 of our 87 long term acute care hospitals operated as hospitals within hospitals or as satellites. Recent federal regulations have lowered rates of reimbursement for services we provide to certain Medicare patients admitted to long term acute care hospitals operated as hospitals within hospitals or as satellites. Compliance with such changes in federal regulations may have an adverse effect on our future net operating revenues and profitability.

Changes in federal regulations applicable to free-standing hospitals and grandfathered long term acute care hospitals operated as hospitals within hospitals or satellites. At June 30, 2009, 22 of our 87 long term acute care hospitals operated as free-standing hospitals and three qualified as grandfathered long term acute care hospitals operated as hospitals within hospitals or satellites. Recent federal regulations have lowered rates of reimbursement for services we provide to certain Medicare patients admitted to free-standing long term acute care hospitals and grandfathered long term acute care hospitals operated as hospitals within hospitals or satellites. Significant aspects of these federal regulations have been postponed for a three year period for annual cost reporting periods beginning on or after July 1, 2007. If these recent federal regulations are applied as currently written at the end of the three year moratorium, they will have an adverse effect on our future net operating revenues and profitability.

Failure to maintain certifications as long term acute care hospitals. All of our 87 long term acute care hospitals are currently certified by Medicare as long term acute care hospitals. If our long term acute care hospitals fail to meet or maintain the standards for certification as long term acute care hospitals, such as minimum average length of patient stay, they will receive significantly less Medicare reimbursement than they currently receive for their patient services.

Modifications to the admissions policies for our inpatient rehabilitation facilities. All of our five acute medical rehabilitation hospitals are currently certified by Medicare as inpatient rehabilitation facilities. Changes to federal regulations have made significant changes to the inpatient rehabilitation facilities certification process. In order to comply with the Medicare inpatient rehabilitation facility certification criteria, it may be necessary for us to implement more restrictive admissions policies at our inpatient rehabilitation facilities and not admit patients whose diagnoses fall outside the specified conditions. Such policies may result in a reduction of patient volume at these hospitals and, as a result, may reduce our future net operating revenues and profitability.

Company Information

Select was formed in December 1996 by Rocco A. Ortenzio and Robert A. Ortenzio and commenced operations during February 1997 upon the completion of its first acquisition. Holdings was formed in October 2004. On February 24, 2005, EGL Acquisition Corp., a wholly-owned subsidiary of Holdings, was merged with Select, with Select continuing as the surviving corporation and a wholly-owned subsidiary of Holdings. We refer to this merger and the related transactions collectively as the Merger Transactions. Holdings was formerly known as EGL Holding Company. Holdings primary asset is its investment in Select. Holdings is owned by an investor group that includes Welsh, Carson, Anderson & Stowe IX, L.P., WCAS Capital Partners IV, L.P. and WCAS Management Corporation, Thoma Cressey Bravo and members of our senior management. We refer to Welsh, Carson, Anderson & Stowe IX, L.P., WCAS Capital Partners IV, L.P. and WCAS Management Corporation, collectively as Welsh Carson and Thoma Cressey Bravo as Thoma Cressey.

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Select Medical Holdings Corporation was incorporated on October 14, 2004 as a Delaware corporation. Our principal executive office is located at 4714 Gettysburg Road, Mechanicsburg, Pennsylvania 17055 and our telephone number is (717) 972-1100.

Our website address is www.selectmedicalcorp.com. Our website and the information contained therein or connected thereto shall not be deemed to be incorporated into this prospectus or the registration statement of which it forms a part.

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THE OFFERING

Shares of common stock offered by us	30,000,000 shares, or 34,500,000 shares if the underwriters exercise their over-allotment option in full.
Conversion of preferred stock	All 22,148,453 shares of our issued and outstanding participating preferred stock shall be converted into 64,276,974 shares of our common stock upon consummation of the offering.
Common stock to be outstanding after this offering	156,092,873 shares, or 160,592,873 shares if the underwriters exercise their over-allotment option in full.
Use of proceeds	<p>We estimate that our net proceeds from the sale of shares of our common stock in this offering will be \$278.7 million, or \$321.0 million if the underwriters exercise their over-allotment option in full, after deducting underwriting discounts and commissions and estimated offering expenses payable by us. We intend to use the net proceeds of this offering to:</p> <ul style="list-style-type: none">repay at least \$139.4 million of term loans outstanding under our senior secured credit facility, and any related prepayment costs; andmake payments to executive officers under our Long Term Cash Incentive Plan in the amount of approximately \$18.0 million. <p>Any remaining net proceeds will be used for repayment or repurchase of indebtedness or for general corporate purposes.</p> <p>Affiliates of J.P. Morgan Securities Inc., Wells Fargo Securities, LLC and Merrill Lynch, Pierce, Fenner & Smith Incorporated, underwriters in this offering, are parties to our senior secured credit facility and will receive a portion of the proceeds from this offering. See Use of Proceeds and Underwriters.</p>
Dividend policy	<p>We do not anticipate paying any dividends on our common stock in the foreseeable future. Any future determination relating to our dividend policy will be made at the discretion of our board of directors and will depend on then existing conditions, including our financial condition, results of operations, contractual restrictions, capital requirements, business prospects and other factors our board of directors may deem relevant. In addition, our ability to declare and pay dividends is restricted by covenants in our senior secured credit facility and the indentures governing Select's senior subordinated notes due 2015, which we refer to as Select's 75/8% senior subordinated notes, and our senior floating rate notes due 2015, which we refer to as the senior floating rate notes. See Description of Indebtedness - Senior Secured Credit Facility - Restrictive Covenants and Other Matters and Risk Factors.</p>

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Proposed New York Stock Exchange
symbol

SEM.

Risk factors

Investment in our common stock involves substantial risks. You should read this prospectus carefully, including the section entitled Risk Factors and the consolidated financial statements and the related notes to those statements included elsewhere in this prospectus before investing in our common stock.

Conflicts of Interest

From time to time, certain of the underwriters and/or their respective affiliates have directly and indirectly engaged in various financial advisory, investment banking and commercial banking services for us and our affiliates, for which they received customary compensation, fees and expense reimbursement. In particular, affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated, J.P. Morgan Securities Inc. and Wells Fargo Securities, LLC, underwriters in this offering, are parties to our senior secured credit facility. In addition, affiliates of J.P. Morgan Securities Inc. have in the past provided treasury and security services to us for customary fees. Our senior secured credit facility was negotiated on an arms length basis and contains customary terms pursuant to which the lenders receive customary fees. We will use a portion of the proceeds from this offering to repay amounts outstanding under this credit facility. See Use of Proceeds. As a result of these repayments, Wells Fargo Securities, LLC will receive 5% or more of the net proceeds from this offering. Accordingly, this offering will be conducted in compliance with the applicable provisions of NASD Rule 2720 of Financial Industry Regulatory Authority (FINRA). Pursuant to those rules, a qualified independent underwriter, as defined by the FINRA rules, must participate in the preparation of the prospectus and perform its usual standard of due diligence with respect to the prospectus. Goldman, Sachs & Co. has agreed to act as qualified independent underwriter for the offering and to perform a due diligence investigation and review and participate in the preparation of the prospectus. In addition, from time to time, certain of the underwriters and their affiliates may effect transactions for their own account or the account of customers, and hold on behalf of themselves or their customers, long or short positions in our debt or equity securities or loans, and may do so in the future. See Underwriting Conflicts of Interest.

Our stockholders approved an amendment to our restated certificate of incorporation that provides that upon consummation of this offering each share of our outstanding preferred stock will convert into a number of common shares to be determined by:

dividing the original cost of a share of the preferred stock (\$26.90 per share of preferred stock) plus all accrued and unpaid dividends thereon less the amount of any previously declared and paid special dividends, or the accreted value of such preferred stock, by the initial public offering price per share in this offering net of any expenses incurred and underwriting commissions or concessions paid or allowed in connection with this offering; plus

.30 shares of common stock for each share of participating preferred stock owned.

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The number of shares of our common stock to be outstanding after this offering is based on 156,092,873 shares outstanding upon consummation of this offering and excludes:

63,000 shares of our common stock issuable upon exercise of options granted under our director equity incentive plan. See Management Compensation Discussion and Analysis Director Compensation Table Option Awards ; and

1,425,002 shares of our common stock issuable upon exercise of options granted under the Select Medical Holdings Corporation 2005 Equity Incentive Plan. See Management Compensation Discussion and Analysis Elements of Compensation Equity Compensation.

Unless otherwise noted, all information in this prospectus:

other than historical financial information, gives effect to a reverse 1 to .30 common stock split;

assumes that the underwriters do not exercise their over-allotment option; and

other than historical financial information, reflects the conversion of 22,148,453 shares of our issued and outstanding preferred stock into 64,276,974 shares of common stock upon consummation of the offering.

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SUMMARY HISTORICAL AND OTHER FINANCIAL DATA

The following table sets forth, for the periods and dates indicated, our summary historical and other financial data. We have derived the statements of operations data for the years ended December 31, 2006, 2007 and 2008, and the balance sheet data as of December 31, 2007 and 2008 from our audited consolidated financial statements appearing elsewhere in this prospectus. We have derived the statements of operations data for the six months ended June 30, 2008 and 2009 and balance sheet data as of June 30, 2009 from our unaudited consolidated financial statements appearing elsewhere in this prospectus. The summary financial data presented below represent portions of our financial statements and are not complete. You should read this information in conjunction with Use of Proceeds, Capitalization, Selected Historical Consolidated Financial Data, Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and related notes included elsewhere in this prospectus.

The pro forma as adjusted consolidated statements of operations for the year ended December 31, 2008 and for the six months ended June 30, 2009 give effect to (1) the 1 for .30 reverse split of our common stock that occurred on September 24, 2009, (2) the conversion of all shares of our issued and outstanding preferred stock into 63,559,714 shares of common stock upon consummation of the offering, based on the accreted value of the preferred stock on June 30, 2009, (3) the issuance of 30,000,000 shares of our common stock upon consummation of the offering, (4) the increase in our interest expense due to an increase of 1.75% in the interest rate on \$384.5 million principal amount of Tranche B-1 term loans that resulted from Amendment No. 3 to our senior secured credit facility which became effective on August 5, 2009, and (5) the decrease in interest expense resulting from the application of all of the estimated net proceeds from this offering to repay indebtedness under our senior secured credit facility and make payments to officers under our Long-Term Cash Incentive Plan as if they had occurred on January 1, 2008. The pro forma consolidated statement of operations excludes non-recurring charges directly attributable to this offering, including \$10.6 million (net of tax) related to payments under our Long Term Cash Incentive Plan and \$2.6 million (net of tax) related to restricted stock which will vest upon completion of this offering.

The pro forma as adjusted balance sheet data as of June 30, 2009 gives effect to (1) the 1 for .30 reverse split of our common stock that occurred on September 24, 2009, (2) the conversion of all shares of our preferred stock into 63,559,714 shares of common stock upon consummation of the offering, (3) the issuance of 30,000,000 shares of our common stock upon consummation of the offering, (4) the application of all of the estimated net proceeds from this offering to repay indebtedness under our senior secured credit facility and make payments to officers under our Long-Term Cash Incentive Plan as if they had occurred on June 30, 2009, and (5) the reduction in equity related to other non-recurring charges related to the offering. You should read this information in conjunction with Unaudited Pro Forma Consolidated Financial Information included elsewhere in this prospectus.

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	Year Ended December 31,			Pro Forma As Adjusted 2008
	2006⁽¹⁾	2007⁽¹⁾	2008⁽¹⁾	
	(in thousands, except per share data)			
Statement of Operations Data:				
Net operating revenues	\$ 1,851,498	\$ 1,991,666	\$ 2,153,362	\$ 2,153,362
Operating expenses ⁽²⁾⁽³⁾	1,546,956	1,740,484	1,885,168	1,885,168
Depreciation and amortization	46,668	57,297	71,786	71,786
Income from operations	257,874	193,885	196,408	196,408
Gain on early retirement of debt ⁽⁴⁾			912	912
Other expense		(167)		
Interest expense, net ⁽⁵⁾	(130,538)	(138,052)	(145,423)	(135,531)
Income from continuing operations before income taxes	127,336	55,666	51,897	61,789
Income tax expense	43,521	18,699	26,063	30,119
Income from continuing operations	83,815	36,967	25,834	31,670
Income from discontinued operations, net of tax	12,818			
Net income	96,633	36,967	25,834	31,670
Less: Net income attributable to non-controlling interests ⁽⁶⁾	1,754	1,537	3,393	3,393
Net income attributable to Select Medical Holdings Corporation	94,879	35,430	22,441	28,277
Less: Preferred dividends	22,663	23,807	24,972	
Net income (loss) available to common and preferred stockholders	\$ 72,216	\$ 11,623	\$ (2,531)	\$ 28,277
Income (loss) per common share ⁽⁷⁾ :				
Basic:				
Income (loss) from continuing operations	\$ 0.26	\$ 0.05	\$ (0.01)	
Income from discontinued operations, net of tax	0.06			
Net income (loss)	\$ 0.32	\$ 0.05	\$ (0.01)	
Diluted:				
Income (loss) from continuing operations	\$ 0.26	\$ 0.05	\$ (0.01)	
Income from discontinued operations, net of tax	0.06			
Net income (loss)	\$ 0.32	\$ 0.05	\$ (0.01)	

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Income (loss) per common share assuming the reverse stock split that occurred in connection with this offering:

Basic:

Income (loss) from continuing operations	\$ 0.87	\$ 0.17	\$ (0.03)	\$ 0.18
Income from discontinued operations, net of tax	0.20			

Net income (loss)	\$ 1.07	\$ 0.17	\$ (0.03)	\$ 0.18
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Diluted:

Income (loss) from continuing operations	\$ 0.87	\$ 0.17	\$ (0.03)	\$ 0.18
Income from discontinued operations, net of tax	0.20			

Net income (loss)	\$ 1.07	\$ 0.17	\$ (0.03)	\$ 0.18
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Balance Sheet Data (at end of period):

Cash and cash equivalents	\$ 81,600	\$ 4,529	\$ 64,260
Working capital	59,468	14,730	118,370
Total assets	2,182,524	2,495,046	2,579,469
Total debt	1,538,503	1,755,635	1,779,925
Preferred stock	467,395	491,194	515,872
Total Select Medical Holdings Corporation stockholders equity	(169,139)	(165,889)	(174,204)

Segment Data:

Specialty Hospitals⁽⁸⁾:

Net operating revenue	\$ 1,378,543	\$ 1,386,410	\$ 1,488,412
Adjusted EBITDA ⁽⁹⁾	283,270	217,175	236,388

Outpatient Rehabilitation:

Net operating revenue	470,339	603,413	664,760
Adjusted EBITDA ⁽⁹⁾	64,823	75,437	77,279

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	Six Months Ended June 30,		
			Pro Forma
	2008⁽¹⁾⁽⁷⁾	2009	As Adjusted
	2009		
	(in thousands, except per share data)		
Statement of Operations Data:			
Net operating revenues	\$ 1,087,084	\$ 1,120,707	\$ 1,120,707
Operating expenses ⁽²⁾⁽³⁾	948,992	952,023	952,023
Depreciation and amortization	35,327	35,670	35,670
Income from operations	102,765	133,014	133,014
Gain on early retirement of debt ⁽⁴⁾		15,316	15,316
Interest expense, net ⁽⁵⁾	(73,268)	(68,250)	(63,806)
Income from operations before income taxes	29,497	80,080	84,524
Income tax expense	13,973	33,880	35,702
Net income	15,524	46,200	48,822
Less: Net income attributable to non-controlling interests ⁽⁶⁾	1,071	1,412	1,412
Net income attributable to Select Medical Holdings Corporation	14,453	44,788	47,410
Less: Preferred dividends	12,279	12,870	
Net income available to common and preferred stockholders	\$ 2,174	\$ 31,918	\$ 47,410
Net income per common share:			
Basic	\$ 0.01	\$ 0.14	
Diluted	\$ 0.01	\$ 0.14	
Net income per common share assuming the reverse stock split that occurred in connection with this offering:			
Basic	\$ 0.03	\$ 0.47	\$ 0.30
Diluted	\$ 0.03	\$ 0.47	\$ 0.30
Balance Sheet Data (at end of period):			
Cash and cash equivalents	\$ 7,534	\$ 27,689	
Working capital	105,745	103,831	
Total assets	2,544,037	2,532,682	
Total debt	1,805,462	1,697,134	
Preferred stock	503,179	528,742	
Total Select Medical Holdings Corporation stockholders equity	(165,703)	(141,659)	
Segment Data:			
Specialty Hospitals ⁽⁸⁾ :			
Net operating revenue	\$ 745,893	\$ 779,563	
Adjusted EBITDA ⁽⁹⁾	118,480	147,741	
Outpatient Rehabilitation:			
Net operating revenue	341,072	341,009	
Adjusted EBITDA ⁽⁹⁾	43,843	46,578	

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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 table reflect the changes in the number of specialty hospitals and outpatient rehabilitation clinics we operate that resulted from acquisitions, start-up activities, closures, sales and consolidations. The operating statistics reflect data for the period of time these operations were managed by us.

	Year Ended December 31, 2006	Year Ended December 31, 2007	Year Ended December 31, 2008
Specialty hospital data⁽⁸⁾:			
Number of hospitals start of period	101	96	87
Number of hospital start-ups	3	3	7
Number of hospitals acquired			2
Number of hospitals closed/sold	(4)	(8)	(1)
Number of hospitals consolidated	(4)	(4)	(2)
Number of hospitals end of period	96	87	93
Available licensed beds	3,867	3,819	4,222
Admissions	39,668	40,008	41,177
Patient days	969,590	987,624	1,005,719
Average length of stay (days)	24	25	24
Net revenue per patient day ⁽¹⁰⁾	\$ 1,392	\$ 1,378	\$ 1,453
Occupancy rate	69%	69%	67%
Percent patient days Medicare	73%	69%	65%
Outpatient rehabilitation data⁽¹¹⁾:			
Number of clinics owned start of period	553	477	918
Number of clinics acquired		570	4
Number of clinic start-ups	12	15	17
Number of clinics closed/sold ⁽¹²⁾	(88)	(144)	(59)
Number of clinics owned end of period	477	918	880
Number of clinics managed end of period	67	81	76
Total number of clinics (all) end of period	544	999	956
Number of visits	2,972,243	4,032,197	4,533,727
Net revenue per visit ⁽¹³⁾	\$ 94	\$ 100	\$ 102

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	Six Months Ended June 30,	
	2008	2009
Specialty hospital data⁽⁸⁾:		
Number of hospitals start of period	87	93
Number of hospital start-ups	5	
Number of hospitals closed/sold		(1)
Number of hospitals end of period	92	92
Available licensed beds	4,126	4,160
Admissions	20,914	21,309
Patient days	512,286	508,983
Average length of stay (days)	25	24
Net revenue per patient day ⁽¹⁰⁾	\$ 1,428	\$ 1,505
Occupancy rate	69%	67%
Percent patient days Medicare	66%	64%
Outpatient rehabilitation data:		
Number of clinics owned start of period	918	880
Number of clinics acquired		1
Number of clinic start-ups	9	7
Number of clinics closed/sold	(33)	(13)
Number of clinics owned end of period	894	875
Number of clinics managed end of period	76	73
Total number of clinics (all) end of period	970	948
Number of visits	2,323,609	2,259,637
Net revenue per visit ⁽¹³⁾	\$ 103	\$ 102

(1) Adjusted for the adoption of SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. See Note 1, Organization and Significant Accounting Policies Recent Accounting Pronouncements, in our audited consolidated financial statements and Note 2, Accounting Policies Recent Accounting Pronouncements, in our interim unaudited consolidated financial statements for additional information.

(2) Operating expenses include cost of services, general and administrative expenses, and bad debt expenses.

(3) Includes compensation expense related to restricted stock and stock options for the years ended December 31, 2006, 2007, and 2008 and for the six months ended June 30, 2008 and 2009.

(4) In the year ended December 31, 2008, we paid approximately \$1.0 million to repurchase and retire a portion of Select's 75/8% senior subordinated notes. These notes had a carrying value of \$2.0 million. The gain on early retirement of debt recognized was net of the write-off of unamortized deferred financing costs related to the debt. During the six months ended June 30, 2009, we paid approximately \$30.1 million to repurchase and retire a portion of Select's 75/8% senior subordinated notes. These notes had a carrying value of \$46.5 million. The gain on early retirement of debt recognized was net of the write-off of unamortized deferred financing costs related to the debt.

- (5) Interest expense, net equals interest expense minus interest income.
- (6) Reflects interests held by other parties in subsidiaries, limited liability companies and limited partnerships owned and controlled by us.
- (7) Adjusted for the adoption of FASB Staff Position EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities. See Note 14 in our audited consolidated financial statements and Note 8 in our interim unaudited consolidated financial statements for additional information.
- (8) Specialty hospitals consist of long term acute care hospitals and inpatient rehabilitation facilities.
- (9) We define Adjusted EBITDA as net income before interest, income taxes, depreciation and amortization, income from discontinued operations, gain on early retirement of debt, stock compensation expense, other expense and non-controlling interests. 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

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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. See footnote 13 to our audited consolidated financial statements and footnote 7 to our interim unaudited consolidated financial statements for the period ended June 30, 2009 for a reconciliation of net income to Adjusted EBITDA as utilized by us in reporting our segment performance in accordance with SFAS No. 131.

- (10) Net revenue per patient day is calculated by dividing specialty hospital patient service revenues by the total number of patient days.
- (11) Outpatient rehabilitation data has been restated to remove the clinics operated by Canadian Back Institute Limited, which we refer to as CBIL, which was sold on March 31, 2006 and is being reported as a discontinued operation in 2006.
- (12) The number of clinics closed/sold for the year ended December 31, 2007 relate primarily to clinics closed in connection with the restructuring plan for integrating the acquisition of HealthSouth Corporation's outpatient rehabilitation division.
- (13) Net revenue per visit is calculated by dividing outpatient rehabilitation clinic revenue by the total number of visits. For purposes of this computation, outpatient rehabilitation clinic revenue does not include contract services revenue.

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RISK FACTORS

Investing in our common stock involves a high degree of risk. You should consider carefully the following risk factors and the other information in this prospectus, including our consolidated financial statements and related notes, before you decide to purchase our common stock. If any of the following risks actually occur, our business, financial condition and operating results could be adversely affected. As a result, the trading price of our common stock could decline and you could lose part or all of your investment.

Risks Relating to Our Business and Industry

If there are changes in the rates or methods of government reimbursements for our services, our net operating revenues and profitability could decline.

Approximately 46% and 47% of our net operating revenues for the year ended December 31, 2008 and the six months ended June 30, 2009, respectively, came from the highly regulated federal Medicare program. In recent years, through legislative and regulatory actions, the federal government has made substantial changes to various payment systems under the Medicare program. President Obama has proposed comprehensive reforms to the healthcare system, including changes to the methods for, and amounts of, Medicare reimbursement. President Obama's proposals would significantly reduce payments from Medicare and Medicaid over the next ten years. Reforms or other changes to these payment systems, including modifications to the conditions on qualification for payment, bundling payments to cover both acute and post-acute care or the imposition of enrollment limitations on new providers, may be proposed or could be adopted, either by the U.S. Congress or by the Centers for Medicare & Medicaid Services, or CMS. If revised regulations are adopted, the availability, methods and rates of Medicare reimbursements for services of the type furnished at our facilities could change. Some of these changes and proposed changes could adversely affect our business strategy, operations and financial results. In addition, there can be no assurance that any increases in Medicare reimbursement rates established by CMS will fully reflect increases in our operating costs.

We conduct business in a heavily regulated industry, and changes in regulations, new interpretations of existing regulations or violations of regulations may result in increased costs or sanctions that reduce our net operating revenues and profitability.

