

SELECT MEDICAL HOLDINGS CORP

Form 10-Q

August 07, 2012

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

**For the Quarterly Period Ended June 30, 2012**

**o Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the Transition Period From                      to                      .**

**Commission File Numbers: 001 34465 and 001 31441**

**SELECT MEDICAL HOLDINGS CORPORATION**

**SELECT MEDICAL CORPORATION**

(Exact name of Registrants as specified in their charters)

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**Delaware**

**20-1764048**

**Delaware**

**23-2872718**

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. employer identification  
number)

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

(Address of principal executive offices and zip code)

**(717) 972-1100**

(Registrants' telephone number, including area code)

Indicate by check mark whether the Registrants (1) have filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods as the Registrants were required to file such reports), and (2) have been subject to such filing requirements for the past 90 days. YES ☒ NO ☐

Indicate by check mark whether the Registrants have submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the Registrants were required to submit and post such files). YES ☒ NO ☐

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

Smaller reporting company ☐

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

As of July 31, 2012, Select Medical Holdings Corporation had outstanding 139,866,719 shares of common stock.

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



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Table of Contents**Consolidated Balance Sheets****(unaudited)****(in thousands, except share and per share amounts)**

	<b>Select Medical Holdings Corporation</b>		<b>Select Medical Corporation</b>	
	<b>December 31, 2011</b>	<b>June 30, 2012</b>	<b>December 31, 2011</b>	<b>June 30, 2012</b>
<b>ASSETS</b>				
Current Assets:				
Cash and cash equivalents	\$ 12,043	\$ 21,520	\$ 12,043	\$ 21,520
Accounts receivable, net of allowance for doubtful accounts of \$47,469 and \$44,783 in 2011 and 2012, respectively	413,743	423,859	413,743	423,859
Current deferred tax asset	18,305	15,533	18,305	15,533
Prepaid income taxes	9,497	4,061	9,497	4,061