The healthcare industry is subject to extensive federal, state and local laws and regulations relating to:

facility and professional licensure, including certificates of need;

conduct of operations, including financial relationships among healthcare providers, Medicare fraud and abuse and physician self-referral;

addition of facilities and services and enrollment of newly developed facilities in the Medicare program;

payment for services; and

safeguarding protected health information.

Both federal and state regulatory agencies inspect, survey and audit our facilities to review our compliance with these laws and regulations. While our facilities intend to comply with existing licensing, Medicare certification requirements and accreditation standards, there can be no assurance that these regulatory authorities will determine

that all applicable requirements are fully met at any given time. In recent years, some regulatory agencies inspecting our facilities have applied these requirements and standards more strictly. A determination by any of these regulatory authorities that a facility is not in compliance with these requirements could lead to the imposition of requirements that the facility takes corrective action, assessment of fines and penalties, or loss of licensure, Medicare certification or accreditation. These consequences could have an adverse effect on our company.

In addition, there have been heightened coordinated civil and criminal enforcement efforts by both federal and state government agencies relating to the healthcare industry. The ongoing investigations relate to, among other things, various referral practices, cost reporting, billing practices, physician ownership and joint ventures involving hospitals. In the future, different interpretations or enforcement of these laws and regulations could subject us to allegations of impropriety or illegality or could require us to make changes in our facilities, equipment, personnel,

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services and capital expenditure programs. These changes may increase our operating expenses and reduce our operating revenues. If we fail to comply with these extensive laws and government regulations, we could become ineligible to receive government program reimbursement, suffer civil or criminal penalties or be required to make significant changes to our operations. In addition, we could be forced to expend considerable resources responding to any related investigation or other enforcement action.

During July 2009, we received a subpoena from the Office of Inspector General of the U.S. Department of Health and Human Services seeking various documents concerning our financial relationships with certain physicians practicing at our hospitals in Columbus, Ohio. We do not know whether the subpoena has been issued in connection with a lawsuit under the qui tam provisions of the federal False Claims Act or in connection with possible civil, criminal or administrative proceedings by the government. We are assembling documents in order to respond to the subpoena and intend to fully cooperate with this investigation. At this time, we are unable to predict the timing and outcome of this matter. See Business Legal Proceedings and Business Government Regulations.

Compliance with changes in federal regulations applicable to long term acute care hospitals operated as hospitals within hospitals or as satellites may have an adverse effect on our future net operating revenues and profitability.

On August 11, 2004, CMS published final regulations applicable to long term acute care hospitals that are operated as hospitals within hospitals or as satellites. We collectively refer to hospitals within hospitals and satellites as HIHs, and we refer to the CMS final regulations as the final regulations. HIHs are separate hospitals located in space leased from, and located in or on the same campus of, another hospital. We refer to such other hospitals as host hospitals.

Effective for hospital cost reporting periods beginning on or after October 1, 2004, the final regulations, subject to certain exceptions, provide lower rates of reimbursement to HIHs for those Medicare patients admitted from their host hospitals that are in excess of a specified percentage threshold. For HIHs opened after October 1, 2004, the Medicare admissions threshold has been established at 25% except for HIHs located in rural areas or co-located with an MSA dominant hospital or single urban hospital (as defined by the current regulations) where the percentage is no more than 50%, nor less than 25%. Certain grandfathered HIHs were initially excluded from the Medicare admission threshold in the August 11, 2004 final regulations. Grandfathered HIHs refer to certain HIHs that were in existence on or before September 30, 1995, and grandfathered satellite facilities refer to satellites of grandfathered HIHs that were in existence on or before September 30, 1999.

For HIHs that meet specified criteria and were in existence as of October 1, 2004, including all but two of our then existing grandfathered HIHs, the Medicare admissions thresholds were phased in over a four year period starting with hospital cost reporting periods beginning on or after October 1, 2004, as follows: (1) for discharges during the cost reporting period beginning on or after October 1, 2004 and before October 1, 2005, the Medicare admissions threshold was the Fiscal 2004 Percentage (as defined below) of Medicare discharges admitted from the host hospital; (2) for discharges during the cost reporting period beginning on or after October 1, 2005 and before October 1, 2006, the Medicare admissions threshold was the lesser of the Fiscal 2004 Percentage of Medicare discharges admitted from the host hospital or 75%; (3) for discharges during the cost reporting period beginning on or after October 1, 2006 and before October 1, 2007, the Medicare admissions threshold was the lesser of the Fiscal 2004 Percentage of Medicare discharges admitted from the host hospital or 50%; and (4) for discharges during cost reporting periods beginning on or after October 1, 2007, the Medicare admissions threshold is 25%.

The Medicare, Medicaid, and SCHIP Extension Act of 2007, or the SCHIP Extension Act, (as amended by the American Recovery and Reinvestment Act, the ARRA) generally limits the application of the Medicare admission threshold on HIHs in existence on October 1, 2004 and subject to the four year phase in described above. For these HIHs, the admission threshold is no lower than 50% for a three year period to commence on a long term acute care

hospital s, or LTCH s, first cost reporting period to begin on or after October 1, 2007. Under the SCHIP Extension Act, for HIHs located in rural areas the percentage threshold is no more than 75% for the same three year period. For HIHs that are co-located with MSA dominant hospitals or single urban hospitals, the percentage threshold is no more than 75% during the same three year period or the percentage of total Medicare discharges in the MSA in which the hospital is located that are from the co-located hospital. In the 2008 rate year final rule, CMS

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applied the Medicare admissions threshold to admissions to grandfathered HIHs and grandfathered satellites from co-located hospitals. The SCHIP Extension Act delays application of the admissions threshold on grandfathered HIHs for a three year period commencing on the first cost reporting period beginning on or after July 1, 2007. The ARRA limits application of the admission threshold to no more than 50% of Medicare admissions to grandfathered satellites from a co-located hospital for a three year period commencing on the first cost reporting period beginning on or after July 1, 2007. As of June 30, 2009, we had 65 LTCH HIHs; three of these HIHs were subject to a maximum 25% Medicare admission threshold, 18 of these HIHs were co-located with a MSA dominate hospital or single urban hospital and were subject to a Medicare admission threshold of no more than 75%, 39 of these HIHs were subject to a maximum 50% Medicare admissions threshold, two of these HIHs were located in a rural area and were subject to a maximum 75% Medicare admission threshold, and three of these HIHs were grandfathered HIHs and not subject to a Medicare admission threshold.

With respect to any HIH, Fiscal 2004 Percentage means the percentage of all Medicare patients discharged by such HIH during its cost reporting period beginning on or after October 1, 2003 and before October 1, 2004 who were admitted to such HIH from its host hospital. In no event, however, is the Fiscal 2004 Percentage less than 25%.

Because these rules are complex and are based on the volume of Medicare admissions from our host hospitals as a percent of our overall Medicare admissions, we cannot predict with any certainty the impact on our future net operating revenues of compliance with these regulations. However, after the expiration of the three year moratorium provided by the SCHIP Extension Act, we expect an adverse financial impact beginning for cost reporting periods on or after December 29, 2010, when the Medicare admissions thresholds decline to 25%.

Expiration of the moratorium imposed on certain federal regulations otherwise applicable to long term acute care hospitals operated as free-standing or grandfathered hospitals within hospitals or grandfathered satellites will have an adverse effect on our future net operating revenues and profitability.

All Medicare payments to our long term acute care hospitals are made in accordance with a prospective payment system specifically applicable to long term acute care hospitals, referred to as LTCH-PPS. On May 1, 2007, CMS published its annual payment rate update for the 2008 LTCH-PPS rate year, or RY 2008. We refer to such rate update as the May 2007 final rule. The May 2007 final rule makes several changes to LTCH-PPS payment methodologies and amounts during RY 2008. As described below, however, many of these changes have been postponed for a three year period by the SCHIP Extension Act.

For cost reporting periods beginning on or after July 1, 2007, the May 2007 final rule expanded the current Medicare HIH admissions threshold to apply to Medicare patients admitted from any individual hospital. Previously, the admissions threshold was applicable only to Medicare HIH admissions from hospitals co-located with an LTCH or satellite of an LTCH. Under the May 2007 final rule, free-standing LTCHs and grandfathered LTCH HIHs are subject to the Medicare admission thresholds, as well as HIHs that admit Medicare patients from non-co-located hospitals. To the extent that any LTCH s or LTCH satellite facility s discharges that are admitted from an individual hospital (regardless of whether the referring hospital is co-located with the LTCH or LTCH satellite) exceed the applicable percentage threshold during a particular cost reporting period, the payment rate for those discharges would be subject to a downward payment adjustment. Cases admitted in excess of the applicable threshold will be reimbursed at a rate comparable to that under general acute care inpatient prospective payment system, or IPPS. IPPS rates are generally lower than LTCH-PPS rates. Cases that reach outlier status in the discharging hospital would not count toward the limit and would be paid under LTCH-PPS.

The SCHIP Extension Act, as amended, postpones the application of the percentage threshold to free-standing LTCHs and grandfathered HIHs for a three year period commencing on an LTCH s first cost reporting period on or after July 1, 2007. However, the SCHIP Extension Act does not postpone the application of the percentage threshold, or the

transition period stated above, to Medicare patients discharged from an LTCH HIH or satellite that were admitted from a non-co-located hospital. In addition, the SCHIP Extension Act, as interpreted by CMS, does not provide relief from the application of the threshold for patients admitted from a co-located hospital to certain non-grandfathered HIHs.

Of the 87 long term acute care hospitals we operated as of June 30, 2009, 22 were operated as free-standing hospitals and three qualified as grandfathered LTCH HIHs. If the May 2007 rule is applied as currently written, there will be an adverse financial impact to our net operating revenues and profitability when the moratorium expires.

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The moratorium on the Medicare certification of new long term care hospitals and beds in existing long term care hospitals will limit our ability to increase long term acute care hospital bed capacity, expand into new areas or increase services in existing areas we serve.

The SCHIP Extension Act imposed a three year moratorium beginning on December 29, 2007 on the establishment and classification of new LTCHs, LTCH satellite facilities and LTCH beds in existing LTCH or satellite facilities. The moratorium does not apply to LTCHs that, before December 29, 2007, (1) began the qualifying period for payment under the LTCH-PPS, (2) had a written agreement with an unrelated party for the construction, renovation, lease or demolition for a LTCH and had expended at least 10% of the estimated cost of the project or \$2,500,000 or (3) had obtained an approved certificate of need. The moratorium also does not apply to an increase in beds in an existing hospital or satellite facility if the LTCH is located in a state where there is only one other LTCH and the LTCH requests an increase in beds following the closure or the decrease in the number of beds of the other LTCH. Since we may still acquire LTCHs that were in existence prior to December 29, 2007, we do not expect this moratorium to materially impact our strategy to expand by acquiring additional LTCHs if such LTCHs can be acquired at attractive valuations. This moratorium, however, may still otherwise adversely affect our ability to increase long term acute care bed capacity, expand into new areas or increase bed capacity in existing areas we serve.

Government implementation of recent changes to Medicare's method of reimbursing our long term acute care hospitals will reduce our future net operating revenues and profitability.

The May 2007 final rule changed the payment methodology for Medicare patients with a length of stay less than or equal to five-sixths of the geometric average length of stay for each long term care diagnosis-related group, or LTC-DRG (also referred to as short-stay outlier or SSO cases). Under this methodology, as a patient's length of stay increases, the percentage of the per diem amount based upon the IPPS component decreases and the percentage based on the LTC-DRG component increases. For the three year period beginning on December 29, 2007, the SCHIP Extension Act delays the SSO policy changes made in the May 2007 final rule. In an interim final rule dated May 6, 2008, CMS revised the regulations to provide that the change in the SSO policy adopted in the RY 2008 annual payment update does not apply for a three year period beginning with discharges occurring on or after December 29, 2007 and before December 29, 2010. The implementation of the payment methodology for short-stay outliers discharged after December 29, 2010 will reduce our future net operating revenues and profitability.

A long term acute care hospital is paid a pre-determined fixed amount for Medicare patients under LTCH-PPS depending upon the LTC-DRG to which each patient is assigned. LTCH-PPS includes special payment policies that adjust the payments for some patients based on a variety of factors. On May 12, 2006, CMS published its final annual payment rate updates for the 2007 LTCH-PPS rate year. We refer to such May 2006 rule as the May 2006 final rule. The May 2006 final rule made several changes to LTCH-PPS payment methodologies and amounts. For discharges occurring on or after July 1, 2006, the rule changed the payment methodology for SSO cases. Payment for these patients was previously based on the lesser of (1) 120% of the cost of the case, (2) 120% of the LTC-DRG specific per diem amount multiplied by the patient's length of stay or (3) the full LTC-DRG payment. The May 2006 final rule modified the limitation in clause (1) above to reduce payment for SSO cases to 100% (rather than 120%) of the cost of the case. The final rule also added a fourth limitation, capping payment for SSO cases at a per diem rate derived from blending 120% of the LTC-DRG specific per diem amount with a per diem rate based on the general acute care hospital IPPS. Under this methodology, as a patient's length of stay increases, the percentage of the per diem amount based upon the IPPS component decreases and the percentage based on the LTC-DRG component increases.

On May 1, 2007, CMS published its final annual payment rate updates for the 2007 LTCH-PPS rate year. The May 2007 final rule further revised the payment adjustment for SSO cases. Beginning with discharges on or after July 1, 2007, for cases with a length of stay that is less than the average length of stay plus one standard deviation for the same diagnosis-related group, or DRG, under IPPS, referred to as the so-called IPPS comparable threshold, the rule

effectively lowered the LTCH payment to a rate based on the general acute care hospital IPPS. SSO cases with covered lengths of stay that exceed the IPPS comparable threshold would continue to be paid under the SSO payment policy described above under the May 2006 final rule. Cases with a covered length of stay less than or equal to the IPPS comparable threshold and less than five-sixths of the geometric average length of stay for that LTC-DRG would be paid at an amount comparable to the IPPS per diem. As previously stated, the SCHIP Extension

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Act delays the SSO policy changes made in the May 2007 final rule for the three year period beginning on December 29, 2007.

CMS estimated that the changes in the May 2006 final rule would result in an approximately 3.7% decrease in LTCH Medicare payments-per-discharge compared to the 2006 rate year, largely attributable to the revised SSO payment methodology. We estimated that the May 2006 final rule reduced Medicare revenues associated with SSO cases and high-cost outlier cases to our long term acute care hospitals by approximately \$29.3 million for the 2007 rate year (July 1, 2006 to June 30, 2007). Of this amount, we estimated an effect of approximately \$15.3 million on our Medicare payments for 2007 and \$14.0 million on our Medicare payments for 2006. Additionally, had CMS updated the LTCH-PPS standard federal rate by the 2007 estimated market basket index of 3.4% rather than applying the zero-percent update, we estimated that we would have received approximately \$31.0 million in additional annual Medicare revenues. We based this increase on our historical Medicare patient volumes and revenues (such revenues would have been paid to our hospitals for discharges beginning on or after July 1, 2006). See Business Government Regulations and Business Government Regulations Overview of U.S. and State Government Reimbursements Long Term Acute Care Hospital Medicare Reimbursement.

If our long term acute care hospitals fail to maintain their certifications as long term acute care hospitals or if our facilities operated as HIHs fail to qualify as hospitals separate from their host hospitals, our net operating revenues and profitability may decline.

All of our 87 long term acute care hospitals are currently certified by Medicare as long term acute care hospitals. Long term acute care hospitals must meet certain conditions of participation to enroll in, and seek payment from, the Medicare program as a long term acute care hospital, including, among other things, maintaining an average length of stay for Medicare patients in excess of 25 days. Similarly, our HIHs must meet conditions of participation in the Medicare program, which include additional criteria establishing separateness from the hospital with which the HIH shares space. If our long term acute care hospitals or HIHs fail to meet or maintain the standards for certification as long term acute care hospitals, they will receive payment under the general acute care hospitals IPPS which is generally lower than payment under the system applicable to long term acute care hospitals. Payments at rates applicable to general acute care hospitals would result in our long term acute care hospitals receiving significantly less Medicare reimbursement than they currently receive for their patient services.

Implementation of additional patient or facility criteria for LTCHs that limit the population of patients eligible for our hospitals services or change the basis on which we are paid could adversely affect our net operating revenue and profitability.

CMS and industry stakeholders have, for a number of years, explored the development of facility and patient certification criteria for LTCHs, potentially as an alternative to the current specific payment adjustment features of LTCH-PPS. In its June 2004 Report to Congress, the Medicare Payment Advisory Commission recommended the adoption by CMS of new facility staffing and services criteria and patient clinical characteristics and treatment requirements for LTCHs in order to ensure that only appropriate patients are admitted to these facilities. The Medicare Payment Advisory Commission is an independent federal body that advises Congress on issues affecting the Medicare program. After the Medicare Payment Advisory Commission's recommendation, CMS awarded a contract to Research Triangle Institute International to examine such recommendation. However, while acknowledging that Research Triangle Institute International's findings are expected to have a substantial impact on future Medicare policy for LTCHs, CMS stated in the May 2006 final rule that many of the specific payment adjustment features of LTCH-PPS then in place may still be necessary and appropriate even with the development of patient- and facility-level criteria for LTCHs. In the preamble to the RY 2009 LTCH-PPS proposed rule, CMS indicated that Research Triangle Institute International continues to work with the clinical community to make recommendations to CMS regarding payment and treatment of critically ill patients in LTCHs. The SCHIP Extension Act requires the Secretary of the Department

of Health and Human Services to conduct a study and submit a report to Congress by June 29, 2009 on the establishment of national LTCH facility and patient criteria and to consider the recommendations contained in the Medicare Payment Advisory Commission's June 2004 report to Congress. Implementation of additional criteria that may limit the population of patients eligible for our hospitals' services or change the basis on which we are paid could adversely affect

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our net operating revenues and profitability. See [Business](#) [Government Regulations](#) [Overview of U.S. and State Government Reimbursements](#) [Long Term Acute Care Hospital Medicare Reimbursement](#).

Implementation of modifications to the admissions policies of our inpatient rehabilitation facilities as required in order to achieve compliance with Medicare regulations may result in a reduction of patient volume at these hospitals and, as a result, may reduce our future net operating revenues and profitability.

All five of our acute medical rehabilitation hospitals are currently certified by Medicare as inpatient rehabilitation facilities, or IRFs. In order for these facilities to be eligible for payment under the IRF prospective payment system (IRF-PPS) for services provided to Medicare patients, each IRF must establish that, during its most recent 12-month cost reporting period, it served an inpatient population requiring intensive rehabilitation services. In particular, for cost reporting periods beginning on or after July 1, 2005, at least 60 percent of an IRFs inpatient population must require intensive rehabilitation services for treatment of one or more of 13 specific conditions with specified comorbidities counting toward this threshold.

In order to comply with Medicare inpatient rehabilitation facility certification criteria, it may be necessary for us to implement more restrictive admissions policies at our inpatient rehabilitation facilities and not admit patients whose diagnoses fall outside the specified conditions. Such policies may result in a reduction of patient volume at these hospitals and, as a result, may reduce our future net operating revenues and profitability. See [Business](#) [Government Regulations](#).

Implementation of annual caps that limit the amount that can be paid for outpatient therapy services rendered to any Medicare beneficiary may reduce our future net operating revenues and profitability.

Our outpatient rehabilitation clinics receive payments from the Medicare program under a fee schedule. Congress has established annual caps that limit the amount that can be paid (including deductible and coinsurance amounts) for outpatient therapy services rendered to any Medicare beneficiary. As directed by Congress in the Deficit Reduction Act of 2005, CMS implemented an exception process for therapy expenses incurred in 2006. Under this process, a Medicare enrollee (or person acting on behalf of the Medicare enrollee) was able to request an exception from the therapy caps if the provision of therapy services was deemed to be medically necessary. Therapy cap exceptions were available automatically for certain conditions and on a case-by-case basis upon submission of documentation of medical necessity. The SCHIP Extension Act extended the cap exception process through June 30, 2008. The Medicare Improvements for Patients and Providers Act of 2008 further extended the caps exceptions process through December 31, 2009.

To date, the implementation of the therapy caps has not had a material adverse effect on our business. However, if the exception process to therapy caps expires and is not renewed, our future net operating revenues and profitability may decline. For the year ended December 31, 2008 and the six months ended June 30, 2009, we received approximately 9.5% and 9.7%, respectively, of our outpatient rehabilitation net operating revenues from Medicare. See [Business](#) [Government Regulations](#).

Our facilities are subject to extensive federal and state laws and regulations relating to the privacy of individually identifiable information.

The Health Insurance Portability and Accountability Act of 1996 required the United States Department of Health and Human Services to adopt standards to protect the privacy and security of individually identifiable health-related information. The department released final regulations containing privacy standards in December 2000 and published revisions to the final regulations in August 2002. The privacy regulations extensively regulate the use and disclosure of individually identifiable health-related information. The regulations also provide patients with significant new

rights related to understanding and controlling how their health information is used or disclosed. The security regulations require health care providers to implement administrative, physical and technical practices to protect the security of individually identifiable health information that is maintained or transmitted electronically.

Violations of the Health Insurance Portability and Accountability Act of 1996 could result in civil or criminal penalties. In addition, there are numerous Federal and state laws and regulations addressing patient and consumer privacy concerns, including unauthorized access or theft of personal information. State statutes and regulations vary

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from state to state and could impose additional penalties. We have developed a comprehensive set of policies and procedures in our efforts to comply with the Health Insurance Portability and Accountability Act of 1996 and other privacy laws. Our compliance officers and information security officers are responsible for implementing and monitoring compliance with our privacy and security policies and procedures at our facilities. We believe that the cost of our compliance with the Health Insurance Portability and Accountability Act of 1996 and other federal and state privacy laws will not have a material adverse effect on our business, financial condition, results of operations or cash flows.

As a result of increased post-payment reviews of claims we submit to Medicare for our services, we may incur additional costs and may be required to repay amounts already paid to us.

We are subject to regular post-payment inquiries, investigations and audits of the claims we submit to Medicare for payment for our services. These post-payment reviews are increasing as a result of new government cost-containment initiatives, including enhanced medical necessity reviews for Medicare patients admitted to LTCHs, and audits of Medicare claims under the Recovery Audit Contractor program, which is transitioning to a national program. These additional post-payment reviews may require us to incur additional costs to respond to requests for records and to pursue the reversal of payment denials, and ultimately may require us to refund amounts paid to us by Medicare that are determined to have been overpaid.

Future acquisitions or joint ventures may use significant resources, may be unsuccessful and could expose us to unforeseen liabilities.

As part of our growth strategy, we may pursue acquisitions or joint ventures of specialty hospitals, outpatient rehabilitation clinics and other related health care facilities and services. These acquisitions or joint ventures may involve significant cash expenditures, debt incurrence, additional operating losses and expenses that could have a material adverse effect on our financial condition and results of operations. Acquisitions or joint ventures (such as our acquisition of HealthSouth Corporation's outpatient rehabilitation division) involve numerous risks, including:

difficulty and expense of integrating acquired personnel into our business;

diversion of management's time from existing operations;

potential loss of key employees or customers of acquired companies; and

assumption of the liabilities and exposure to unforeseen liabilities of acquired companies, including liabilities for failure to comply with healthcare regulations.

We cannot assure you that we will succeed in obtaining financing for acquisitions or joint ventures at a reasonable cost, or that such financing will not contain restrictive covenants that limit our operating flexibility. We also may be unable to operate acquired hospitals and outpatient rehabilitation clinics profitably or succeed in achieving improvements in their financial performance.

Future cost containment initiatives undertaken by private third-party payors may limit our future net operating revenues and profitability.

Initiatives undertaken by major insurers and managed care companies to contain healthcare costs affect the profitability of our specialty hospitals and outpatient rehabilitation clinics. These payors attempt to control healthcare costs by contracting with hospitals and other healthcare providers to obtain services on a discounted basis. We believe that this trend may continue and may limit reimbursements for healthcare services. If insurers or managed care

companies from whom we receive substantial payments reduce the amounts they pay for services, our profit margins may decline, or we may lose patients if we choose not to renew our contracts with these insurers at lower rates.

If we fail to maintain established relationships with the physicians in the areas we serve, our net operating revenues may decrease.

Our success is partially dependent upon the admissions and referral practices of the physicians in the communities our hospitals and our outpatient rehabilitation clinics serve, and our ability to maintain good relations with these physicians. Physicians referring patients to our hospitals and clinics are generally not our employees and,

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in many of the local areas that we serve, most physicians have admitting privileges at other hospitals and are free to refer their patients to other providers. If we are unable to successfully cultivate and maintain strong relationships with these physicians, our hospitals' admissions and clinics' businesses may decrease, and our net operating revenues may decline.

Changes in federal or state law limiting or prohibiting certain physician referrals may preclude physicians from investing in our hospitals or referring to hospitals in which they already own an interest.

The federal self-referral law, or Stark Law, 42 U.S.C. § 1395nn, prohibits a physician who has a financial relationship with an entity from referring his or her Medicare or Medicaid patients to that entity for certain designated health services, including inpatient and outpatient hospital services. Under current law, physicians who have a direct or indirect ownership interest in a hospital will not be prohibited from referring to the hospital because of the applicability of the whole hospital exception to the Stark Law. Various bills recently introduced in Congress have included provisions that further restrict physician ownership in hospitals to which the physician refers patients. These provisions would typically limit the Stark Law's whole hospital exception to existing hospitals with physician ownership. Physicians with ownership in new hospitals would be prohibited from referring to that hospital. Certain requirements and limitations would also be placed on existing hospitals with physician ownership, such as limiting the expansion of any such hospital and limiting the amount and terms of physician investment. Furthermore, initiatives are underway in some states to restrict physician referrals to physician-owned hospitals. Currently, nine of our hospitals have physicians as minority owners. The aggregate revenue of these nine hospitals was \$151.1 million for the year ended 2008, or approximately 7.0% of our revenues for the year ended December 31, 2008. The average physician minority ownership of these hospitals was approximately 12.3% for the year ended December 31, 2008. There can be no assurance that new legislation or regulation prohibiting or limiting physician referrals to physician-owned hospitals will not be successfully enacted in the future. If such federal or state laws are adopted, among other outcomes, physicians who have invested in, or considered investing in, our hospitals could be precluded from referring to, investing in or continuing to be physician owners of a hospital. In addition, expansion of our physician-owned hospitals may be limited, and the revenues, profitability and overall financial performance of our hospitals may be negatively affected.

Shortages in qualified nurses or therapists could increase our operating costs significantly.

Our specialty hospitals are highly dependent on nurses for patient care and our outpatient rehabilitation clinics are highly dependant on therapists for patient care. The availability of qualified nurses and therapists nationwide has declined in recent years, and the salaries for nurses and therapists have risen accordingly. We cannot assure you we will be able to attract and retain qualified nurses or therapists in the future. Additionally, the cost of attracting and retaining nurses and therapists may be higher than we anticipate, and as a result, our profitability could decline.

Competition may limit our ability to acquire hospitals and clinics and adversely affect our growth.

We have historically faced limited competition in acquiring specialty hospitals and outpatient rehabilitation clinics, but we may face heightened competition in the future. Our competitors may acquire or seek to acquire many of the hospitals and clinics that would be suitable acquisition candidates for us. This increased competition could hamper our ability to acquire companies, or such increased competition may cause us to pay a higher price than we would otherwise pay in a less competitive environment. Increased competition from both strategic and financial buyers could limit our ability to grow by acquisitions or make our cost of acquisitions higher and therefore decrease our profitability.

If we fail to compete effectively with other hospitals, clinics and healthcare providers in our local areas, our net operating revenues and profitability may decline.

The healthcare business is highly competitive, and we compete with other hospitals, rehabilitation clinics and other healthcare providers for patients. If we are unable to compete effectively in the specialty hospital and outpatient rehabilitation businesses, our net operating revenues and profitability may decline. Many of our specialty hospitals operate in geographic areas where we compete with at least one other hospital that provides similar

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services. Our outpatient rehabilitation clinics face competition from a variety of local and national outpatient rehabilitation providers. Other outpatient rehabilitation clinics in local areas we serve may have greater name recognition and longer operating histories than our clinics. The managers of these clinics may also have stronger relationships with physicians in their communities, which could give them a competitive advantage for patient referrals.

Our business operations could be significantly disrupted if we lose key members of our management team.

Our success depends to a significant degree upon the continued contributions of our senior officers and key employees, both individually and as a group. Our future performance will be substantially dependent in particular on our ability to retain and motivate four key employees, Rocco A. Ortenzio, our Executive Chairman, Robert A. Ortenzio, our Chief Executive Officer, Patricia A. Rice, our President and Chief Operating Officer, and Martin F. Jackson, our Executive Vice President and Chief Financial Officer. We currently have an employment agreement in place with each of Messrs. Rocco and Robert Ortenzio and Ms. Rice and a change in control agreement with Mr. Jackson. Each of these individuals also has a significant equity ownership in our company. We have no reason to believe that we will lose the services of any of these individuals in the foreseeable future; however, we currently have no effective replacement for any of these individuals due to their experience, reputation in the industry and special role in our operations. We also do not maintain any key life insurance policies for any of our employees. The loss of the services of any of these individuals would disrupt significant aspects of our business, could prevent us from successfully executing our business strategy and could have a material adverse affect on our results of operations.

Significant legal actions as well as the cost and possible lack of available insurance could subject us to substantial uninsured liabilities.

Physicians, hospitals and other healthcare providers have become subject to an increasing number of legal actions alleging malpractice, product liability or related legal theories. Many of these actions involve large claims and significant defense costs. We are also subject to lawsuits under federal and state whistleblower statutes designed to combat fraud and abuse in the healthcare industry. These whistleblower lawsuits are not covered by insurance and can involve significant monetary damages and award bounties to private plaintiffs who successfully bring the suits.

We currently maintain professional malpractice liability insurance and general liability insurance coverages under a combination of policies with a total annual aggregate limit of \$30.0 million. Our insurance for the professional liability coverage is written on a claims-made basis and our commercial general liability coverage is maintained on an occurrence basis. These coverages are generally subject to a self-insured retention of \$2.0 million per medical incident for professional liability claims and \$2.0 million per occurrence for general liability claims. We review our insurance program annually and may make adjustments to the amount of insurance coverage and self-insured retentions in future years. In recent years, many insurance underwriters have become more selective in the insurance limits and types of coverage they will provide as a result of rising settlement costs. Insurance underwriters, in some instances, will no longer underwrite risk in certain states that have a history of high medical malpractice awards. There can be no assurance that malpractice insurance will be available in certain states in the future nor that we will be able to obtain insurance coverage at a reasonable price. Since our professional liability insurance is on a claims-made basis, any failure to obtain malpractice insurance in any state in the future would increase our exposure not only to claims arising such state in the future but also to claims arising from injuries that may have already occurred but which had not been reported during the period in which we previously had insurance coverage in that state. In addition, our insurance coverage does not cover punitive damages and may not cover all claims against us. See Business Government Regulations Other Healthcare Regulations.

Concentration of ownership among our existing executives, directors and principal stockholders may prevent new investors from influencing significant corporate decisions.

Upon completion of this offering, Welsh Carson and Thoma Cressey will beneficially own approximately 53.9% and 8.2%, respectively, of our outstanding common stock. Our executives, directors and principal stockholders, including Welsh Carson and Thoma Cressey, will beneficially own, in the aggregate, approximately 80.8% of our outstanding common stock. As a result, these stockholders will have significant control over our management and policies and will be

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able to exercise influence over all matters requiring stockholder approval, including the election of directors, amendment of our certificate of incorporation and approval of significant corporate transactions. The directors elected by these stockholders will be able to make decisions affecting our capital structure, including decisions to issue additional capital stock, implement stock repurchase programs and incur indebtedness. This influence may have the effect of deterring hostile takeovers, delaying or preventing changes in control or changes in management, or limiting the ability of our other stockholders to approve transactions that they may deem to be in their best interest.

We are a holding company and therefore depend on our subsidiaries to service our obligations under our indebtedness and for any funds to pay dividends to our stockholders. Our ability to repay our indebtedness or pay dividends to our stockholders depends entirely upon the performance of our subsidiaries and their ability to make distributions.

We have no operations of our own and derive all of our revenues and cash flow from our subsidiaries. Our subsidiaries are separate and distinct legal entities and have no obligation, contingent or otherwise, to pay any amounts due under our 10% senior subordinated notes and senior floating rate notes, or to make any funds available therefor, whether by dividend, distribution, loan or other payments. In addition, any of our rights in the assets of any of our subsidiaries upon any liquidation or reorganization of any subsidiary will be subject to the prior claims of that subsidiary's creditors, including lenders under our senior secured credit facility and holders of Select's 75/8% senior subordinated notes. On a pro forma as adjusted basis giving effect to this offering and the use of proceeds therefrom, our total consolidated balance sheet liabilities as of June 30, 2009 were \$1,877.1 million, of which \$1,436.4 million constituted indebtedness, including \$507.4 million of indebtedness (excluding \$30.7 million of letters of credit) under our senior secured credit facility, \$611.5 million of Select's 75/8% senior subordinated notes, \$136.4 million of our 10% senior subordinated notes and \$175.0 million of our senior floating rate notes. Our total consolidated balance sheet liabilities as of June 30, 2009 were \$2,138.2 million, of which \$1,697.1 million constituted indebtedness, including \$768.1 million of indebtedness (excluding \$30.7 million of letters of credit) under our senior secured credit facility, \$611.5 million of Select's 75/8% senior subordinated notes, \$136.4 million of our 10% senior subordinated notes and \$175.0 million of our senior floating rate notes. In addition, as of such date, we would have been able to borrow up to an additional \$154.3 million under our senior secured credit facility. We and our restricted subsidiaries may incur additional debt in the future, including borrowings under our senior secured credit facility.

We depend on our subsidiaries, which conduct the operations of the business, for dividends and other payments to generate the funds necessary to meet our financial obligations, including payments of principal and interest on our indebtedness. We would also depend on our subsidiaries for any funds to pay dividends to our stockholders. In the event our subsidiaries are unable to pay dividends to us, we may not be able to service debt, pay obligations or pay dividends on common stock. The terms of our senior secured credit facility and the terms of the indentures governing Select's 75/8% senior subordinated notes restrict Select and its subsidiaries from, in each case, paying dividends or otherwise transferring its assets to us. Such restrictions include, among others, financial covenants, prohibition of dividends in the event of a default and limitations on the total amount of dividends. In addition, legal and contractual restrictions in agreements governing other current and future indebtedness, as well as financial condition and operating requirements of our subsidiaries, currently limit and may, in the future, limit our ability to obtain cash from our subsidiaries. The earnings from other available assets of our subsidiaries may not be sufficient to pay dividends or make distributions or loans to enable us to make payments in respect of our indebtedness when such payments are due. In addition, even if such earnings were sufficient, we cannot assure you that the agreements governing the current and future indebtedness of our subsidiaries will permit such subsidiaries to provide us with sufficient dividends, distributions or loans to fund interest and principal payments on our indebtedness when due. If our subsidiaries are unable to make dividends or otherwise distribute funds to us, we may not be able to satisfy the terms of our indebtedness, there will not be sufficient funds remaining to make distributions to our stockholders and the value of your investment in our common stock will be materially decreased.

Our substantial indebtedness may limit the amount of cash flow available to invest in the ongoing needs of our business.

We have a substantial amount of indebtedness. On a pro forma as adjusted basis giving effect to this offering and the use of proceeds therefrom, as of June 30, 2009 we had approximately \$1,436.4 million of total indebtedness. As of June 30, 2009, we had approximately \$1,697.1 million of total indebtedness. For the year ended December 31, 2008 and the six

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month period ended June 30, 2009, our principal repayments on indebtedness, including our repayments under our revolving credit facility net of borrowings were \$13.5 million and \$72.4 million, respectively. Additionally, for the year ended December 31, 2008 and the six month period ended June 30, 2009, we paid cash interest of \$135.8 million and \$64.7 million, respectively on our indebtedness.

Our indebtedness could have important consequences to you. For example, it:

requires us to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness, reducing the availability of our cash flow to fund working capital, capital expenditures, development activity, acquisitions and other general corporate purposes;

increases our vulnerability to adverse general economic or industry conditions;

limits our flexibility in planning for, or reacting to, changes in our business or the industries in which we operate;

makes us more vulnerable to increases in interest rates, as borrowings under our senior secured credit facility and the senior floating rate notes are at variable rates;

limits our ability to obtain additional financing in the future for working capital or other purposes, such as raising the funds necessary to repurchase all notes tendered to us upon the occurrence of specified changes of control in our ownership; and

places us at a competitive disadvantage compared to our competitors that have less indebtedness.

See Description of Indebtedness, Unaudited Pro Forma Consolidated Financial Information and Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

Our senior secured credit facility requires Select to comply with certain financial covenants, the default of which may result in the acceleration of certain of our indebtedness.

Our senior secured credit facility requires Select to maintain certain interest expense coverage ratios and leverage ratios which become more restrictive over time. For the four consecutive fiscal quarters ended June 30, 2009, Select was required to maintain an interest expense coverage ratio (its ratio of consolidated EBITDA to cash interest expense) for the prior four consecutive quarters of at least 1.75 to 1.00. As of June 30, 2009, Select was required to maintain its leverage ratio (its ratio of total indebtedness to consolidated EBITDA for the prior four consecutive fiscal quarters) at less than 5.25 to 1.00. On a pro forma as adjusted basis giving effect to this offering and the use of proceeds therefrom, for the four quarters ended June 30, 2009, Select's interest expense coverage ratio was 2.42 to 1.00 and Select's leverage ratio was 3.68 to 1.00 based upon the initial public offering price of \$10.00 per share. Select's actual interest expense coverage ratio was 2.25 to 1.00 for the four quarters ended June 30, 2009, and Select's actual leverage ratio was 4.56 to 1.00 as of June 30, 2009.

While Select has never defaulted on compliance with any of these financial covenants, its ability to comply with these ratios in the future may be affected by events beyond its control. Inability to comply with the required financial ratios could result in a default under our senior secured credit facility. In the event of any default under our senior secured credit facility, the lenders under our senior secured credit facility could elect to terminate borrowing commitments and declare all borrowings outstanding, together with accrued and unpaid interest and other fees, to be immediately due and payable. Any default under our senior secured credit facility that results in the acceleration of the outstanding indebtedness under our senior secured credit facility would also constitute an event of default under Select's

75/8% senior subordinated notes and the senior floating rate notes, and the trustee or holders of each such notes could elect to declare such notes to be immediately due and payable. See Description of Indebtedness.

Despite our substantial level of indebtedness, we and our subsidiaries may be able to incur additional indebtedness. This could further exacerbate the risks described above.

We and our subsidiaries may be able to incur additional indebtedness in the future. Although our senior secured credit facility, the indentures governing each of Select's 75/8% senior subordinated notes and the senior floating rate notes each contain or will contain restrictions on the incurrence of additional indebtedness, these restrictions are subject to a

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number of qualifications and exceptions, and the indebtedness incurred in compliance with these restrictions could be substantial. Also, these restrictions do not prevent us or our subsidiaries from incurring obligations that do not constitute indebtedness. As of June 30, 2009, we had \$154.3 million of revolving loan availability under our senior secured credit facility (after giving effect to \$30.7 million of outstanding letters of credit). In addition, to the extent new debt is added to our and our subsidiaries' current debt levels, the substantial leverage risks described above would increase. See Description of Indebtedness.

Our inability to access external sources of financing when our senior secured credit facility terminates could have a material adverse effect on our business, operating results and financial condition.

Our Tranche B term loans mature on February 24, 2012 and Tranche B-1 term loans mature on August 22, 2014. Our revolving credit facility will terminate on February 24, 2011.

We expect to repay and/or refinance indebtedness under our senior secured credit facility at or prior to its scheduled termination or maturity, as applicable. In addition, upon its termination, we will need to enter into a new revolving credit facility to continue to operate our business. There can be no assurance that we will be successful in our effort to enter into a new revolving credit facility and/or refinance indebtedness under our senior secured credit facility in the future. Many lenders have been adversely impacted by recent events in the United States and international financial markets and, as a result, have ceased or reduced the amount of lending they have made available to borrowers. While we expect there to be alternatives available to us to enter into a new revolving credit facility and/or refinance our indebtedness under our senior secured credit facility, we cannot assure you that any of these alternatives will be successfully implemented.

We depend on our revolving credit facility to meet our cash requirements to operate our business. If we repay our revolving credit facility upon its termination and are unable to enter into a new revolving credit facility on terms acceptable to us, or at all, we may be forced to reduce our operations and may not be able to respond to changing business conditions or competitive pressures. As a result, our business, operating results and financial condition could be adversely affected.

Our inability to refinance our revolving credit facility, Tranche B term loans and Tranche B-1 term loans prior to their scheduled termination or maturity could cause an event of default under our senior secured credit facility because we may not otherwise have cash available to make final repayments of principal under our revolving credit facility, Tranche B term loans and Tranche B-1 term loans. We cannot assure you that we will be able to refinance indebtedness under our senior secured credit facility on terms acceptable to us, if at all. If an event of default were to occur under our senior secured credit facility due to our failure to make repayments of principal upon the termination or maturity of our revolving credit facility, Tranche B term loans or Tranche B-1 term loans, then an event of default would also occur under Select's 75/8% senior subordinated notes, our senior floating rate notes and our 10% senior subordinated notes. Upon an event of default under our senior secured credit facility, Select's 75/8% senior subordinated notes, our senior floating rate notes and our 10% senior subordinated notes, our lenders will be entitled to take various actions, including all actions permitted to be taken by a secured creditor, and our business, operating results and financial condition could be adversely affected. See Description of Indebtedness Senior Secured Credit Facility Restrictive Covenants and Other Matters.

We are exposed to the credit risk of our payors which in the future may cause us to make larger allowances for doubtful accounts or incur bad debt write-offs.

In the future, due to deteriorating economic conditions or other factors commercial payors may default on their payments to us, and individual patients may default on co-payments and deductibles for which they are responsible under the terms of either commercial insurance programs or Medicare. Although we review the credit risk of our

commercial payors regularly, such risks will nevertheless arise from events or circumstances that are difficult to anticipate or control, such as a general economic downturn. As a result of the credit risk exposure of our payors defaulting on their payments to us in the future, we may have to make larger allowances for doubtful accounts or incur bad debt write-offs, both of which may have an adverse impact on our profitability.

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Adverse economic conditions could materially adversely affect our net operating revenues in our outpatient rehabilitation segment from commercial payors.

Our net operating revenues may be materially adversely affected by adverse conditions in the general economy that could reduce the frequency of visits by patients of our outpatient rehabilitation clinics. While we believe that patient demand for the services provided by our outpatient rehabilitation clinics will not generally be impacted by the current state of the general economy, adverse economic conditions may result in some patients with commercial insurance electing to defer treatment or decrease the frequency of visits to our outpatient rehabilitation clinics in order to minimize their copay obligations. This could have a material adverse effect on the amount of our net operating revenues in our outpatient rehabilitation segment from commercial payors.

Risks Relating to this Offering

The price of our common stock may be volatile and you could lose all or part of your investment.

Volatility in the market price of our common stock may prevent you from being able to sell your shares at or above the price you paid for your shares. The market price of our common stock could fluctuate significantly for various reasons, which include:

our quarterly or annual earnings or those of other companies in our industry;

changes in laws or regulations, or new interpretations or applications of laws and regulations, that are applicable to our business;

the public's reaction to our press releases, our other public announcements and our filings with the SEC;

changes in accounting standards, policies, guidance, interpretations or principles;

additions or departures of our senior management personnel;

sales of common stock by our directors and executive officers;

sales or distribution of common stock by our sponsors;

adverse market reaction to any indebtedness we may incur or securities we may issue in the future;

downgrades of our stock or negative research reports published by securities or industry analysts;

actions by stockholders; and

changes in general conditions in the United States and global economies or financial markets, including those resulting from Acts of God, war, incidents of terrorism or responses to such events.

In addition, in recent years, the stock market has experienced extreme price and volume fluctuations. This volatility has had a significant impact on the market price of securities issued by many companies, including companies in our industry. The price of our common stock could fluctuate based upon factors that have little or nothing to do with our company, and these fluctuations could materially reduce our stock price.

In the past, following periods of market volatility in the price of a company's securities, security holders have often instituted class action litigation. If the market value of our common stock experiences adverse fluctuations and we become involved in this type of litigation, regardless of the outcome, we could incur substantial legal costs and our management's attention could be diverted from the operation of our business, causing our business to suffer.

There is no existing market for our common stock and we do not know if one will develop to provide you with adequate liquidity.

There is no existing public market for our common stock. An active market for our common stock may not develop following the completion of this offering, or if it does develop, may not be maintained. If an active trading market does not develop, you may have difficulty selling any of our common stock that you buy. The initial public offering price for the shares will be determined by negotiations between us and the representatives of the underwriters and may not be indicative of prices that will prevail in the open market following this offering.

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Consequently, you may not be able to sell shares of our common stock at prices equal to or greater than the price paid by you in this offering. In addition, our existing officers, directors and principal stockholders will maintain significant ownership interests in our stock following completion of this offering, which may restrict liquidity in the trading market for our stock.

Future sales of our common stock, including shares purchased in this offering, in the public market could lower our stock price.

Sales of substantial amounts of our common stock in the public market following this offering by our existing stockholders, upon the exercise of outstanding stock options or by persons who acquire shares in this offering may adversely affect the market price of our common stock. Such sales could also create public perception of difficulties or problems with our business. These sales might also make it more difficult for us to sell securities in the future at a time and price that we deem necessary or appropriate.

Upon the completion of this offering, we will have outstanding 156,092,873 shares of common stock, of which:

30,000,000 shares are shares that we are selling in this offering and, unless purchased by affiliates, may be resold in the public market immediately after this offering; and

126,092,873 shares will be restricted securities, as defined in Rule 144 under the Securities Act, and eligible for sale in the public market pursuant to the provisions of Rule 144, of which 125,090,669 shares are subject to lock-up agreements and will become available for resale in the public market beginning 180 days after the date of this prospectus.

With limited exceptions, as described under the caption **Underwriters**, these lock-up agreements prohibit a stockholder from selling, contracting to sell or otherwise disposing of any common stock or securities that are convertible or exchangeable for common stock or entering into any arrangement that transfers the economic consequences of ownership of our common stock for at least 180 days from the date of this prospectus. In the event that at least two of the four representatives of the underwriters agree in writing, such representatives may at any time and without notice authorize the release of all or any portion of the securities subject to these lock-up agreements. The representatives of the underwriters have advised us that they have no present intent or agreement to release any shares subject to a lock-up and will consider the release of any lock-up on a case-by-case basis. Upon a request to release any shares subject to a lock-up, the representatives of the underwriters would consider the particular circumstances surrounding the request including, but not limited to, the length of time before the lock-up expires, the number of shares requested to be released, reasons for the request, the possible impact on the market for our common stock and whether the holder of our shares requesting the release is an officer, director or other affiliate of ours. As a result of these lock-up agreements, notwithstanding earlier eligibility for sale under the provisions of Rule 144, none of these shares may be sold until at least 180 days after the date of this prospectus.

At our request, the underwriters have reserved up to 900,000 shares, or 3% of our common stock offered by this prospectus, for sale under a directed share program to our officers, directors, employees, business associates and other individuals who have family or personal relationships with our employees. If any of our current directors or executive officers subject to lock-up agreements purchase these reserved shares, the shares will be restricted from sale under the lock-up agreements. If any of these shares are purchased by other persons, such shares will not be subject to lock-up agreements.

As restrictions on resale end, our stock price could drop significantly if the holders of these restricted shares sell them or are perceived by the market as intending to sell them. These sales might also make it more difficult for us to sell securities in the future at a time and at a price that we deem appropriate.

You will suffer immediate and substantial dilution.

The initial public offering price per share is substantially higher than the pro forma net tangible book value per share immediately after the offering. As a result, you will pay a price per share that substantially exceeds the book value of our tangible assets as of June 30, 2009 after subtracting our liabilities. As illustrated in Dilution, at the initial public offering price of \$10.00 per share, you will incur immediate and substantial dilution in the amount of \$15.92 per share. Purchasers

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of shares of our common stock in this offering will have contributed approximately 30.8% of the aggregate price paid by all purchasers of our common stock, but will only own 19.3% of the shares of our common stock outstanding after this offering. In addition, as of June 30, 2009, there were outstanding options to purchase 1,479,842 shares of common stock at a weighted average exercise price of \$6.73 per share. If the underwriters exercise their over-allotment option, or if outstanding options to purchase our common stock are exercised, you will experience additional dilution. Any future equity issuances will result in even further dilution to holders of our common stock.

Certain provisions of Delaware law and our certificate of incorporation and bylaws that will be in effect after this offering may deter takeover attempts, which may limit the opportunity of our stockholders to sell their shares at a favorable price, and may make it more difficult for our stockholders to remove our board of directors and management.

Provisions in our certificate of incorporation and bylaws, as they will be in effect upon the closing of this offering, may have the effect of delaying or preventing a change of control or changes in our management. These provisions include the following:

prohibition on stockholder action through written consents;

a requirement that special meetings of stockholders be called only by our board of directors;

advance notice requirements for stockholder proposals and nominations;

availability of blank check preferred stock;

establish a classified board of directors so that not all members of our board of directors are elected at one time;

the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors or due to the resignation or departure of an existing board member;

the prohibition of cumulative voting in the election of directors, which would otherwise allow less than a majority of stockholders to elect director candidates;

the ability of our board of directors to alter our bylaws without obtaining stockholder approval;

limitations on the removal of directors; and

the required approval of at least 66 $\frac{2}{3}$ % of the shares entitled to vote at an election of directors to adopt, amend or repeal our bylaws or repeal the provisions of our restated certificate of incorporation regarding the election and removal of directors and the inability of stockholders to take action by written consent in lieu of a meeting.

In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law, or DGCL. These provisions may prohibit large stockholders, particularly those owning 15% or more of our outstanding voting stock, from merging or combining with us. These provisions in our certificate of incorporation and bylaws and under the DGCL could discourage potential takeover attempts, could reduce the price that investors are willing to pay for shares of our common stock in the future and could potentially result in the market price being lower than they would without these provisions.

Although no shares of preferred stock will be outstanding upon the completion of this offering and although we have no present plans to issue any preferred stock, our certificate of incorporation authorizes the board of directors to issue up to 70,000,000 shares of preferred stock. The preferred stock may be issued in one or more series, the terms of which will be determined at the time of issuance by our board of directors without further action by the stockholders. These terms may include voting rights, including the right to vote as a series on particular matters, preferences as to dividends and liquidation, conversion rights, redemption rights and sinking fund provisions. The issuance of any preferred stock could diminish the rights of holders of our common stock and, therefore, could reduce the value of our common stock. In addition, specific rights granted to future holders of preferred stock could be used to restrict our ability to merge with, or sell assets to, a third party. The ability of our board of directors to issue preferred stock and the foregoing anti-takeover provisions may prevent or frustrate attempts by a third party to

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acquire control of our company, even if some of our stockholders consider such change of control to be beneficial. See Description of Capital Stock.

Since we do not expect to pay any dividends for the foreseeable future, investors in this offering may be forced to sell their stock in order to realize a return on their investment.

We do not anticipate that we will pay any dividends to holders of our common stock for the foreseeable future. Any payment of cash dividends will be at the discretion of our board of directors and will depend on our financial condition, capital requirements, legal requirements, earnings and other factors. Our ability to pay dividends is restricted by the terms of our senior secured credit facilities and might be restricted by the terms of any indebtedness that we incur in the future. Consequently, you should not rely on dividends in order to receive a return on your investment. See Dividend Policy.

Affiliates of ours and affiliates of the underwriters will receive a significant portion of the proceeds from this offering.

At the initial public offering price of \$10.00 per share, the net proceeds to us from this offering will be approximately \$278.7 million, after deducting underwriting discounts and commissions and estimated offering expenses payable by us. We will apply at least \$8.2 million of the proceeds to repay indebtedness under our senior secured credit facilities held by affiliates of the underwriters and approximately \$18.0 million of the proceeds to make payments to executive officers under our Long Term Cash Incentive Plan. To the extent the proceeds from this offering are used as described above, they will not be available for other corporate purposes.

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FORWARD-LOOKING STATEMENTS

This prospectus contains forward-looking statements. These statements relate to future events or our future financial performance. We have attempted to identify forward-looking statements by terminology including anticipates, believes, can, continue, could, estimates, expects, intends, may, plans, potential, predicts, and other comparable terminology. These statements are only predictions and involve known and unknown risks, uncertainties, and other factors, including those discussed under Risk Factors. The following factors, among others, could cause our actual results and performance to differ materially from the results and performance projected in, or implied by, the forward-looking statements:

additional changes in government reimbursement for our services may result in a reduction in net operating revenues, an increase in costs and a reduction in profitability;

the failure of our long term acute care hospitals to maintain their status as such 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;

implementation of modifications to the admissions policies for our inpatient rehabilitation facilities, as required to achieve compliance with Medicare guidelines, may result in a loss of patient volume at these hospitals and, as a result, may reduce our future net operating revenues and profitability;

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

future 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 or lack of adequate available insurance could subject us to substantial uninsured liabilities;

the ability to obtain any necessary or desired waiver or amendment from our lenders may be difficult due to the current uncertainty in the credit markets;

the inability to draw funds under our senior secured credit facility because of lender defaults;

concentration of ownership among our existing executives, directors and principal stockholders may prevent new investors from influencing significant corporate decisions; and

other factors discussed under the headings Risk Factors, Management's Discussion and Analysis of Financial Condition and Results of Operations and Business.

Although we believe that the expectations reflected in the forward-looking statements are reasonable based on our current knowledge of our business and operations, we cannot guarantee future results, levels of activity, performance or achievements. Forward-looking statements apply only as of the date of this prospectus and we assume no obligation to provide revisions to any forward-looking statements should circumstances change.

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USE OF PROCEEDS

We estimate that our net proceeds from this offering will be approximately \$278.7 million after deducting underwriting discounts and commissions and estimated offering expenses payable by us. If the underwriters' option to purchase additional shares in this offering is exercised in full, we estimate that our net proceeds will be approximately \$321.0 million.

We intend to use the net proceeds of this offering as follows:

To repay at least \$139.4 million of term loans outstanding under our senior secured credit facility, and any related prepayment costs.

To make payments under the Long Term Cash Incentive Plan in the amount of approximately \$18.0 million, which will be recognized as an expense in the quarter in which the offering occurs. We expect approximately \$4.5 million will be paid to Rocco A. Ortenzio, approximately \$6.3 million will be paid to Robert A. Ortenzio, approximately \$2.7 million will be paid to Patricia A. Rice, approximately \$1.3 million will be paid to Martin F. Jackson, approximately \$0.9 million will be paid to S. Frank Fritsch, approximately \$0.5 million will be paid to David W. Cross, approximately \$0.9 million will be paid to James J. Talalai and approximately \$0.9 million will be paid to Michael E. Tarvin.

Any remaining net proceeds will be used for repayment or repurchase of indebtedness under our senior secured credit facility, Select's 75/8% senior subordinated notes, our senior floating rate notes and/or our 10% senior subordinated notes or for general corporate purposes.

The average interest rate for the year ended December 31, 2008 of our indebtedness under our senior secured credit facility was 6.1%. Our current revolving credit facility will terminate on February 24, 2011. Our Tranche B term loans mature on February 24, 2012 and our Tranche B-1 term loans mature on August 22, 2014. JPMorgan Chase Bank, N.A., an affiliate of J.P. Morgan Securities Inc., Wachovia Bank, National Association, an affiliate of Wells Fargo Securities, LLC, and Merrill Lynch Capital Corporation, an affiliate of Merrill Lynch, Pierce, Fenner & Smith Incorporated are lenders under our senior secured credit facility and therefore affiliates of these underwriters will receive a portion of the net proceeds from this offering and an affiliate of Wells Fargo Securities, LLC will receive more than 5% of the net proceeds from the offering based on the application of the net proceeds from this offering as set forth under Capitalization. Based on term and revolving loans held as of August 31, 2009 and the application of the net proceeds from this offering as set forth under Capitalization, the amounts to be repaid to affiliates of J.P. Morgan Securities Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated and Wells Fargo Securities, LLC with the proceeds from this offering will be approximately \$11.0 million, \$10.9 million and \$22.3 million, respectively. In addition, from time to time, certain of the underwriters and their affiliates may effect transactions for their own account or the account of customers, and hold on behalf of themselves or their customers, long or short positions in our debt or equity securities or loans, and may do so in the future. See Underwriters.

Select's 75/8% senior subordinated notes mature on February 1, 2015 and bear interest at a stated rate of 75/8%. Our senior floating rate notes mature on September 15, 2015 and bear interest at a rate per annum, reset semi-annually, equal to the 6-month LIBOR plus 5.75%. The variable interest rate of our senior floating rate notes was 7.7% at June 30, 2009. Our 10% senior subordinated notes mature on December 15, 2015 and bear interest at a rate of 10% per annum, except that if any interest payment is not paid in cash, such unpaid amount will be multiplied by 1.2 and added to the outstanding principal amount of the notes (with the result that such unpaid interest will have accrued at an effective rate of 12% instead of 10%).

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DIVIDEND POLICY

Since its formation, Holdings has not declared or paid cash dividends on its common stock. Any payment of cash dividends on our common stock in the future will be at the discretion of our board of directors and will depend upon our results of operations, earnings, capital requirements, financial condition, future prospects, contractual restrictions and other factors deemed relevant by our board of directors. In addition, our ability to declare and pay dividends is restricted by covenants in our senior secured credit facility and the indentures governing Select's 75/8% senior subordinated notes and the senior floating rate notes. We currently intend to retain any future earnings to fund the operation, development and expansion of our business and repay outstanding indebtedness, and therefore we do not anticipate paying any cash dividends in the foreseeable future.

Table of Contents**CAPITALIZATION**

The following table sets forth our capitalization as of June 30, 2009:

on an actual basis;

on a pro forma basis to give effect to the conversion of all shares of our issued and outstanding preferred stock into 63,559,714 shares of common stock based upon the initial public offering price of \$10.00 per share as if the conversion had occurred on June 30, 2009; and

on a pro forma as adjusted basis to give effect to (1) the conversion of all shares of our issued and outstanding preferred stock into 63,559,714 shares of common stock based upon the initial public offering price of \$10.00 per share, (2) the sale of shares of common stock in this offering at the initial public offering price of \$10.00 per share, and after deducting underwriting discounts and commissions and estimated fees and expenses payable by us, and (3) the application of all of the net proceeds of this offering to repay indebtedness under our senior secured credit facility and make payments to officers under our Long-Term Cash Incentive Plan as if the events had occurred on June 30, 2009.

You should read this information in conjunction with Prospectus Summary The Offering, Use of Proceeds, Selected Historical Consolidated Financial Data, Management's Discussion and Analysis of Financial Condition and Results of Operations, and with our consolidated financial statements and related notes included elsewhere in this prospectus.

		As of June 30, 2009	
	Actual	Pro Forma	Pro Forma As Adjusted
Cash and cash equivalents	\$ 27,689	\$ 27,689	\$ 27,689
Debt:			
Senior floating rate notes	\$ 175,000	\$ 175,000	\$ 175,000
10% senior subordinated notes due 2015 ⁽¹⁾	136,418	136,418	136,418
Revolving credit facility ⁽²⁾	115,000	115,000	
Term loan facility ⁽³⁾	653,100	653,100	507,400
75/8% senior subordinated notes due 2015	611,500	611,500	611,500
Other debt	6,116	6,116	6,116
Total debt	1,697,134	1,697,134	1,436,434
Preferred stock	528,742		
Total Select Medical Holdings Corporation stockholders' equity	(141,659)	387,083	656,654
Total capitalization	\$ 2,084,217	\$ 2,084,217	\$ 2,093,088

(1) Reflects the balance sheet liability of our 10% senior subordinated notes calculated in accordance with GAAP. The balance sheet liability so reflected is less than the \$150.0 million aggregate principal amount of such notes

because such notes were issued with original issue discount. The remaining unamortized original issue discount is \$13.6 million at June 30, 2009. Interest on our 10% senior subordinated notes accrues on the full principal amount thereof, and we will be obligated to repay the full principal amount thereof at maturity or upon any mandatory or voluntary prepayment thereof. On any interest payment date on or after February 24, 2010, we will be obligated to pay an amount of accrued original issue discount on our 10% senior subordinated notes if necessary to ensure that the notes will not be considered applicable high yield discount obligations within the meaning of the Internal Revenue Code of 1986, as amended. The \$150.0 million aggregate principal payable at maturity on our 10% senior subordinated notes would be reduced by prior payments of accrued original issue discount.

- (2) The revolving credit facility is a part of our senior secured credit facility and provides for borrowings of up to \$300.0 million of which \$154.3 million was available as of June 30, 2009 for working capital and general corporate purposes (after giving effect to \$30.7 million of outstanding letters of credit at June 30, 2009).
- (3) We borrowed \$680.0 million in term loans under our senior secured credit facility. Between February 24, 2005 and June 30, 2009 we repaid approximately \$26.9 million of our outstanding term loans.

Table of Contents**DILUTION**

Purchasers of shares of common stock in this offering will experience immediate and substantial dilution in the net tangible book value of the common stock from the initial public offering price. Net tangible book value per share represents the amount of our total tangible assets less our total liabilities, divided by the number of shares of our common stock outstanding. Dilution in net tangible book value per share represents the difference between the amount per share that you pay in this offering and the net tangible book value per share immediately after this offering. Our net tangible book deficit as of June 30, 2009 was approximately \$1,718.0 million, or \$27.96 per share.

After giving effect to the sale of 30,000,000 shares of our common stock in this offering at the initial public offering price of \$10.00 per share, the conversion of all shares of our issued and outstanding preferred stock into shares of common stock based upon the initial public offering price of \$10.00 per share, the effect on net tangible book value from the payments to officers under the Long Term Incentive Plan and the issuance of restricted stock which will vest upon completion of this offering and after the deduction of underwriting discounts and commissions and estimated fees and expenses payable by us, our pro forma net tangible book deficit at June 30, 2009 would have been approximately \$919.7 million, or \$5.92 per share. This represents an immediate increase in net tangible book value of \$3.60 per share to existing stockholders and an immediate and substantial dilution of \$15.92 per share to new investors. The following table illustrates this per share dilution:

		Per Share
Initial public offering price per share		\$ 10.00
Actual net tangible book deficit per share as of June 30, 2009	\$ (27.96)	
Increase attributable to conversion of preferred stock	18.44	
Increase per share attributable to this offering	3.60	
Pro forma net tangible book value per share after this offering as of June 30, 2009		\$ (5.92)
Dilution per share to new investors		\$ 15.92

If the underwriters exercise in full their over-allotment option to purchase additional shares of our common stock in this offering at the initial public offering price of \$10.00 per share, the number of shares of common stock held by existing stockholders will be 125,375,613, or 78.4% of the aggregate number of shares of common stock outstanding after this offering, the number of shares of common stock held by new investors will be increased to 34,500,000, or 21.6% of the aggregate number of shares of common stock outstanding after this offering, the increase per share attributable to existing investors would be \$4.03, the pro forma net tangible book deficit per share after this offering would be \$5.49, and the dilution per share to new investors would be \$15.49.

The following table summarizes, on the pro forma basis described above as of June 30, 2009, after giving effect to the conversion of 22,148,453 shares of our issued and outstanding preferred stock into 63,559,714 shares of common stock based upon the initial public offering price of \$10.00 per share, the total number of shares of common stock purchased from us and the total consideration and the average price per share paid by existing holders and by investors participating in this offering. The calculation below is based on the initial public offering price of \$10.00 per share, before deducting underwriting discounts and commissions and estimated fees and expenses payable by us.

	Shares Purchased		Total Consideration		Average Price per Share
	Number	Percentage	Amount	Percentage	
Existing holders	125,375,613	80.7%	\$ 673,835,771	69.2%	\$ 5.37
New investors	30,000,000	19.3%	\$ 300,000,000	30.8%	10.00
Total	155,375,613	100.0%	\$ 973,835,771	100.0%	\$ 6.27

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The pro forma dilution information above is for illustration purposes only. The number of shares of our common stock outstanding after the offering as shown above is based on the number of shares outstanding as of June 30, 2009. As of June 30, 2009, there were options outstanding to purchase 1,479,842 shares of our common stock, with exercise prices ranging from \$3.33 to \$10.00 per share and a weighted average exercise price of \$6.73 per share. The tables and calculations above assume that those options have not been exercised. To the extent outstanding options are exercised, you would experience further dilution if the exercise price is less than our net tangible book value per share. In addition, if we grant options, warrants, preferred stock or other convertible securities or rights to purchase our common stock in the future with exercise prices below the initial public offering price, new investors will incur additional dilution upon exercise of such securities or rights.

Table of Contents**SELECTED HISTORICAL CONSOLIDATED FINANCIAL DATA**

You should read the following selected historical consolidated financial data in conjunction with our consolidated financial statements and the accompanying notes. You should also read Management's Discussion and Analysis of Financial Condition and Results of Operations, which is contained elsewhere in this prospectus. The historical financial data as of December 31, 2004, 2005, 2006, 2007 and 2008 and for the year ended December 31, 2004, for the period from January 1 through February 24, 2005 (Predecessor Period), for the period from February 25 through December 31, 2005 and for the years ended December 31, 2006, 2007 and 2008 (Successor Period) have been derived from consolidated financial statements audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm. The selected historical consolidated financial data as of December 31, 2007 and 2008, and for the years ended December 31, 2006, 2007 and 2008 have been derived from our consolidated financial information included elsewhere in this prospectus. The selected historical consolidated financial data as of December 31, 2004, 2005 and 2006 and for the year ended December 31, 2004 and for the period from January 1 through February 24, 2005 (Predecessor Period), and for the period from February 25 through December 31, 2005 (Successor Period) have been derived from our audited consolidated financial information not included elsewhere in this prospectus. We derived the historical financial data as of June 30, 2009 and for the six months ended June 30, 2008 and 2009 from our unaudited interim consolidated financial statements, which are included elsewhere in this prospectus.

	Predecessor Period		Period from February 25 through December 31, 2005⁽¹⁾⁽²⁾	Successor Period		
	Year Ended December 31, 2004⁽¹⁾	Period from January 1 through February 24, 2005⁽¹⁾		Year Ended December 31,		
				2006⁽¹⁾⁽²⁾	2007⁽¹⁾⁽²⁾	2008⁽¹⁾⁽²⁾
	(in thousands, except per share data)		(in thousands, except per share data)			
Statement of Operations Data:						
Net operating revenues	\$ 1,601,524	\$ 277,736	\$ 1,580,706	\$ 1,851,498	\$ 1,991,666	\$ 2,153,362
Operating expenses ⁽³⁾⁽⁴⁾	1,340,068	373,418	1,322,068	1,546,956	1,740,484	1,885,168
Depreciation and amortization	38,951	5,933	37,922	46,668	57,297	71,786
Income (loss) from operations	222,505	(101,615)	220,716	257,874	193,885	196,408
Gain (loss) on early retirement of debt ⁽⁵⁾		(42,736)				912
Merger related charges ⁽⁶⁾		(12,025)				
Other income (expense)	1,096	267	1,092		(167)	
Interest expense, net ⁽⁷⁾	(30,716)	(4,128)	(101,441)	(130,538)	(138,052)	(145,423)
Income (loss) from continuing operations before income taxes	192,885	(160,237)	120,367	127,336	55,666	51,897
	76,551	(59,794)	49,336	43,521	18,699	26,063

Income tax expense (benefit)						
Income (loss) from continuing operations	116,334	(100,443)	71,031	83,815	36,967	25,834
Income from discontinued operations, net of tax	4,458	522	3,072	12,818		
Net income (loss)	120,792	(99,921)	74,103	96,633	36,967	25,834
Less: Net income attributable to non-controlling interests ⁽⁸⁾	2,608	330	1,776	1,754	1,537	3,393
Net income (loss) attributable to Select Medical Holdings Corporation	118,184	(100,251)	72,327	94,879	35,430	22,441
Less: Preferred dividends			23,519	22,663	23,807	24,972
Net income (loss) available to common and preferred stockholders	\$ 118,184	\$ (100,251)	\$ 48,808	\$ 72,216	\$ 11,623	\$ (2,531)

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	Predecessor Period			Successor Period		
	Year Ended December 31, 2004 ⁽¹⁾	Period from January 1 through February 24, 2005 ⁽¹⁾	Period from February 25 through December 31, 2005 ⁽¹⁾⁽²⁾	Year Ended December 31, 2006 ⁽¹⁾⁽²⁾	Year Ended December 31, 2007 ⁽¹⁾⁽²⁾	Year Ended December 31, 2008 ⁽¹⁾⁽²⁾
	(in thousands, except per share data)			(in thousands, except per share data)		
Income (loss) per common share:						
Basic:						
Income (loss) from continuing operations	\$ 1.11	\$ (0.99)	\$ 0.21	\$ 0.26	\$ 0.05	\$ (0.01)
Income from discontinued operations, net of tax	0.04	0.01	0.01	0.06		
Net income (loss)	\$ 1.15	\$ (0.98)	\$ 0.22	\$ 0.32	\$ 0.05	\$ (0.01)
Diluted:						
Income (loss) from continuing operations	\$ 1.07	\$ (0.99)	\$ 0.21	\$ 0.26	\$ 0.05	\$ (0.01)
Income from discontinued operations, net of tax	0.04	0.01	0.01	0.06		
Net income (loss)	\$ 1.11	\$ (0.98)	\$ 0.22	\$ 0.32	\$ 0.05	\$ (0.01)
Weighted average common shares outstanding:						
Basic	102,165	102,026	171,330	180,183	190,286	198,554
Diluted	106,529	102,026	171,330	180,183	190,286	198,554
Balance Sheet Data (at end of period):						
Cash and cash equivalents	\$ 247,476		\$ 35,861	\$ 81,600	\$ 4,529	\$ 64,260
Working capital	313,715		77,556	59,468	14,730	118,370

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Total assets	1,113,721	2,168,385	2,182,524	2,495,046	2,579,469
Total debt	354,590	1,628,889	1,538,503	1,755,635	1,779,925
Total Select Medical Holdings Corporation stockholders equity	515,943	(244,658)	(169,139)	(165,889)	(174,204)

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	Successor Period For the Six Months Ended June 30, 2008⁽¹⁾⁽²⁾ 2009 (in thousands, except per share data)	
Statement of Operations Data:		
Net operating revenues	\$ 1,087,084	\$ 1,120,707
Operating expenses ⁽³⁾⁽⁴⁾	948,992	952,023
Depreciation and amortization	35,327	35,670
Income from operations	102,765	133,014
Gain on early retirement of debt ⁽⁵⁾		15,316
Interest expense, net ⁽⁷⁾	(73,268)	(68,250)
Income from operations before income taxes	29,497	80,080
Income tax expense	13,973	33,880
Net income	15,524	46,200
Less: Net income attributable to non-controlling interests ⁽⁸⁾	1,071	1,412
Net income attributable to Select Medical Holdings Corporation	14,453	44,788
Less: Preferred dividends	12,279	12,870
Net income available to common and preferred stockholders	\$ 2,174	\$ 31,918
Net income per common share:		
Basic	\$ 0.01	\$ 0.14
Diluted	0.01	0.14
Weighted average common shares outstanding:		
Basic	197,270	201,698
Diluted	197,270	203,306
Balance Sheet Data (at end of period):		
Cash and cash equivalents	\$ 7,534	\$ 27,689
Working capital	105,745	103,831
Total assets	2,544,037	2,532,682
Total debt	1,805,462	1,697,134
Total Select Medical Holdings Corporation stockholders' equity	(165,703)	(141,659)

(1) Adjusted for the adoption of SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. See Note 1, Organization and Significant Accounting Policies - Recent Accounting Pronouncements, in our audited consolidated financial statements and Note 2, Accounting Policies - Recent Accounting Pronouncements, in our interim unaudited consolidated financial statements for additional information.

(2) Adjusted for the adoption of FASB Staff Position EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities. See Note 14 in our audited consolidated financial

statements and Note 8 in our interim unaudited consolidated financial statements for additional information.

- (3) Operating expenses include cost of services, general and administrative expenses, and bad debt expenses.
- (4) Includes stock compensation expense related to the repurchase of outstanding stock options in the Predecessor Period from January 1 through February 24, 2005, compensation expense related to restricted stock, stock options and long term incentive compensation in the Successor Periods from February 25 through December 31, 2005, and for the years ended December 31, 2006, 2007 and 2008 and for the six months ended June 30, 2008 and 2009.
- (5) The loss in the Predecessor Period of January 1 through February 24, 2005 consists of the tender premium cost of \$34.8 million and the remaining write-off of unamortized deferred financing costs of \$7.9 million related to the tender offers for all of Select's 9 1/2% senior subordinated notes due 2009 and all of Select's 7 1/2% senior subordinated notes due 2013 completed in connection with the Merger. In the year ended December 31, 2008, we paid approximately \$1.0 million to repurchase and retire a portion of Select's 7 5/8% senior subordinated notes. These notes had a carrying value of \$2.0 million. The gain on early retirement of debt recognized was net of the write-off of unamortized deferred financing costs related to the debt. During the six months ended June 30, 2009, we paid approximately \$30.1 million to repurchase and retire a portion of Select's 7 5/8% senior subordinated notes. These notes had a carrying value of \$46.5 million. The gain on early retirement of debt recognized was net of the write-off of unamortized deferred financing costs related to the debt.
- (6) As a result of the Merger, Select incurred costs in the Predecessor Period of January 1 through February 24, 2005 directly related to the Merger. This included the cost of the investment advisor hired by the special committee of Select's board of directors to evaluate the Merger, legal and accounting fees, costs associated with the Hart-Scott-Rodino filing relating to the Merger, the cost associated with purchasing a six year extended reporting period under our directors and officers liability insurance policy and other associated expenses.
- (7) Interest expense, net equals interest expense minus interest income.
- (8) Reflects interests held by other parties in subsidiaries, limited liability companies and limited partnerships owned and controlled by us.

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UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL INFORMATION

Our consolidated financial statements are included elsewhere in this prospectus. The unaudited pro forma consolidated financial information presented here should be read together with these financial statements and related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations.

We adjusted our historical consolidated statement of operations for the year ended December 31, 2008 and the six months ended June 30, 2009 to reflect (1) the 1 for .30 reverse split of our common stock that occurred on September 24, 2009, (2) the conversion of all shares of our issued and outstanding preferred stock into 63,559,714 shares of common stock based upon the initial public offering price of \$10.00 per share, based on the accreted value of the preferred stock on June 30, 2009, (3) the issuance of 30,000,000 shares of our common stock at the initial public offering price of \$10.00 per share, (4) the increase in our interest expense due to an increase of 1.75% in the interest rate on \$384.5 million principal amount of Tranche B-1 term loans that resulted from Amendment No. 3 to our senior secured credit facility which became effective on August 5, 2009, and (5) the decrease in interest expense resulting from the application of all of the estimated net proceeds from this offering to repay indebtedness under our senior secured credit facility and make payments to officers under our Long Term Cash Incentive Plan as if these events had occurred on January 1, 2008. The pro forma consolidated statement of operations excludes non-recurring charges directly attributable to this offering, including \$10.6 million (net of tax) related to payments under our Long Term Cash Incentive Plan and \$2.6 million (net of tax) related to restricted stock which will vest upon completion of this offering.

We adjusted our historical consolidated balance sheet at June 30, 2009 to reflect (1) the 1 for .30 reverse split of our common stock that occurred on September 24, 2009, (2) the conversion of all shares of our preferred stock into 63,559,714 shares of common stock based upon the initial public offering price of \$10.00 per share, (3) the issuance of 30,000,000 shares of our common stock at the initial public offering price of \$10.00 per share, (4) the application of all of the net proceeds from this offering to repay indebtedness under our senior secured credit facility and make payments to officers under our Long Term Cash Incentive Plan as if these events had occurred on June 30, 2009, and (5) the reduction in equity related to other non-recurring charges related to the offering.

Certain information normally included in financial statements prepared in accordance with generally accepted accounting principles has been omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

The pro forma consolidated balance sheet and pro forma consolidated statements of operations are not necessarily indicative of our financial position and results that would have occurred had the above events been completed on the above indicated dates and should not be construed as being representative of future results of operations.

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	As of June 30, 2009				
	Historical ^(a)	Reverse Stock Split and Conversion of Preferred Stock	Pro Forma (in thousands)	Adjustments for Offering	Pro Forma as Adjusted
ASSETS					
Current Assets:					
Cash and cash equivalents	\$ 27,689		\$ 27,689		\$ 27,689
Accounts receivable, net of allowance for doubtful accounts	339,615		339,615		339,615
Current deferred tax asset	52,270		52,270		52,270
Prepaid income taxes				8,430 ⁽²⁾	8,430
Other current assets	21,776		21,776		21,776
Total Current Assets	441,350		441,350	8,430	449,780
Property and equipment, net	460,420		460,420		460,420
Goodwill	1,506,661		1,506,661		1,506,661
Other identifiable intangibles	69,663		69,663		69,663
Assets held for sale	11,342		11,342		11,342
Other assets	43,246		43,246		43,246
Total Assets	\$ 2,532,682		\$ 2,532,682	8,430	\$ 2,541,112
LIABILITIES AND EQUITY					
Current Liabilities:					
Bank overdrafts	\$ 16,472		\$ 16,472		\$ 16,472
Current portion of long-term debt and notes payable	10,670		10,670		10,670
Accounts payable	68,777		68,777		68,777
Accrued payroll	57,832		57,832		57,832
Accrued vacation	40,380		40,380		40,380
Accrued interest	35,500		35,500		35,500
Accrued restructuring	6,061		6,061		6,061
Accrued other	95,893		95,893		95,893
Income taxes payable	441		441	(441) ⁽²⁾	
Due to third party payors	5,493		5,493		5,493
Total Current Liabilities	337,519		337,519	(441)	337,078
Long-term debt, net of current portion	1,686,464		1,686,464	(260,700) ⁽²⁾	1,425,764

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Non-current deferred tax liability	51,967		51,967		51,967
Other non-current liabilities	62,248		62,248		62,248
Total Liabilities	2,138,198		2,138,198	(261,141)	1,877,057
Preferred stock	528,742	(528,742) ⁽¹⁾			
Stockholders' Equity:					
Common stock	205	(80) ⁽¹⁾	125	30 ⁽²⁾	155
Capital in excess of par	(288,844)	543,661 ⁽¹⁾	254,817	282,306 ⁽²⁾	537,123
Retained earnings	160,103	(14,839) ⁽¹⁾	145,264	(12,765) ⁽²⁾	132,499
Accumulated other comprehensive loss	(13,123)		(13,123)		(13,123)
Total Select Medical Holdings Corporation Stockholders' Equity	(141,659)	528,742	387,083	269,571	656,654
Non-controlling interest	7,401		7,401		7,401
Total Equity	(134,258)	528,742	394,484	269,571	664,055
Total Liabilities and Equity	\$ 2,532,682	\$	\$ 2,532,682	\$ 8,430	\$ 2,541,112

(footnotes begin on page 43)

Table of Contents**UNAUDITED PRO FORMA CONSOLIDATED STATEMENT OF OPERATIONS**

Year Ended December 31, 2008

	Historical ^{(a)(b)}	Reverse Stock Split and Conversion of Preferred Stock (in thousands, except per share data)	Pro Forma	Adjustments for Offering	Pro Forma As Adjusted
Net operating revenues	\$ 2,153,362		\$ 2,153,362		\$ 2,153,362
Operating expenses	1,885,168		1,885,168		1,885,168
Depreciation and amortization	71,786		71,786		71,786
Total cost and expenses	1,956,954		1,956,954		1,956,954
Income from operations	196,408		196,408		196,408
Gain on early retirement of debt	912		912		912
Interest expense, net	(145,423)		(145,423)	9,892 ⁽⁴⁾	(135,531)
Income before income taxes	51,897		51,897	9,892	61,789
Income tax expense	26,063		26,063	4,056 ⁽⁵⁾	30,119
Net income	25,834		25,834	5,836	31,670
Less: Net income attributable to non-controlling interests	3,393		3,393		3,393
Net income attributable to Select Medical Holdings Corporation	22,441		22,441	5,836	28,277
Less: Preferred dividends	24,972	(24,972) ⁽³⁾			
Net loss available to common stockholders	\$ (2,531)	\$ 24,972	\$ 22,441	\$ 5,836	\$ 28,277
Basic income per common share			\$ 0.18		\$ 0.18
Weighted average basic common shares outstanding			123,126 ⁽⁶⁾	31,821	154,947 ⁽⁶⁾
Diluted income per common share			\$ 0.18		\$ 0.18

Weighted average diluted common shares outstanding	123,393 ₍₆₎	31,821	155,214 ₍₆₎
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(footnotes begin on page 43)

Table of Contents**UNAUDITED PRO FORMA CONSOLIDATED STATEMENT OF OPERATIONS**

	Six Months Ended June 30, 2009				
	Historical	Reverse Stock Split and Conversion of Preferred Stock (in thousands, except per share data)	Pro Forma	Adjustments for Offering	Pro Forma As Adjusted
Net operating revenues	\$ 1,120,707		\$ 1,120,707		\$ 1,120,707
Operating expenses	952,023		952,023		952,023
Depreciation and amortization	35,670		35,670		35,670
Total costs and expenses	987,693		987,693		987,693
Income from operations	133,014		133,014		133,014
Gain on early retirement of debt	15,316		15,316		15,316
Interest expense, net	(68,250)		(68,250)	4,444 ⁽⁴⁾	(63,806)
Income before income taxes	80,080		80,080	4,444	84,524
Income tax expense	33,880		33,880	1,822 ⁽⁵⁾	35,702
Net income	46,200		46,200	2,622	48,822
Less: Net income attributable to non-controlling interests	1,412		1,412		1,412
Net income attributable to Select Medical Holdings Corporation	44,788		44,788	2,622	47,410
Less: Preferred dividends	12,870	(12,870) ⁽³⁾			
Net income available to common stockholders	\$ 31,918	\$ 12,870	\$ 44,788	\$ 2,622	\$ 47,410
Basic loss per common share			\$ 0.36		\$ 0.30
Weighted average basic common shares outstanding			124,070 ⁽⁶⁾	30,954	155,024 ⁽⁶⁾
Diluted income per common share			\$ 0.36		\$ 0.30
			124,552 ⁽⁶⁾	30,954	155,506 ⁽⁶⁾

Weighted average diluted
common shares
outstanding

- (a) Adjusted for the adoption of SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. See Note 1, Organization and Significant Accounting Policies – Recent Accounting Pronouncements, in our audited consolidated financial statements and Note 2, Accounting Policies – Recent Accounting Pronouncements, in our interim unaudited consolidated financial statements for additional information.
- (b) Adjusted for the adoption of FASB Staff Position EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities. See Note 14 in our audited consolidated financial statements and Note 8 in our interim unaudited consolidated financial statements for additional information.

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NOTES TO UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL INFORMATION

The following adjustments were applied to our Consolidated Balance Sheet to arrive at the Unaudited Pro Forma and Pro Forma as Adjusted Consolidated Balance Sheet.

(1) We reflected:

- (i) the elimination of \$528.7 million liquidation value of our preferred stock reflecting the conversion of all shares of our issued and outstanding preferred stock into 63,559,714 shares of common stock;
- (ii) a deemed dividend of \$14.8 million for the value of the contingent beneficial conversion feature associated with our preferred stock; and
- (iii) the 1 for .30 reverse split for our common stock that occurred on September 24, 2009.

(2) We reflected:

- (i) our issuance of 30,000,000 shares of common stock assuming this offering had occurred on June 30, 2009;
- (ii) the repayment of \$260.7 million of indebtedness outstanding under our senior secured credit facilities; and
- (iii) a non-recurring charge related to payments under our Long Term Cash Incentive Plan in the amount of \$18.0 million reduced by \$7.4 million of income tax benefit.
- (iv) a non-recurring charge in the amount of \$3.6 million reduced by \$1.5 million of income tax benefit, related to the August 12, 2009 issuance of 363,608 shares of restricted stock to employees which will vest upon completion of this offering.

The following adjustments were applied to our Consolidated Statement of Operations to arrive at the Unaudited Pro Forma and Pro Forma as Adjusted Consolidated Statement of Operations.

(3) We reflected the elimination of \$25.0 million and \$12.9 million for the year ended December 31, 2008 and the six months ended June 30, 2009, respectively, of preferred dividends on our preferred stock reflecting the conversion of 22,148,453 shares of our issued outstanding preferred stock into 63,559,714 shares of common stock.

(4) We reflected:

- (i) an increase in our interest expense of \$6.7 million and \$3.4 million for the year ended December 31, 2008 and the six months ended June 30, 2009 for the increase in the interest rate of 1.75% on \$384.5 million principal amount of Tranche B-1 term loans that resulted from Amendment No. 3 to our senior secured credit facility which became effective on August 5, 2009.
- (ii) the reduction in interest expense of \$16.6 million and \$7.8 million for the year ended December 31, 2008 and the six months ended June 30, 2009 for the assumed repayment of \$260.7 million under our senior secured credit facility.

(5) We reflected additional tax expense of \$4.1 million and \$1.8 million for the year ended December 31, 2008 and the six months ended June 30, 2009, respectively, related to the net reduction in interest expense.

(6) Weighted average common shares outstanding were computed as follows (in thousands):

	Year Ended December 31, 2008		Six Months Ended June 30, 2009	
	Pro Forma	Pro Forma As Adjusted	Pro Forma	Pro Forma As Adjusted
Weighted average common shares outstanding after reverse-stock split	59,566	59,566	60,510	60,510
Effect of preferred stock conversion	63,560 ^(a)	63,560 ^(a)	63,560 ^(a)	63,560 ^(a)
Effect of vesting of restricted shares which is contingent upon the completion of this offering		1,821		954
Effect of shares issued in this offering		30,000		30,000
Weighted average basic common shares	123,126	154,947	124,070	155,024
Dilutive effect of stock options	267	267	482	482
Weighted average diluted common shares	123,393	155,214	124,552	155,506

(a) Based on accreted value of preferred stock of \$528.7 million as of June 30, 2009.

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**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION
AND RESULTS OF OPERATIONS**

The following discussion should be read in conjunction with the Selected Historical Consolidated Financial Data, and our consolidated financial statements and the related notes included elsewhere in this prospectus. The following discussion contains, in addition to historical information, forward-looking statements that include risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth under the heading Risk Factors and elsewhere in this prospectus.

Overview

We are a leading operator of specialty hospitals and outpatient rehabilitation clinics in the United States. As of June 30, 2009, we operated 87 long term acute care hospitals and five acute medical rehabilitation hospitals in 25 states, and 948 outpatient rehabilitation clinics in 37 states and the District of Columbia. We also provide medical rehabilitation services on a contracted basis to nursing homes, hospitals, assisted living and senior care centers, schools and work sites. We began operations in 1997 under the leadership of our current management team.

We manage our company through two business segments, our specialty hospital segment and our outpatient rehabilitation segment. We had net operating revenues of \$2,153.4 million for the year ended December 31, 2008 and \$1,120.7 million for the six months ended June 30, 2009. Of these totals, we earned approximately 69% and 70% of our net operating revenues from our specialty hospitals and approximately 31% and 30% from our outpatient rehabilitation business for the year ended December 31, 2008 and the six months ended June 30, 2009, respectively.

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. Patients in our long term acute care hospitals typically suffer from serious and often complex medical conditions that require a high degree of care. Patients in our inpatient rehabilitation facilities typically suffer from debilitating injuries, including traumatic brain and spinal cord injuries, and require rehabilitation care in the form of physical and vocational rehabilitation services. Our outpatient rehabilitation business consists of clinics and contract services that provide physical, occupational and speech rehabilitation services. Our outpatient rehabilitation patients are typically diagnosed with musculoskeletal impairments that restrict their ability to perform normal activities of daily living.

Acquisition of HealthSouth Corporation's Outpatient Rehabilitation Division

In 2007, we completed the acquisition of the outpatient rehabilitation division of HealthSouth Corporation. At the closing on May 1, 2007, we acquired 539 outpatient rehabilitation clinics. On June 20, 2007, one additional outpatient facility located in Washington, D.C. was acquired upon the receipt of regulatory approval. The closing of the purchase of 29 additional outpatient rehabilitation clinics that was deferred pending certain state regulatory approvals was completed as of October 31, 2007 and resulted in the release of an additional \$23.4 million of the purchase price. The aggregate purchase price of \$245.0 million was reduced by approximately \$7.0 million at closing for assumed indebtedness and other matters. We funded the acquisition through borrowings of \$100.0 million under an incremental term loan, borrowings of \$100.0 million under our revolving credit facility and the balance with cash on hand.

In conjunction with the acquisition, we recorded an estimated liability of \$18.7 million for restructuring costs associated with workforce reductions and lease termination costs resulting from our plans for integrating the acquired business. This estimated liability was accounted for as additional purchase price. We expect to pay severance costs through 2009 and lease termination costs through 2016.

Amendments to Credit Agreement

On August 5, 2009, we entered into Amendment No. 3 to our senior secured credit facility with a group of holders of Tranche B term loans and JPMorgan Chase Bank, N.A., as administrative agent. Amendment No. 3 extended the maturity of \$384.5 million principal amount of Tranche B term loans from February 24, 2012 to August 22, 2014 and made related technical changes to the senior secured credit facility. Holders of Tranche B term

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loans that extended the maturity of their Tranche B term loans now hold Tranche B-1 term loans that mature on August 22, 2014, and holders of Tranche B term loans that did not extend the maturity of their Tranche B term loans continue to hold Tranche B term loans that mature on February 24, 2012. The applicable rate for the Tranche B-1 term loans under our senior secured credit facility has increased to 3.75% for adjusted LIBOR loans and 2.75% for alternate base rate loans. We may apply future voluntary prepayments entirely to Tranche B term loans or pro rata between Tranche B term loans and Tranche B-1 term loans. Under the terms of Amendment No. 3, if, prior to August 5, 2011, our senior secured credit facility is amended to reduce the applicable rate for Tranche B-1 term loans, then we will be required to pay a fee in an amount equal to 1% of the outstanding Tranche B-1 term loans held by those holders of Tranche B-1 term loans that agree to amend our senior secured credit facility to reduce the applicable rate. In addition, if, prior to August 5, 2011, we make any prepayment of Tranche B-1 term loans with proceeds of any term loan indebtedness, we will be required to pay a fee to holders of Tranche B-1 term loans in an amount equal to 1% of the outstanding Tranche B-1 term loans that are being prepaid.

On March 19, 2007, we entered into Amendment No. 2 and on March 28, 2007, we entered into an Incremental Facility Amendment with a group of lenders and JPMorgan Chase Bank, N.A. as administrative agent. Amendment No. 2 increased the general exception to the prohibition on asset sales under our senior secured credit facility from \$100.0 million to \$200.0 million, relaxed the interest expense coverage ratio and leverage ratio covenants starting March 31, 2007 in anticipation of the incurrence of additional indebtedness in connection with the HealthSouth acquisition and waived Select's requirement to prepay certain term loan borrowings following the year ended December 31, 2006. The Incremental Facility Amendment provided to our company an incremental term loan of \$100.0 million, the proceeds of which we used to pay a portion of the purchase price for the HealthSouth transaction.

CBIL Sale

On March 1, 2006, we sold our wholly-owned subsidiary CBIL for approximately C\$89.8 million in cash (US\$79.0 million). At the time of the sale, CBIL operated 109 outpatient rehabilitation clinics in seven Canadian provinces and had approximately 1,000 employees. We conducted all of our Canadian operations through CBIL. The financial results of CBIL have been reclassified as discontinued operations for all periods presented in this prospectus. As a result of this transaction, we have recognized a gain on sale (net of tax) of \$11.5 million in 2006.

Summary Financial Results

Six Months Ended June 30, 2009

For the six months ended June 30, 2009, our net operating revenues increased 3.1% to \$1,120.7 million compared to \$1,087.1 million for the six months ended June 30, 2008. This increase in net operating revenues primarily resulted from a 4.5% increase in our specialty hospital net operating revenue. The increase in specialty hospital net operating revenue is principally due to the hospitals we opened in 2008. We had income from operations for the six months ended June 30, 2009 of \$133.0 million compared to \$102.8 million for the six months ended June 30, 2008. The increase in income from operations is principally related to an increase in the profitability of our specialty hospitals opened as of January 1, 2008 and operated throughout both periods, and an improvement in the operating results of the hospitals opened in 2008. Our interest expense for the six months ended June 30, 2009 was \$68.3 million compared to \$73.5 million for the six months ended June 30, 2008. The decrease in interest expense is attributable to a reduction in outstanding debt balances and a decline in interest rates. Cash flow from operations provided \$57.2 million of cash for the six months ended June 30, 2009.

Year Ended December 31, 2008

For the year ended December 31, 2008, our net operating revenues increased 8.1% to \$2,153.4 million compared to \$1,991.7 million for the year ended December 31, 2007. This increase in net operating revenues resulted from a 7.4% increase in our specialty hospital net operating revenue and a 10.2% increase in our outpatient rehabilitation net operating revenue. The increase in our specialty hospital revenue is due to increases in our discharge payment rates for Medicare and an increase in our non-Medicare patient volume. The increase in our outpatient rehabilitation net operating revenue is primarily attributable to the net operating revenues generated by

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clinics acquired from HealthSouth Corporation on May 1, 2007. We had income from operations for the year ended December 31, 2008 of \$196.4 million compared to \$193.9 million for the year ended December 31, 2007. Our interest expense for the year ended December 31, 2008 was \$145.9 million compared to \$140.2 million for the year ended December 31, 2007. The increase in interest expense resulted from higher average debt levels existing for the year ended December 31, 2008 resulting primarily from borrowings to finance the HealthSouth transaction, offset by the effect of declining interest rates in 2008. Cash flow from operations provided \$107.4 million of cash for the year ended December 31, 2008.

Year Ended December 31, 2007

For the year ended December 31, 2007, our net operating revenues increased 7.6% to \$1,991.7 million compared to \$1,851.5 million for the year ended December 31, 2006. This increase in net operating revenues resulted from a 0.6% increase in our specialty hospital net operating revenue and a 28.3% increase in our outpatient rehabilitation net operating revenue. The significant increase in our outpatient rehabilitation net operating revenue is primarily attributable to the net operating revenues generated by clinics acquired from HealthSouth Corporation on May 1, 2007. We had income from operations for the year ended December 31, 2007 of \$193.9 million compared to \$257.9 million for the year ended December 31, 2006. The decline in income from operations principally related to a decline in the profitability of our specialty hospitals which resulted primarily from regulatory changes related to long term acute care hospitals, or LTCHs. Our interest expense for the year ended December 31, 2007 was \$140.2 million compared to \$131.8 million for the year ended December 31, 2006. The increase in interest expense resulted from higher average debt levels resulting primarily from borrowings to finance the HealthSouth transaction and higher interest rates experienced during the year ended December 31, 2007. Cash flow from operations provided \$86.0 million of cash for the year ended December 31, 2007.

Regulatory Changes***Medicare Reimbursement of Long Term Acute Care Hospital Services***

In the last few years, there have been significant regulatory changes affecting LTCHs that have affected our net operating revenues and, in some cases, caused us to change our operating models and strategies. The following is a summary of some of the more significant healthcare regulatory changes that have affected our financial performance in the past or are likely to affect our financial performance in the future.

We have been subject to regulatory changes that occur through the rulemaking procedures of the Centers for Medicare & Medicaid Services, or CMS. Historically, rule updates occurred twice each year. All Medicare payments to our long term acute care hospitals are made in accordance with a prospective payment system specifically applicable to long term acute care hospitals, referred to as LTCH-PPS. Proposed rules specifically related to LTCHs were generally published in January, finalized in May and effective on July 1st of each year. Additionally, LTCHs are subject to annual updates to the rules related to the inpatient prospective payment system, or IPPS, that are typically proposed in May, finalized in August and effective on October 1st of each year. In the annual payment rate update for the 2009 fiscal year, CMS consolidated the two historical annual updates into one annual update. The final rule adopted a 15-month rate update for fiscal year 2009 and moves the LTCH-PPS from a July-June update cycle to an October-September cycle. Beginning fiscal year 2010 the LTCH rate year will begin October 1, coinciding with the start of the federal fiscal year.

August 2004 Final Rule. On August 11, 2004, CMS published final regulations applicable to LTCHs that are operated as hospital within hospitals or as satellites. We collectively refer to hospital within hospitals and satellites as HIHs, and we refer to the CMS final regulations as the final regulations. HIHs are separate hospitals located in space leased from, and located in or on the same campus of, another hospital. We refer to such other hospitals as host hospitals.

Effective for hospital cost reporting periods beginning on or after October 1, 2004, subject to certain exceptions, the final regulations provide lower rates of reimbursement to HIHs for those Medicare patients admitted from their host hospitals that are in excess of a specified percentage threshold. For HIHs opened after October 1, 2004, the Medicare admissions threshold has been established at 25% except for HIHs located in rural areas or co-located with MSA dominant hospitals or single urban hospitals where the percentage is no more than 50%, nor less than 25%. For HIHs that met specified criteria and were in existence as of October 1, 2004,

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including all but two of our then existing HIHs, the Medicare admissions thresholds were to have been phased in over a four year period starting with hospital cost reporting periods that began on or after October 1, 2004. However, as described below, many of these changes have been postponed for a three year period by the Medicare, Medicaid, and SCHIP Extension Act of 2007, or SCHIP Extension Act, and further clarified in the American Recovery and Reinvestment Act of 2009, or ARRA.

August 2005 Final Rule. On August 12, 2005, CMS published the final rules for general acute care hospitals IPPS, for fiscal year 2006, which included an update of the relative weights for the long term care diagnosis-related group, or LTC-DRG. CMS estimated the changes to the relative weights would reduce LTCH Medicare payments-per-discharge by approximately 4.2% in fiscal year 2006 (the period from October 1, 2005 through September 30, 2006).

May 2006 Final Rule. On May 12, 2006, CMS published its final annual payment rate updates for the 2007 LTCH-PPS rate year (affecting discharges and cost reporting periods beginning on or after July 1, 2006 and before July 1, 2007), or RY 2007. The May 2006 final rule revised the payment adjustment formula for short stay outlier, or SSO, patients. For discharges occurring on or after July 1, 2006, the rule changed the payment methodology for Medicare patients with a length of stay less than or equal to five-sixths of the geometric average length of stay for each SSO case. In addition, for discharges occurring on or after July 1, 2006, the May 2006 final rule provided for (1) a zero-percent update to the LTCH-PPS standard federal rate used as a basis for LTCH-PPS payments for RY 2007; (2) the elimination of the surgical case exception to the three day or less interruption of stay policy, under which surgical exception Medicare reimburses a general acute care hospital directly for surgical services furnished to a long term acute care hospital patient during a brief interruption of stay from the long term acute care hospital, rather than requiring the long term acute care hospital to bear responsibility for such surgical services; and (3) increasing the costs that a long term acute care hospital must bear before Medicare will make additional payments for a case under its high-cost outlier policy for RY 2007.

CMS estimated that the changes in the May 2006 final rule would result in an approximately 3.7% decrease in LTCH Medicare payments-per-discharge compared to the 2006 rate year, largely attributable to the revised SSO payment methodology. We estimated that the May 2006 final rule reduced Medicare revenues associated with SSO cases and high-cost outlier cases to our long term acute care hospitals by approximately \$29.3 million for RY 2007.

Additionally, had CMS updated the LTCH-PPS standard federal rate by the 2007 estimated market basket index of 3.4% rather than applying the zero-percent update, we estimated that we would have received approximately \$31.0 million in additional annual Medicare revenues based on our historical Medicare patient volumes and revenues (such revenues would have been paid to our hospitals for discharges beginning on or after July 1, 2006).

August 2006 Final Rule. On August 18, 2006, CMS published the IPPS final rule for fiscal year 2007, which is the period from October 1, 2006 through September 30, 2007, that included an update of the LTC-DRG relative weights for fiscal year 2007. CMS estimated the changes to the relative weights would reduce LTCH Medicare payments-per-discharge by approximately 1.3% in fiscal year 2007. The August 2006 final rule also included changes to the diagnosis-related groups, or DRGs, in IPPS that apply to LTCHs, as the LTC-DRGs are based on the IPPS DRGs.

May 2007 Final Rule. On May 11, 2007, CMS published its annual payment rate update for the 2008 LTCH-PPS rate year, or RY 2008 (affecting discharges and cost reporting periods beginning on or after July 1, 2007 and before July 1, 2008). The May 2007 final rule made several changes to LTCH-PPS payment methodologies and amounts during RY 2008 although, as described below, many of these changes have been postponed for a three year period by the SCHIP Extension Act.

For cost reporting periods beginning on or after July 1, 2007, the May 2007 final rule expanded the Medicare HIH admissions threshold to apply to Medicare patients admitted from any individual hospital. Previously, the admissions threshold was applicable only to Medicare HIH admissions from hospitals co-located with an LTCH or satellite of an LTCH. Under the May 2007 final rule, free-standing LTCHs and grandfathered HIHs would be subject to the Medicare admission thresholds, as well as HIHs and satellites that admit Medicare patients from non-co-located hospitals. To the extent that any LTCH s or LTCH satellite facility s discharges that are admitted from an individual hospital (regardless of whether the referring hospital is co-located with the LTCH or LTCH satellite)

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exceed the applicable percentage threshold during a particular cost reporting period, the payment rate for those discharges would be subject to a downward payment adjustment. Cases admitted in excess of the applicable threshold would be reimbursed at a rate comparable to that under general acute care IPPS, which is generally lower than LTCH-PPS rates. Cases that reach outlier status in the discharging hospital would not count toward the limit and would be paid under LTCH-PPS. CMS estimated the impact of the expansion of the Medicare admission thresholds would result in a reduction of 2.2% of the aggregate payments to all LTCHs in RY 2008.

The applicable percentage threshold is generally 25% after the completion of the phase-in period described below. The percentage threshold for LTCH discharges from a referring hospital that is an MSA dominant hospital or a single urban hospital is the percentage of total Medicare discharges in the MSA that are from the referring hospital, but no less than 25% nor more than 50%. For Medicare discharges from LTCHs or LTCH satellites located in rural areas, as defined by the Office of Management and Budget, the percentage threshold is 50% from any individual referring hospital. The expanded 25% rule is being phased in over a three year period. The three year transition period starts with cost reporting periods beginning on or after July 1, 2007 and before July 1, 2008, when the threshold is the lesser of 75% or the percentage of the LTCH s or LTCH satellite s admissions discharged from the referring hospital during its cost reporting period beginning on or after July 1, 2004 and before July 1, 2005, or RY 2005. For cost reporting periods beginning on or after July 1, 2008 and before July 1, 2009, the threshold will be the lesser of 50% or the percentage of the LTCH s or LTCH satellite s admissions from the referring hospital, during its RY 2005 cost reporting period. For cost reporting periods beginning on or after July 1, 2009, all LTCHs will be subject to the 25% threshold (or applicable threshold for rural, urban-single, or MSA dominant hospitals). The SCHIP Extension Act, as amended by the ARRA, postponed the application of the percentage threshold to all free-standing and grandfathered HIHs for a three year period commencing on an LTCH s first cost reporting period on or after July 1, 2007. However, the SCHIP Extension Act did not postpone the application of the percentage threshold, or the transition period stated above, to those Medicare patients discharged from an LTCH HIH or HIH satellite that were admitted from a non-co-located hospital. The SCHIP Extension Act only postpones the expansion of the admission threshold in the May 2007 final rule to free-standing LTCHs and grandfathered HIHs.

The May 2007 final rule further revised the payment adjustment formula for short stay outlier, or SSO cases. Beginning with discharges on or after July 1, 2007, for cases with a length of stay that is less than the average length of stay plus one standard deviation for the same DRG under IPPS, referred to as the so-called IPPS comparable threshold, the rule effectively lowers the LTCH payment to a rate based on the general acute care hospital IPPS. SSO cases with covered lengths of stay that exceed the IPPS comparable threshold would continue to be paid under the SSO payment policy described above under the May 2006 final rule. Cases with a covered length of stay less than or equal to the IPPS comparable threshold and less than five-sixths of the geometric average length of stay for that LTC-DRG would be paid at an amount comparable to the IPPS per diem. The SCHIP Extension Act also postponed, for the three year period beginning on December 29, 2007, the SSO policy changes made in the May 2007 final rule.

The May 2007 final rule updated the standard federal rate by 0.71% for RY 2008. As a result, the federal rate for RY 2008 is equal to \$38,356.45, compared to \$38,086.04 for RY 2007. Subsequently, the SCHIP Extension Act eliminated the update to the standard federal rate that occurred for RY 2008 effective April 1, 2008. This adjustment to the standard federal rate was applied prospectively on April 1, 2008 and reduced the federal rate back to \$38,086.04. In a technical correction to the May 2007 final rule, CMS increased the fixed-loss amount for high cost outlier in RY 2008 to \$20,738, compared to \$14,887 in RY 2007. CMS projected an estimated 0.4% decrease in LTCH payments in RY 2008 due to this change in the fixed-loss amount and the overall impact of the May 2007 final rule to be a 1.2% decrease in total estimated LTCH-PPS payments for RY 2008.

The May 2007 final rule provided that beginning with the annual payment rate updates to the LTC-DRG classifications and relative weights for the fiscal year 2008, or FY 2008 (affecting discharges beginning on or after October 1, 2007 and before September 30, 2008), annual updates to the LTC-DRG classification and relative weights

are to have a budget neutral impact. Under the May 2007 final rule, future LTC-DRG reclassification and recalibrations, by themselves, should neither increase nor decrease the estimated aggregated LTCH-PPS payments.

The May 2007 final rule is complex and the SCHIP Extension Act postponed the implementation of certain portions of the May 2007 final rule. While we cannot predict the ultimate long-term impact of LTCH-PPS because

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the payment system remains subject to significant change, if the May 2007 final rule becomes effective as currently written, after the expiration of the applicable provisions of the SCHIP Extension Act, our future net operating revenues and profitability will be adversely affected.

August 2007 Final Rule. On August 22, 2007, CMS published the IPPS final rule for FY 2008, which created a new patient classification system with categories referred to as MS-DRGs and MS-LTC-DRGs, respectively, for hospitals reimbursed under IPPS and LTCH-PPS. Beginning with discharges on or after October 1, 2007, the new classification categories take into account the severity of the patient's condition. CMS assigned proposed relative weights to each MS-DRG and MS-LTC-DRG to reflect their relative use of medical care resources.

The August 2007 final rule published a budget neutral update to the MS-LTC-DRG classification and relative weights. In the preamble to the IPPS final rule for FY 2008 CMS restated that it intends to continue to update the LTC-DRG weights annually in the IPPS rulemaking and those weights would be modified by a budget neutrality adjustment factor to ensure that estimated aggregate LTCH payments after reweighting are equal to estimated aggregate LTCH payments before reweighting.

Medicare, Medicaid, and SCHIP Extension Act of 2007. On December 29, 2007, President Bush signed into law the SCHIP Extension Act. Among other changes in the federal health care programs, the SCHIP Extension Act makes significant changes to Medicare policy for LTCHs including a new statutory definition of an LTCH, a report to Congress on new LTCH patient criteria, relief from certain LTCH-PPS payment policies for three years, a three year moratorium on the establishment and classification of new LTCHs and LTCH beds, elimination of the payment update for the last quarter of RY 2008 and new medical necessity reviews by Medicare contractors through at least October 1, 2010.

The SCHIP Extension Act precludes the Secretary from implementing, during the three year moratorium period, the provisions added by the May 2007 final rule that extended the 25% rule to free-standing LTCHs and grandfathered HIHs. The SCHIP Extension Act also modifies, during the moratorium, the effect of the 25% rule for non-grandfathered LTCH HIHs, non-grandfathered satellites and grandfathered LTCH HIHs, as it applies to admissions from co-located hospitals. For HIHs and satellite facilities, the applicable percentage threshold is set at 50% and not phased in to the 25% level. For those HIHs and satellite facilities located in rural areas and those which receive referrals from MSA dominant hospitals or single urban hospitals, the percentage threshold is set at no more than 75%. The ARRA further revises the SCHIP Extension Act to postpone the percentage limitations established in the SCHIP Extension Act to the three cost reporting periods beginning on or after July 1, 2007 for freestanding LTCHs, grandfathered HIHs and grandfathered satellites and on or after October 1, 2007 for non-grandfathered LTCH HIHs and non-grandfathered satellites.

The SCHIP Extension Act also precludes the Secretary from implementing, for the three year period beginning on December 29, 2007, a one-time adjustment to the LTCH standard federal rate. This rule, established in the original LTCH-PPS regulations, permits CMS to restate the standard federal rate to reflect the effect of changes in coding since the LTCH-PPS base year. In the preamble to the May 2007 final rule, CMS discussed making a one-time prospective adjustment to the LTCH-PPS rates for the 2009 rate year. In addition, the SCHIP Extension Act reduced the Medicare payment update for the portion of RY 2008 from April 1, 2008 to June 30, 2008 to the same base rate applied to LTCH discharges during RY 2007.

For the three calendar years following December 29, 2007, the Secretary must impose a moratorium on the establishment and classification of new LTCHs, LTCH satellite facilities, and LTCH beds in existing LTCH or satellite facilities. This moratorium does not apply to LTCHs that, before the date of enactment, (1) began the qualifying period for payment under the LTCH-PPS, (2) have a written agreement with an unrelated party for the construction, renovation, lease or demolition for a LTCH and have expended at least 10% of the estimated cost of the

project or \$2,500,000, or (3) have obtained an approved certificate of need. As a result of the SCHIP Extension Act's three calendar year moratorium on the development of new LTCHs, we have stopped all new LTCH development.

May 6, 2008 Interim Final Rule. On May 6, 2008, CMS published an interim final rule with comment period, which implemented portions of the SCHIP Extension Act. The May 6, 2008 interim final rule addressed: (1) the payment adjustment for very short-stay outliers, (2) the standard federal rate for the last three months of RY 2008,

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(3) adjustment of the high cost outlier fixed-loss amount for the last three months of RY 2008, and (4) made references to the SCHIP Extension Act in the discussion of the basis and scope of the LTCH-PPS rules.

May 9, 2008 Final Rule. On May 9, 2008, CMS published its annual payment rate update for the 2009 LTCH-PPS rate year, or RY 2009 (affecting discharges and cost reporting periods beginning on or after July 1, 2008). The final rule adopts a 15-month rate update, from July 1, 2008 through September 30, 2009 and moves LTCH-PPS from a July-June update cycle to the same update cycle as the general acute care hospital inpatient rule (October – September). For RY 2009, the rule establishes a 2.7% update to the standard federal rate. The rule increases the fixed-loss amount for high cost outlier cases to \$22,960, which is \$2,222 higher than the 2008 LTCH-PPS rate year. The final rule provides that CMS may make a one-time reduction in the LTCH-PPS rates to reflect a budget neutrality adjustment no earlier than December 29, 2010 and no later than October 1, 2012. CMS estimated this reduction will be approximately 3.75%.

May 22, 2008 Interim Final Rule. On May 22, 2008, CMS published an interim final rule with comment period, which implements portions of the SCHIP Extension Act not addressed in the May 6, 2008 interim final rule. Among other things, the May 22, 2008 interim final rule establishes a definition for free-standing LTCHs as a hospital that: (1) has a Medicare provider agreement, (2) has an average length of stay of greater than 25 days, (3) does not occupy space in a building used by another hospital, (4) does not occupy space in one or more separate or entire buildings located on the same campus as buildings used by another hospital and (5) is not part of a hospital that provides inpatient services in a building also used by another hospital.

August 2008 Final Rule. On August 19, 2008, CMS published the IPPS final rule for FY 2009 (affecting discharges and cost reports beginning on or after October 1, 2008 and before October 1, 2009), which made limited revisions to the classifications of cases in MS-LTC-DRGs. The final rule also includes a number of hospital ownership and physician referral provisions, including expansion of a hospital's disclosure obligations by requiring physician-owned hospitals to disclose ownership or investment interests held by immediate family members of a referring physician. The final rule requires physician-owned hospitals to furnish to patients, on request, a list of physicians or immediate family members who own or invest in the hospital. Moreover, a physician-owned hospital must require all physician owners or investors who are also active members of the hospital's medical staff to disclose in writing their ownership or investment interests in the hospital to all patients they refer to the hospital. CMS can terminate the Medicare provider agreement of a physician-owned hospital if it fails to comply with these disclosure provisions or with the requirement that a hospital disclose in writing to all patients whether there is a physician on-site at the hospital 24 hours per day, 7 days per week.

The American Recovery and Reinvestment Act of 2009. On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009, the ARRA. The ARRA makes several technical corrections to the SCHIP Extension Act, including a clarification that, during the moratorium period established by the SCHIP Extension Act, the percentage threshold for grandfathered satellites is set at 50% and not phased in to the 25% level for admissions from a co-located hospital. In addition, the ARRA clarifies that the application of the percentage threshold is postponed for a LTCH HIH or satellite that was co-located with a provider-based, off-campus location of an IPPS hospital that did not deliver services payable under IPPS. The ARRA also provides that the postponement of the percentage threshold established in the SCHIP Extension Act will be effective for cost reporting periods beginning on or after July 1, 2007 for freestanding LTCHs and grandfathered HIHs and satellites and on or after October 1, 2007 for other LTCH HIHs and satellites.

June 3, 2009 Interim Final Rule. On June 3, 2009, CMS published an interim final rule in which CMS adopted a new table of MS-LTC-DRG relative weights that will apply to the remainder of fiscal year 2009 (through September 30, 2009). This interim final rule revises the MS-LTC-DRG relative weights for payment under the LTCH-PPS for FY 2009 due to CMS's misapplication of its established methodology in the calculation of the budget neutrality factor.

This error resulted in relative weights that are higher, by approximately 3.9 percent for all of FY 2009 (October 1, 2008 through September 30, 2009) which has the effect of reducing reimbursement by approximately 3.9%. However, CMS is only applying the corrected weights to the remainder of fiscal year 2009 (that is, from June 3, 2009 through September 30, 2009).

July 31, 2009 Final Rule. On July 31, 2009, CMS released its annual payment rate update for the LTCH PPS for FY 2010 (affecting discharges and cost reporting periods beginning on or after October 1, 2009 and before

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September 30, 2010). For FY 2010 CMS adopted a 2.5% increase in payments under the LTCH PPS. As a result, the standard federal rate for FY 2010 is set at \$39,896.65, an increase from \$39,114.36 in FY 2009. The increase in the standard federal rate uses a 2% update factor based on the market basket update of 2.5% less an adjustment of 0.5% to account for changes in documentation and coding practices. The fixed loss amount for high cost outlier cases is set at \$18,425. This is a decrease from the fixed-loss amount in the 2009 rate year of \$22,960.

The July 31, 2009 annual payment rate update also included an interim final rule implementing provisions of the ARRA discussed above, including amendments to provisions of the SCHIP Extension Act relating to payments to LTCHs and LTCH satellite facilities and increases in beds in existing LTCHs and LTCH satellite facilities under the LTCH PPS.

In the same federal register, CMS finalized three interim final rules with comment period that it previously published but had yet to respond to public comment. First, CMS finalized the June 3, 2009 interim final rule that adopted a new table of MS-LTC-DRG relative weights for the period between June 3, 2009 and September 30, 2009. Second, CMS finalized the May 6, 2008 interim final rule that implemented changes to LTCH PPS mandated by the SCHIP Extension Act addressing: (1) payment adjustments for certain short-stay outliers, (2) the federal standard rate for the last three months of rate year 2008, and (3) adjustment of the high cost outlier fixed-loss amount. Finally, CMS finalized the May 22, 2008 interim final rule that implemented changes to LTCH PPS mandated by the SCHIP Extension Act modifying the percentage threshold policy for certain LTCHs and addressing the three-year moratorium on the establishment of new LTCHs and bed increases at existing LTCHs and LTCH satellites.

Medicare Reimbursement of Outpatient Rehabilitation Services

CMS released the final rule for the 2009 Medicare physician fee schedule on October 30, 2008. The final rule increased the annual per beneficiary cap on outpatient therapy services for 2009 to \$1,840 for combined physical therapy and speech language pathology services and \$1,840 for occupational therapy services. The per beneficiary cap was \$1,810 for calendar year 2008. The final rule also extended the therapy cap exceptions process through December 31, 2009 as authorized by Congress.

Medicare Reimbursement of Inpatient Rehabilitation Facility Services

August 2006 Final Rule. In the August 2006 final rule updating the inpatient rehabilitation facility prospective payment system (IRF-PPS) for discharges occurring on or after October 1, 2006 and on or before September 30, 2007, CMS reduced the standard payment amount by 2.6% and increased the outlier threshold for fiscal year 2007 to \$5,534 from \$5,129 for fiscal year 2006. CMS stated that the reduction in standard payment was to account for coding changes that did not reflect real changes in case mix.

August 2007 Final Rule. In the August 2007 final rule updating IRF-PPS for discharges occurring on or after October 1, 2007 and on or before September 30, 2008, CMS increased the standard payment amount by 3.2% and increased the outlier threshold for fiscal year 2008 to \$7,362 from \$5,534 for fiscal year 2007.

August 2008 Final Rule. On August 8, 2008, CMS published the final rule for the inpatient rehabilitation facility prospective payment system (IRF-PPS) for FY 2009. The final rule included changes to the IRF-PPS regulations designed to implement portions of the SCHIP Extension Act. In particular, the patient classification criteria compliance threshold was established at 60 percent (with comorbidities counting toward this threshold). In addition to updating the various values that compose the IRF-PPS, the final rule updated the outlier threshold amount to \$10,250 from \$7,362 for fiscal year 2008.

August 2009 Final Rule. On August 7, 2009, CMS published its final rule establishing the annual payment rate update for the IRF-PPS for FY 2010 (affecting discharges and cost reporting periods beginning on October 1, 2009 through September 30, 2010). The standard federal rate is established at \$13,661 for FY 2010, an increase from \$12,958 in FY 2009. The proposed outlier threshold amount is set at \$10,652, an increase from \$10,250 in FY 2009.

In the same final rule, CMS adopted new coverage criteria, including requirements for preadmission screening, post-admission evaluations, and individualized treatment planning that emphasize the role of physicians in ordering and overseeing beneficiaries' IRF care. Among other things, the rule requires IRF services to be ordered by a

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rehabilitation physician with specialized training and experience in rehabilitation services and be coordinated by an interdisciplinary team meeting the rule's specifications. The interdisciplinary team must meet weekly to review the patient's progress and make any needed adjustments to the individualized plan of care. IRFs must use qualified personnel to provide required rehabilitation nursing, physical therapy, occupational therapy, speech-language pathology, social services, psychological services, and prosthetic and orthotic services (CMS notes that it also is considering adopting specific standards on the use of group therapies at a future date). The rule also includes new documentation requirements, including a requirement that IRFs submit patient assessment data on Medicare Advantage patients. While the final rule's payment rate updates are effective for IRF discharges on or after October 1, 2009, CMS has adopted a January 1, 2010 effective date for the new coverage requirements to provide facilities more time to comply with the new framework. If we fail to implement the new coverage criteria, claims for our services may be denied in whole or in part.

Professional Licensure and Corporate Practice

Healthcare professionals at our hospitals and outpatient rehabilitation clinics are required to be individually licensed or certified under applicable state law. We take steps to ensure that our employees and agents possess all necessary licenses and certifications.

Some states prohibit the corporate practice of therapy so that business corporations such as ours are restricted from practicing therapy through the direct employment of therapists. The laws relating to corporate practice vary from state to state, and are not fully developed in each state in which we have clinics. We believe that each of our outpatient therapy clinics complies with any current corporate practice prohibition of the state in which it is located. For example, in those states that apply the corporate practice prohibition, we either contract to obtain therapy services from an entity permitted to employ therapists or we manage the physical therapy practice owned by licensed therapists through which the therapy services are provided. However, in those states where we furnish our services through business corporations, future interpretations of the corporate practice prohibition, enactment of new legislation or adoption of new regulations could have a material adverse effect on the business and operations of our outpatient therapy clinics. If new legislation, regulations or interpretations establish that our clinics do not comply with state corporate practice prohibition, we could be subject to civil, and perhaps criminal, penalties, and may be required to restructure our business operations or close our clinics in any such state.

Facility Licensure, Certification and Accreditation

Our hospitals and outpatient rehabilitation clinics are subject to extensive and changing federal, state and local regulations and private accreditation standards. Hospitals are required to comply with state hospital standards setting requirements related to patient rights, composition and responsibilities of the hospital governing body, medical staff, quality improvement, infection control, nursing services, food and nutrition, medical records, drug distribution, diagnostic and treatment services, surgical services, emergency services and social work. Our hospitals are also required to meet conditions of participation under Medicare programs in order to qualify to receive reimbursement under these programs. In addition, many of our hospitals and outpatient rehabilitation clinics are accredited by The Joint Commission by voluntarily complying with a specific set of accreditation standards.

Our hospitals and outpatient rehabilitation clinics are subject to inspections, surveys and other reviews by governmental and private regulatory authorities, not only at scheduled intervals but also in response to complaints from patients and others. While our hospitals and outpatient rehabilitation clinics intend to comply with existing licensing, Medicare certification requirements and accreditation standards, there can be no assurance that regulatory authorities will determine that all applicable requirements are fully met at any given time. A determination by an applicable regulatory authority that a facility is not in compliance with these requirements could lead to the imposition of requirements that the facility takes corrective action, assessment of fines and penalties or loss of licensure,

Medicare certification or accreditation. These consequences could have a material adverse effect on the Company.

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Federal Health Care Reform Proposals

Additional changes in federal health care policy have been proposed by President Obama and are expected to be considered by Congress this year. Specifically, on February 26, 2009, the Obama Administration released its proposed federal budget for fiscal year 2010, which would establish a reserve fund of \$633.8 billion over 10 years to finance comprehensive health reform. The reserve fund would be paid for by tax increases and health system savings. Among other things, the plan calls for bundled payments to hospitals that would cover not just the hospitalization, but care from certain post-acute providers for the 30 days after the hospitalization. A significant portion of the services furnished by our specialty hospitals and outpatient rehabilitation clinics are to patients discharged from acute care hospitals. Therefore, the proposal to bundle payments to hospitals could have a material impact on volume of referrals to our facilities by acute care hospitals and the payment rates that we receive for our services.

On June 15, 2009, the Obama Administration released new proposals to cut an additional \$313 billion from Medicare and Medicaid over 10 years, in addition to the provisions included in the Administration's proposed fiscal year 2010 budget. Among other things, the Administration endorses adopting the Medicare Payment Advisory Commission's recommendations for reducing payments in 2010 to inpatient rehabilitation facilities and long-term care hospitals, including a proposal to reduce payments to long term acute care hospitals by 1.8 percent. In addition, the Administration endorses implementing additional prepayment reviews in order to cut waste, fraud, and abuse in the federal health care programs.

Development of New Specialty Hospitals and Clinics

In addition to the growth of our business through the acquisition and integration of other businesses, we have also grown our business through specialty hospital and outpatient rehabilitation facility development opportunities. Since our inception in 1997 through June 30, 2009, we have internally developed 61 specialty hospitals and 270 outpatient rehabilitation facilities. As a result of the SCHIP Extension Act however, which prohibits the establishment and classification of new LTCHs and satellites during the three calendar years beginning on December 29, 2007, we have stopped all new LTCH development, except for LTCHs currently under construction that are excluded from the moratorium. In addition, we will continue to evaluate opportunities to develop new inpatient rehabilitation hospitals. Some of this development may be accomplished through joint ventures with others. The moratorium will not, however, apply to LTCHs acquired by us in the future so long as those LTCHs were in existence prior to December 29, 2007. We also intend to open new outpatient rehabilitation clinics in the local areas that we currently serve where we can benefit from existing referral relationships and brand awareness to produce incremental growth.

Critical Accounting Matters

Sources of Revenue

Our net operating revenues are derived from a number of sources, including commercial, managed care, private and governmental payors. Our net operating revenues include amounts estimated by management to be reimbursable from each of the applicable payors and the federal Medicare program. Amounts we receive for treatment of patients are generally less than the standard billing rates. We account for the differences between the estimated reimbursement rates and the standard billing rates as contractual adjustments, which we deduct from gross revenues to arrive at net operating revenues.

Net operating revenues generated directly from the Medicare program from all segments represented approximately 46%, 48% and 53% of net operating revenues for the years ended December 31, 2008, 2007 and 2006, respectively. Net operating revenues generated directly from the Medicare program from all segments represented approximately 47% and 46% of net operating revenues for the six months ended June 30, 2009 and 2008, respectively.

Approximately 63%, 65% and 69% of our specialty hospital revenues for the years ended December 31, 2008, 2007 and 2006, respectively, were received for services provided to Medicare patients. Approximately 63% of our specialty hospital revenues for both the six months ended June 30, 2009 and 2008 were received for services provided to Medicare patients.

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Most of our specialty hospitals receive bi-weekly periodic interim payments from Medicare instead of being paid on an individual claim basis. Under a periodic interim payment methodology, Medicare estimates a hospital's claim volume and reimbursement per case based on historical trends and makes bi-weekly interim payments to us based on these estimates. Twice a year per hospital, Medicare reconciles the differences between the actual claim data and the estimated payments. To the extent our actual patient experience is different from the historical trends used by Medicare to develop the estimate, the periodic interim payment will result in our being either temporarily over-paid or under-paid for our Medicare claims. At each balance sheet date, we record any aggregate underpayment as an account receivable or any aggregate overpayment as a payable to third-party payors on our balance sheet. The timing of receipt of bi-weekly periodic interim payments can have a significant impact on our accounts receivable balance and days sales outstanding as of the end of any reporting period.

Contractual Adjustments

Net operating revenues include amounts estimated by us to be reimbursable by Medicare and Medicaid under prospective payment systems and provisions of cost-reimbursement and other payment methods. In addition, we are reimbursed by non-governmental payors using a variety of payment methodologies. Amounts we receive for treatment of patients covered by these programs are generally less than the standard billing rates. Contractual allowances are calculated and recorded through our internally developed systems. In our specialty hospital segment our billing system automatically calculates estimated Medicare reimbursement and associated contractual allowances. For non-governmental payors in our specialty hospital segment, we manually calculate the contractual allowance for each patient based upon the contractual provisions associated with the specific payor. In our outpatient segment, we perform provision testing, using internally developed systems, whereby we monitor a payor's historical paid claims data and compare it against the associated gross charges. This difference is determined as a percentage of gross charges and is applied against gross billing revenue to determine the contractual allowances for the period. Additionally, these contractual percentages are applied against the gross receivables on the balance sheet to determine that adequate contractual reserves are maintained for the gross accounts receivables reported on the balance sheet. We account for any difference as additional contractual adjustments deducted from gross revenues to arrive at net operating revenues in the period that the difference is determined. The estimation processes described above and used in recording our contractual adjustments have historically yielded consistent and reliable results.

Allowance for Doubtful Accounts

Substantially all of our accounts receivable are related to providing healthcare services to patients. Collection of these accounts receivable is our primary source of cash and is critical to our operating performance. Our primary collection risks relate to non-governmental payors who insure these patients, and deductibles, co-payments and self-insured amounts owed by the patient. Deductibles, co-payments and self-insured amounts are an immaterial portion of our net accounts receivable balance. At June 30, 2009, deductibles, co-payments and self-insured amounts owed by the patient accounted for approximately 0.3% of our net accounts receivable balance before doubtful accounts. Our general policy is to verify insurance coverage prior to the date of admission for a patient admitted to our hospitals or in the case of our outpatient rehabilitation clinics, we verify insurance coverage prior to their first therapy visit. Our estimate for the allowance for doubtful accounts is calculated by providing a reserve allowance based upon the age of an account balance. Generally we reserve as uncollectible all governmental accounts over 365 days and non-governmental accounts over 180 days from discharge. This method is monitored based on our historical cash collections experience. Collections are impacted by the effectiveness of our collection efforts with non-governmental payors and regulatory or administrative disruptions with the fiscal intermediaries that pay our governmental receivables.

We estimate bad debts for total accounts receivable within each of our operating units. We believe our policies have resulted in reasonable estimates determined on a consistent basis. We believe that we collect substantially all of our

third-party insured receivables (net of contractual allowances) which include receivables from governmental agencies. To date, we believe there has not been a material difference between our bad debt allowances and the ultimate historical collection rates on accounts receivable. We review our overall reserve adequacy by monitoring historical cash collections as a percentage of net revenue less the provision for bad debts. Uncollected accounts are

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written off the balance sheet when they are turned over to an outside collection agency, or when management determines that the balance is uncollectible, whichever occurs first.

The following table is an aging of our net (after allowances for contractual adjustments but before doubtful accounts) accounts receivable (in thousands):

	Balance as of December 31,				Balance as of	
	2007		2008		June 30, 2009	
	0-90 Days	Over 90 Days	0-90 Days	Over 90 Days	0-90 Days	Over 90 Days
Medicare and Medicaid	\$ 76,927	\$ 15,131	\$ 101,687	\$ 12,780	\$ 132,780	\$ 13,584
Commercial insurance, and other	175,152	60,052	186,200	68,803	175,930	70,006
Total net accounts receivable	\$ 252,079	\$ 75,183	\$ 287,887	\$ 81,583	\$ 308,710	\$ 83,590

The approximate percentage of total net accounts receivable (after allowance for contractual adjustments but before doubtful accounts) summarized by aging categories is as follows:

	As of December 31,		As of
	2007	2008	June 30, 2009
0 to 90 days	77.0%	77.9%	78.7%
91 to 180 days	10.0%	8.8%	8.4%
181 to 365 days	6.0%	6.7%	4.7%
Over 365 days	7.0%	6.6%	8.2%
Total	100.0%	100.0%	100.0%

The approximate percentage of total net accounts receivable (after allowance for contractual adjustments but before doubtful accounts) summarized by insured status is as follows:

	As of December 31,		As of
	2007	2008	June 30, 2009
Government payors and insured receivables	99.7%	99.7%	99.7%
Self-pay receivables (including deductible and co-payments)	0.3%	0.3%	0.3%
Total	100.0%	100.0%	100.0%

Insurance

Under a number of our insurance programs, which include our employee health insurance program and certain components under our property and casualty insurance program, we are liable for a portion of our losses. In these cases we accrue for our losses under an occurrence based principle whereby we estimate the losses that will be incurred by us in a given accounting period and accrue that estimated liability. Where we have substantial exposure, we utilize actuarial methods in estimating the losses. In cases where we have minimal exposure, we will estimate our losses by analyzing historical trends. We monitor these programs quarterly and revise our estimates as necessary to take into account additional information. At June 30, 2009, December 31, 2008 and December 31, 2007, we have recorded a liability of \$62.1 million, \$62.9 million and \$58.9 million, respectively, for our estimated losses under these insurance programs.

Related Party Transactions

We are party to various rental and other agreements with companies affiliated with us through common ownership. Our payments to these related parties amounted to \$3.3 million for the year ended December 31, 2008 and \$2.3 million for each of the years ended December 31, 2007 and 2006. Our payments to these related parties

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amounted to \$2.2 million for the six months ended June 30, 2009 and \$1.7 million for the six months ended June 30, 2008. Our future commitments are related to commercial office space we lease for our corporate headquarters in Mechanicsburg, Pennsylvania. These future commitments as of June 30, 2009 amount to \$46.2 million through 2023. These transactions and commitments are described more fully in the notes to our consolidated financial statements included herein.

Consideration of Impairment Related to Goodwill and Other Intangible Assets

Goodwill and certain other indefinite-lived intangible assets are no longer amortized, but instead are subject to periodic impairment evaluations under Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets. Our most recent impairment assessment was completed during the fourth quarter of 2008, which indicated that there was no impairment with respect to goodwill or other recorded intangible assets. The majority of our goodwill resides in our specialty hospital reporting unit. In performing periodic impairment tests, the fair value of the reporting unit is compared to the carrying value, including goodwill and other intangible assets. If the carrying value exceeds the fair value, an impairment condition exists, which results in an impairment loss equal to the excess carrying value. Impairment tests are required to be conducted at least annually, or when events or conditions occur that might suggest a possible impairment. These events or conditions include, but are not limited to, a significant adverse change in the business environment, regulatory environment or legal factors; a current period operating or cash flow loss combined with a history of such losses or a projection of continuing losses; or a sale or disposition of a significant portion of a reporting unit. The occurrence of one of these events or conditions could significantly impact an impairment assessment, necessitating an impairment charge and adversely affecting our results of operations. For purposes of goodwill impairment assessment, we have defined our reporting units as specialty hospitals, outpatient rehabilitation clinics and contract therapy with goodwill having been allocated among reporting units based on the relative fair value of those divisions when the Merger occurred in 2005 and based on subsequent acquisitions.

To determine the fair value of our reporting units, we use a discounted cash flow approach. Included in the discounted cash flow are assumptions regarding revenue growth rates, internal development of specialty hospitals and rehabilitation clinics, future EBITDA margin estimates, future selling, general and administrative expense rates and the weighted average cost of capital for our industry. We also must estimate residual values at the end of the forecast period and future capital expenditure requirements. Each of these assumptions requires us to use our knowledge of (1) our industry, (2) our recent transactions, and (3) reasonable performance expectations for our operations. If any one of the above assumptions changes or fails to materialize, the resulting decline in our estimated fair value could result in a material impairment charge to the goodwill associated with any one of the reporting units.

Realization of Deferred Tax Assets

We account for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes or SFAS No. 109, which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS No. 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax asset will not be realized. As part of the process of preparing our consolidated financial statements, we estimate our income taxes based on our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. We also recognize as deferred tax assets the future tax benefits from net operating loss carryforwards. We evaluate the realizability of these deferred tax assets by assessing their valuation allowances and by adjusting the amount of such allowances, if necessary. Among the factors used to assess the likelihood of realization are our projections of future taxable income streams, the expected timing of the reversals of existing temporary differences, and the impact of tax planning strategies that could be implemented to avoid the potential loss of future tax benefits. However, changes in tax codes, statutory tax rates or future taxable

income levels could materially impact our valuation of tax accruals and assets and could cause our provision for income taxes to vary significantly from period to period.

At December 31, 2008 and June 30, 2009, we had deferred tax assets in excess of deferred tax liabilities of approximately \$19.0 million and \$0.3 million, respectively. Those amounts are net of approximately \$23.0 million

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and \$23.1 million of valuation reserves related primarily to state and federal tax net operating losses that may not be realized at December 31, 2008 and June 30, 2009, respectively.

Uncertain Tax Positions

We record and review quarterly our uncertain tax positions. Reserves for uncertain tax positions are established for exposure items related to various federal and state tax matters. Income tax reserves are recorded when an exposure is identified and when, in the opinion of management, it is more likely than not that a tax position will not be sustained and the amount of the liability can be estimated. While we believe that our reserves for uncertain tax positions are adequate, the settlement of any such exposures at amounts that differ from current reserves may require us to materially increase or decrease our reserves for uncertain tax positions.

Stock Based Compensation

Based on the initial public offering price of \$10.00 per share, the aggregate intrinsic value of our vested outstanding stock options and restricted stock as of June 30, 2009 was \$163.4 million, and the aggregate intrinsic value of our unvested outstanding stock options and restricted stock as of June 30, 2009 was \$8.6 million. Determining the fair value of our stock requires making complex and subjective judgments. Our approach to valuation is based on a discounted future cash flow approach that uses our estimates of revenue and estimated costs as well as discount rates determined by analyzing comparable companies and industry capital structures. These estimates are consistent with the plans and estimates that we use to manage the business. The fair value of the common stock has generally been determined contemporaneously with the grants. There is inherent uncertainty in making these estimates. Although it is reasonable to expect that the completion of the registration process will add value to the shares because they will have increased liquidity and marketability, the amount of additional value cannot be measured with precision or certainty.

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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, sales and consolidations. The operating statistics reflect data for the period of time these operations were managed by us.

	Year Ended December 31, 2006	Year Ended December 31, 2007	Year Ended December 31, 2008
Specialty hospital data⁽¹⁾:			
Number of hospitals start of period	101	96	87
Number of hospital start-ups	3	3	7
Number of hospitals acquired			2
Number of hospitals closed/sold	(4)	(8)	(1)
Number of hospitals consolidated	(4)	(4)	(2)
Number of hospitals end of period	96	87	93
Available licensed beds	3,867	3,819	4,222
Admissions	39,668	40,008	41,177
Patient days	969,590	987,624	1,005,719
Average length of stay (days)	24	25	24
Net revenue per patient day ⁽²⁾	\$ 1,392	\$ 1,378	\$ 1,453
Occupancy rate	69%	69%	67%
Percent patient days Medicare	73%	69%	65%
Outpatient rehabilitation data⁽³⁾:			
Number of clinics owned start of period	553	477	918
Number of clinics acquired		570	4
Number of clinic start-ups	12	15	17
Number of clinics closed/sold ⁽⁴⁾	(88)	(144)	(59)
Number of clinics owned end of period	477	918	880
Number of clinics managed end of period	67	81	76
Total number of clinics (all) end of period	544	999	956
Number of visits	2,972,243	4,032,197	4,533,727
Net revenue per visit ⁽⁵⁾	\$ 94	\$ 100	\$ 102

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	Six Months Ended June 30,	
	2008	2009
Specialty hospital data⁽¹⁾:		
Number of hospitals start of period	87	93
Number of hospital start-ups	5	
Number of hospitals closed		(1)
Number of hospitals end of period	92	92
Available licensed beds	4,126	4,160
Admissions	20,914	21,309
Patient days	512,286	508,983
Average length of stay (days)	25	24
Net revenue per patient day ⁽²⁾	\$ 1,428	\$ 1,505
Occupancy rate	69%	67%
Percent patient days Medicare	66%	64%
Outpatient rehabilitation data:		
Number of clinics owned start of period	918	880
Number of clinics acquired		1
Number of clinic start-ups	9	7
Number of clinics closed/sold	(33)	(13)
Number of clinics owned end of period	894	875
Number of clinics managed end of period	76	73
Total number of clinics (all) end of period	970	948
Number of visits	2,323,609	2,259,637
Net revenue per visit ⁽⁵⁾	\$ 103	\$ 102

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

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

(3) Outpatient rehabilitation data has been restated to remove the clinics operated by CBIL. CBIL was sold March 31, 2006 and is being reported as a discontinued operation in 2006.

(4) The number of clinics closed/sold for the year ended December 31, 2007 relate primarily to clinics closed in connection with the restructuring plan for integrating the acquisition of HealthSouth Corporation's outpatient rehabilitation division.

(5) Net revenue per visit is calculated by dividing outpatient rehabilitation clinic revenue by the total number of visits. For purposes of this computation, outpatient rehabilitation 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:

	Year Ended December 31, 2006⁽¹⁾	Year Ended December 31, 2007⁽¹⁾	Year Ended December 31, 2008⁽¹⁾
Net operating revenues	100.0%	100.0%	100.0%
Cost of services ⁽²⁾	80.2	83.3	83.2
General and administrative	2.4	2.2	2.2
Bad debt expense	1.0	1.9	2.2
Depreciation and amortization	2.5	2.9	3.3
Income from operations	13.9	9.7	9.1
Gain on early retirement of debt			0.0
Other expense		0.0	
Interest expense, net	(7.1)	(6.9)	(6.7)
Income from continuing operations before income taxes	6.8	2.8	2.4
Income tax expense	2.4	0.9	1.2
Income from continuing operations	4.4	1.9	1.2
Income from discontinued operations, net of tax	0.7		
Net income	5.1	1.9	1.2
Net income attributable to non-controlling interests	0.1	0.1	0.2
Net income attributable to Select Medical Holdings Corporation	5.0%	1.8%	1.0%

	Six Months Ended June 30, 2008⁽¹⁾ 2009	
Net operating revenues	100.0%	100.0%
Cost of services ⁽²⁾	82.9	80.7
General and administrative	2.2	2.3
Bad debt expense	2.1	2.0
Depreciation and amortization	3.3	3.2
Income from operations	9.5	11.8

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Gain on early retirement of debt		1.4
Interest expense, net	(6.8)	(6.1)
Income from operations before income taxes	2.7	7.1
Income tax expense	1.3	3.0
Net income	1.4	4.1
Net income attributable to non-controlling interest	0.1	0.1
Net income attributable to Select Medical Holdings Corporation	1.3%	4.0%

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

	Year Ended December 31, 2006	Year Ended December 31, 2007 (in thousands)	Year Ended December 31, 2008	% Change 2006- 2007	% Change 2007- 2008
Net operating revenues:					
Specialty hospitals	\$ 1,378,543	\$ 1,386,410	\$ 1,488,412	0.6%	7.4%
Outpatient rehabilitation	470,339	603,413	664,760	28.3	10.2
Other ⁽⁴⁾	2,616	1,843	190	(29.5)	(89.7)
Total company	\$ 1,851,498	\$ 1,991,666	\$ 2,153,362	7.6%	8.1%
Income (loss) from operations:					
Specialty hospitals	\$ 252,539	\$ 180,090	\$ 192,450	(28.7)%	6.9%
Outpatient rehabilitation	51,859	57,979	52,964	11.8	(8.6)
Other ⁽⁴⁾	(46,524)	(44,184)	(49,006)	5.0	(10.9)
Total company	\$ 257,874	\$ 193,885	\$ 196,408	(24.8)%	1.3%
Adjusted EBITDA: ⁽³⁾					
Specialty hospitals	\$ 283,270	\$ 217,175	\$ 236,388	(23.3)%	8.8%
Outpatient rehabilitation	64,823	75,437	77,279	16.4	2.4
Other ⁽⁴⁾	(39,769)	(37,684)	(43,380)	5.2	(15.1)
Adjusted EBITDA margins: ⁽³⁾					
Specialty hospitals	20.5%	15.7%	15.9%	(23.4)%	1.3%
Outpatient rehabilitation	13.8	12.5	11.6	(9.4)	(7.2)
Other ⁽⁴⁾ :	N/M	N/M	N/M	N/M	N/M
Total assets:					
Specialty hospitals	\$ 1,742,803	\$ 1,882,476	\$ 1,910,402		
Outpatient rehabilitation	258,773	513,397	504,869		
Other ⁽⁴⁾	180,948	99,173	164,198		
Total company	\$ 2,182,524	\$ 2,495,046	\$ 2,579,469		
Purchases of property and equipment, net:					
Specialty hospitals	\$ 146,291	\$ 146,901	\$ 40,069		
Outpatient rehabilitation	6,527	14,737	13,271		
Other ⁽⁴⁾	2,278	4,436	3,164		
Total company	\$ 155,096	\$ 166,074	\$ 56,504		

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	Six Months Ended June 30,		% Change
	2008	2009	
	(in thousands)		
Net operating revenues:			
Specialty hospitals	\$ 745,893	\$ 779,563	4.5%
Outpatient rehabilitation	341,072	341,009	(0.0)
Other ⁽⁴⁾	119	135	13.4
Total company	\$ 1,087,084	\$ 1,120,707	3.1%
Income (loss) from operations:			
Specialty hospitals	\$ 96,604	\$ 126,204	30.6%
Outpatient rehabilitation	32,142	34,181	6.3
Other ⁽⁴⁾	(25,981)	(27,371)	(5.4)
Total company	\$ 102,765	\$ 133,014	29.4%
Adjusted EBITDA: ⁽³⁾			
Specialty hospitals	\$ 118,480	\$ 147,741	24.7%
Outpatient rehabilitation	43,843	46,578	6.2
Other ⁽⁴⁾	(23,039)	(25,041)	(8.7)
Adjusted EBITDA margins: ⁽³⁾			
Specialty hospitals	15.9%	19.0%	19.5%
Outpatient rehabilitation	12.9	13.7	6.2
Other ⁽⁴⁾	N/M	N/M	N/M
Total assets:			
Specialty hospitals	\$ 1,925,514	\$ 1,920,040	
Outpatient rehabilitation	510,248	492,936	
Other ⁽⁴⁾	108,275	119,706	
Total company	\$ 2,544,037	\$ 2,532,682	
Purchases of property and equipment, net:			
Specialty hospitals	\$ 17,388	\$ 15,377	
Outpatient rehabilitation	6,813	5,009	
Other ⁽⁴⁾	1,906	595	
Total company	\$ 26,107	\$ 20,981	

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The following tables reconcile same hospitals information:

	Year Ended December 31,	
	2006	2007
	(in thousands)	
Net operating revenue		
Specialty hospitals net operating revenue	\$ 1,378,543	\$ 1,386,410
Less: Specialty hospitals in development, opened or closed after 1/1/06	106,940	81,514
Specialty hospitals same store net operating revenue	\$ 1,271,603	\$ 1,304,896
Adjusted EBITDA ⁽³⁾		
Specialty hospitals Adjusted EBITDA ⁽³⁾	\$ 283,270	\$ 217,175
Less: Specialty hospitals in development, opened or closed after 1/1/06	5,867	(13,524)
Specialty hospitals same store Adjusted EBITDA ⁽³⁾	\$ 277,403	\$ 230,699
All specialty hospitals Adjusted EBITDA margin ⁽³⁾	20.5%	15.7%
Specialty hospitals same store Adjusted EBITDA margin ⁽³⁾	21.8%	17.7%

	Year Ended December 31,	
	2007	2008
	(in thousands)	
Net operating revenue		
Specialty hospitals net operating revenue	\$ 1,386,410	\$ 1,488,412
Less: Specialty hospitals in development, opened or closed after 1/1/07	79,500	85,709
Specialty hospitals same store net operating revenue	\$ 1,306,910	\$ 1,402,703
Adjusted EBITDA ⁽³⁾		
Specialty hospitals Adjusted EBITDA ⁽³⁾	\$ 217,175	\$ 236,388
Less: Specialty hospitals in development, opened or closed after 1/1/07	(10,928)	(21,339)
Specialty hospitals same store Adjusted EBITDA ⁽³⁾	\$ 228,103	\$ 257,727
All specialty hospitals Adjusted EBITDA margin ⁽³⁾	15.7%	15.9%
Specialty hospitals same store Adjusted EBITDA margin ⁽³⁾	17.5%	18.4%

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	Six Months Ended June 30,	
	2008	2009
	(in thousands)	
Net operating revenue		
Specialty hospitals net operating revenue	\$ 745,893	\$ 779,563
Less: Specialty hospitals in development, opened or closed after 1/1/08	23,070	51,890
Specialty hospitals same store net operating revenue	\$ 722,823	\$ 727,673
Adjusted EBITDA ⁽³⁾		
Specialty hospitals Adjusted EBITDA ⁽³⁾	\$ 118,480	\$ 147,741
Less: Specialty hospitals in development, opened or closed after 1/1/08	(11,426)	(2,257)
Specialty hospitals same store Adjusted EBITDA ⁽³⁾	\$ 129,906	\$ 149,998
All specialty hospitals Adjusted EBITDA margin ⁽³⁾	15.9%	19.0%
Specialty hospitals same store Adjusted EBITDA margin ⁽³⁾	18.0%	20.6%

N/M Not Meaningful.

- (1) Adjusted for the adoption of SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements. See Note 1, Organization and Significant Accounting Policies Recent Accounting Pronouncements, in our audited consolidated financial statements and Note 2, Accounting Policies Recent Accounting Pronouncements, in our interim unaudited consolidated financial statements for additional information.
- (2) Cost of services includes salaries, wages and benefits, operating supplies, lease and rent expense and other operating costs.
- (3) We define Adjusted EBITDA as net income before interest, income taxes, depreciation and amortization, income from discontinued operations, gain on early retirement of debt, stock compensation expense, other expense and non-controlling interests. 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. See Note 13 to our audited consolidated financial statements and footnote 7 to our interim unaudited consolidated financial statements for the period ended June 30, 2009 for a reconciliation of net income to Adjusted EBITDA as utilized by us in reporting our segment performance in accordance with SFAS No. 131.

(4) Other includes our general and administrative services and non-healthcare services.

Six Months Ended June 30, 2009 Compared to Six Months Ended June 30, 2008

Net Operating Revenues

Our net operating revenues increased by 3.1% to \$1,120.7 million for the six months ended June 30, 2009 compared to \$1,087.1 million for the six months ended June 30, 2008.

Specialty Hospitals. Our specialty hospital net operating revenues increased by 4.5% to \$779.6 million for the six months ended June 30, 2009 compared to \$745.9 million for the six months ended June 30, 2008. For the six months ended June 30, 2009, the hospitals opened in 2008 increased net operating revenues by \$34.3 million and the hospitals acquired in 2008 increased net operating revenues by \$11.7 million. These increases were offset partially by the loss of revenues from hospitals that closed during 2008 and 2009, which accounted for \$17.2 million of the difference in net operating revenues between the six months ended June 30, 2008 and June 30, 2009. Net operating revenues for the specialty hospitals opened as of January 1, 2008 and operated by us throughout both periods were \$727.7 million for the six months ended June 30, 2009, compared to \$722.8 million for the six months ended June 30, 2008. Our patient days for these same store hospitals decreased 4.1% and the decrease was attributable to a decline in our Medicare patient days. The occupancy percentage in our same store hospitals decreased to 70% for

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the six months ended June 30, 2009 from 72% for the six months ended June 30, 2008. The effect on net operating revenues from the decrease in patient days was offset by an increase in our average net revenue per patient day. Our average net revenue per patient day in our same store hospitals increased 5.1% to \$1,506 for the six months ended June 30, 2009 from \$1,433 for the six months ended June 30, 2008. This increase in net revenue per patient day was primarily the result of an increase in the severity of the Medicare cases we treated.

Outpatient Rehabilitation. Our outpatient rehabilitation net operating revenues was \$341.0 million for the six months ended June 30, 2009 compared to \$341.1 million for the six months ended June 30, 2008. The number of patient visits in our outpatient rehabilitation clinics decreased 2.8% for the six months ended June 30, 2009 to 2,259,637 visits compared to 2,323,609 visits for the six months ended June 30, 2008. The decline in visits, which principally occurred during the first quarter of 2009, was the result of various factors in numerous locations where we operate, including staffing shortages and increased competition. Net revenue per visit in our clinics was \$102 for the six months ended June 30, 2009 and \$103 for the six months ended June 30, 2008. The reduction in net operating revenue in our clinics due to the decline in patient visits was offset by an increase in our other outpatient revenues of approximately \$8.5 million that resulted primarily from new business.

Operating Expenses

Our operating expenses remained generally constant and were \$952.0 million for the six months ended June 30, 2009 compared to \$949.0 million for the six months ended June 30, 2008. Our operating expenses include our cost of services, general and administrative expense and bad debt expense. As a percentage of our net operating revenues, our operating expenses were 85.0% for the six months ended June 30, 2009 compared to 87.2% for the six months ended June 30, 2008. Our cost of services were \$904.4 million for the six months ended June 30, 2009 compared to \$901.6 million for the six months ended June 30, 2008. A major component of these costs is our labor expense. This increase was the result of an increase in the cost of services in our specialty hospital segment offset by a reduction in the cost of services in our outpatient rehabilitation segment. The increase in cost of services we experienced in the specialty hospital segment was due to the growth in the hospitals we opened or acquired in 2008. The reduction in cost of services in the outpatient segment was principally due to the reduction we experienced in patient visits. A component of cost of services is facility rent expense, which was \$58.3 million for the six months ended June 30, 2009 compared to \$54.6 million for the six months ended June 30, 2008. General and administrative expenses were \$25.7 million for the six months ended June 30, 2009 compared to \$24.3 million for the six months ended June 30, 2008. The increase of \$1.4 million in general and administrative expense is due to increases in non-salary related operating expenses. Our bad debt expense as a percentage of net operating revenues was 2.0% for the six months ended June 30, 2009 compared to 2.1% for the six months ended June 30, 2008.

Adjusted EBITDA

Specialty Hospitals. Adjusted EBITDA increased by 24.7% to \$147.7 million for the six months ended June 30, 2009 compared to \$118.5 million for the six months ended June 30, 2008. Our Adjusted EBITDA margins increased to 19.0% for the six months ended June 30, 2009 from 15.9% for the six months ended June 30, 2008. The hospitals opened as of January 1, 2008 and operated by us throughout both periods had Adjusted EBITDA of \$150.0 million for the six months ended June 30, 2009, an increase of \$20.1 million or 15.5% over the Adjusted EBITDA of \$129.9 million for these hospitals for the six months ended June 30, 2008. Our Adjusted EBITDA margin in these same store hospitals increased to 20.6% for the six months ended June 30, 2009 from 18.0% for the six months ended June 30, 2008. The principal reason for the growth in our Adjusted EBITDA margin for these same store hospitals is an increase in our net revenue per patient day due to an increase in the severity of our Medicare cases while at the same time controlling our costs related to these cases. We also reduced the Adjusted EBITDA losses in our recently opened hospitals. Our hospitals opened during 2008 incurred Adjusted EBITDA losses of \$2.9 million for the six months ended June 30, 2009 compared to Adjusted EBITDA losses of \$12.1 million incurred for the six months ended

June 30, 2008.

Outpatient Rehabilitation. Adjusted EBITDA increased by 6.2% to \$46.6 million for the six months ended June 30, 2009 compared to \$43.8 million for the six months ended June 30, 2008. Our Adjusted EBITDA margins increased to 13.7% for the six months ended June 30, 2009 from 12.9% for the six months ended June 30, 2008. The increase in Adjusted EBITDA was primarily the result of the growth in our other non-clinic outpatient business.

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Other. The Adjusted EBITDA loss was \$25.0 million for the six months ended June 30, 2009 compared to an Adjusted EBITDA loss of \$23.0 million for the six months ended June 30, 2008 and is primarily related to our general and administrative expenses.

Income from Operations

For the six months ended June 30, 2009 we experienced income from operations of \$133.0 million compared to \$102.8 million for the six months ended June 30, 2008. The increase in income from operations resulted primarily from the improved operating performance we experienced in both the specialty hospitals opened in 2008 and the specialty hospitals opened as of January 1, 2008 and operated by us throughout both periods.

Gain on Early Retirement of Debt

For the six months ended June 30, 2009, we paid approximately \$30.1 million to repurchase and retire a portion of our 75/8% senior subordinated notes. These notes had a carrying value of \$46.5 million. A gain on early retirement of debt in the amount of \$15.3 million was recognized on the transactions which was net of the write-off of unamortized deferred financing costs related to the debt.

Interest Expense

Interest expense was \$68.3 million for the six months ended June 30, 2009 compared to \$73.5 million for the six months ended June 30, 2008. The decrease in interest expense is related to lower average outstanding debt balances in 2009 and a decline in interest rates.

Income Taxes

We recorded income tax expense of \$33.9 million for the six months ended June 30, 2009. The expense represented an effective tax rate of 42.3%. We recorded income tax expense of \$14.0 million for the six months ended June 30, 2008. The expense represented an effective tax rate of 47.4%. The reduction in the effective rate is principally due to a reduction in the reserve for uncertain tax positions, a reduction in the accrued interest and penalties associated with these uncertain tax positions and the smaller relative effect that permanent items have on the effective tax rate due to the increase in our taxable income.

Non-Controlling Interests

Non-controlling interests in consolidated earnings were \$1.4 million for the six months ended June 30, 2009 and \$1.1 million for the six months ended June 30, 2008.

Year Ended December 31, 2008 Compared to Year Ended December 31, 2007

Net Operating Revenues

Our net operating revenues increased by 8.1% to \$2,153.4 million for the year ended December 31, 2008 compared to \$1,991.7 million for the year ended December 31, 2007.

Specialty Hospitals. Our specialty hospital net operating revenues increased 7.4% to \$1,488.4 million for the year ended December 31, 2008 compared to \$1,386.4 million for the year ended December 31, 2007. Net operating revenues for the specialty hospitals opened as of January 1, 2007 and operated by us throughout both periods increased 7.3% to \$1,402.7 million for the year ended December 31, 2008 from \$1,306.9 million for the year ended

December 31, 2007. This increase was partially offset by the loss of revenues from closed hospitals, which accounted for \$52.2 million of the difference in net operating revenues between 2007 and 2008. Hospitals opened in 2007 and 2008 increased net operating revenues by \$58.4 million for the year ended December 31, 2008. The increase in same store hospitals net operating revenues resulted from increases in our patient days and our average net revenue per patient day. Our patient days for these same store hospitals increased 2.1% and was attributable to an increase in our non-Medicare patient days. Our average net revenue per patient day in our same store hospitals increased 5.0% to \$1,458 for the year ended December 31, 2008 from \$1,388 for the year ended December 31, 2007.

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This increase in net revenue per patient day resulted from increased Medicare revenues and was primarily the result of an increase in the severity of the Medicare cases we treated.

Outpatient Rehabilitation. Our outpatient rehabilitation net operating revenues increased 10.2% to \$664.8 million for the year ended December 31, 2008 compared to \$603.4 million for the year ended December 31, 2007. The increase in outpatient rehabilitation net operating revenues was primarily attributable to an increase in patient visits. The number of patient visits in our outpatient rehabilitation clinics increased 12.4% for the year ended December 31, 2008 to 4,533,727 visits compared to 4,032,197 visits for the year ended December 31, 2007. Substantially all of the increase in net operating revenues and patient visits was related to the acquisition of the outpatient rehabilitation division of HealthSouth Corporation in May 2007. Net revenue per visit in our clinics was \$102 for the year ended December 31, 2008 compared to \$100 for the year ended December 31, 2007.

Other. Our other revenues were \$0.2 million for the year ended December 31, 2008 compared to \$1.8 million for the year ended December 31, 2007. These revenues relate to revenue from other non-healthcare services.

Operating Expenses

Our operating expenses increased by 8.3% to \$1,885.2 million for the year ended December 31, 2008 compared to \$1,740.5 million for the year ended December 31, 2007. Our operating expenses include our cost of services, general and administrative expense and bad debt expense. The increase in operating expenses occurred in both of our operating segments. In our specialty hospital segment, the cause of the increase in costs was equally divided between costs related to the increase in patient volume and an increase in the cost to treat patients. In our outpatient rehabilitation segment the cause of the increase in costs was principally related to the increased patient volumes resulting from the acquisition of the outpatient division of HealthSouth Corporation. As a percentage of our net operating revenues, our operating expenses were 87.6% for the year ended December 31, 2008 compared to 87.4% for the year ended December 31, 2007. The increase in the relative percentage of our operating expenses compared to net operating revenue was principally related to our bad debt costs. Cost of services as a percentage of operating revenues was 83.2% for the year ended December 31, 2008 compared to 83.3% for the year ended December 31, 2007. These costs primarily reflect our labor expenses. Another component of cost of services is facility rent expense, which was \$110.2 million for the year ended December 31, 2008 compared to \$98.5 million for the year ended December 31, 2007. The increase in rent expense was principally related to the acquisition of the outpatient rehabilitation division of HealthSouth Corporation and recently opened specialty hospitals that are leased. General and administrative expenses were 2.2% of net operating revenues for both the years ended December 31, 2008 and 2007. Our bad debt expense as a percentage of net operating revenues was 2.2% for the year ended December 31, 2008 compared to 1.9% for the year ended December 31, 2007. The increase in our bad debt expense occurred principally in our specialty hospitals. In our specialty hospitals we experienced an aging of our accounts receivable which caused us to increase our reserves for doubtful accounts for the year ended December 31, 2008. Additionally, we are experiencing an increase in the write-off of uncollectible Medicare co-payments and deductibles where state Medicaid programs are the secondary payor which has the effect of increasing our bad debt expense.

Adjusted EBITDA

Specialty Hospitals. Adjusted EBITDA increased by 8.8% to \$236.4 million for the year ended December 31, 2008 compared to \$217.2 million for the year ended December 31, 2007. Our Adjusted EBITDA margins increased to 15.9% for the year ended December 31, 2008 from 15.7% for the year ended December 31, 2007. The hospitals opened before January 1, 2007 and operated throughout both years had Adjusted EBITDA of \$257.7 million, an increase of \$29.6 million or 13.0% over the Adjusted EBITDA of these hospitals for the year ended December 31, 2007. Our Adjusted EBITDA margin in these same store hospitals increased to 18.4% for the year ended December 31, 2008 from 17.5% for the year ended December 31, 2007. The principal reasons for the growth in our

Adjusted EBITDA and Adjusted EBITDA margin for these same store hospitals are the result of increased patient volume and the increase in our net revenue per patient day. Our hospitals opened during 2007 and 2008 incurred Adjusted EBITDA losses of \$22.4 million and \$11.3 million for the year ended December 31, 2008 and 2007, respectively.

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Outpatient Rehabilitation. Adjusted EBITDA increased by 2.4% to \$77.3 million for the year ended December 31, 2008 compared to \$75.4 million for the year ended December 31, 2007. Our Adjusted EBITDA margins decreased to 11.6% for the year ended December 31, 2008 from 12.5% for the year ended December 31, 2007. Our Adjusted EBITDA margins decreased for the year ended December 31, 2008 compared to the year ended December 31, 2007 due to lower margins generated by the outpatient rehabilitation clinics acquired from HealthSouth Corporation. The principal cause of the lower margins has been a reduction in patient volume at these clinics. Due to the small size of these clinics, it is difficult for us to reduce our cost structures to offset patient volume declines.

Other. The Adjusted EBITDA loss was \$43.4 million for the year ended December 31, 2008 compared to a loss of \$37.7 million for the year ended December 31, 2007 and was primarily related to our general and administrative expenses.

Income from Operations

For the year ended December 31, 2008, we had income from operations of \$196.4 million compared to income from operations of \$193.9 million for the year ended December 31, 2007. The decrease in income from operations resulted from an increase in depreciation and amortization expense offset by the Adjusted EBITDA changes described above. The increase in depreciation and amortization expense resulted primarily from increased depreciation expense associated with free-standing hospitals we have placed in service and an increase in depreciation and amortization expense related to the outpatient rehabilitation clinics acquired from HealthSouth Corporation.

Interest Expense

Interest expense was \$145.9 million for the year ended December 31, 2008 compared to \$140.2 million for the year ended December 31, 2007. The increase in interest expense is related to higher average outstanding debt balances under our senior secured credit facility existing during the year ended December 31, 2008. The increase in outstanding debt is principally related to the borrowings on our senior secured credit facility used to fund the acquisition of the outpatient rehabilitation division of HealthSouth Corporation, offset by the effect of declining interest rates in 2008.

Gain on Early Retirement of Debt

In the three months ended December 31, 2008, we paid approximately \$1.0 million to repurchase and retire a portion of Select's 75/8% senior subordinated notes. These notes had a carrying value of \$2.0 million. A gain on early retirement of debt in the amount of \$0.9 million was recognized on the transaction which included the write-off of the unamortized deferred financing costs related to the debt.

Income Taxes

We recorded income tax expense of \$26.1 million for the year ended December 31, 2008. This expense represented an effective tax rate of 50.2%. For the year ended December 31, 2007, we recorded income tax expense of \$18.7 million. This expense represented an effective tax rate of 33.6%. In the year ended December 31, 2008 we experienced an effective tax rate that was higher than our expected blended federal and state tax rate as a result of an increase in valuation reserves due to our inability to use state net operating losses arising in the tax entities acquired from HealthSouth Corporation and excess federal capital losses that can only be offset by future capital gains. For the year ended December 31, 2007 we recognized a lower effective tax rate as a result of greater than expected tax benefits generated on the sale of equipment and subsidiaries.

Non-Controlling Interests

Non-Controlling interests in consolidated earnings were \$3.4 million for the year ended December 31, 2008 compared to \$1.5 million for the year ended December 31, 2007. This increase in non-controlling interest is due to an increase in the non-controlling ownership in three of our specialty hospitals.

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Year Ended December 31, 2007 Compared to Year Ended December 31, 2006

Net Operating Revenues

Our net operating revenues increased by 7.6% to \$1,991.7 million for the year ended December 31, 2007 compared to \$1,851.5 million for the year ended December 31, 2006.

Specialty Hospitals. Our specialty hospital net operating revenues increased 0.6% to \$1,386.4 million for the year ended December 31, 2007 compared to \$1,378.5 million for the year ended December 31, 2006. Net operating revenues for the specialty hospitals opened before January 1, 2006 and operated by us throughout both years increased 2.6% to \$1,304.9 million for the year ended December 31, 2007 from \$1,271.6 million for the year ended December 31, 2006. This increase was offset by the loss of revenues from closed hospitals, which accounted for \$57.2 million of the difference in net revenues between 2006 and 2007. Hospitals opened in 2006 and 2007 increased net operating revenues by \$31.8 million for the year ended December 31, 2007. The increase in same store hospitals net operating revenues resulted from an increase in our patient days. Our patient days for these same store hospitals increased 4.0% and our occupancy percentage remained constant at 71% for both the year ended December 31, 2007 and the year ended December 31, 2006. The \$33.3 million increase in our same store specialty hospitals net operating revenue was the result of a \$63.7 million increase in our non-Medicare net operating revenues that was offset by a reduction in our Medicare net operating revenues of \$30.4 million. The reduction in Medicare net operating revenues has resulted from LTCH regulatory changes that have reduced the payment rates for Medicare cases and a reductio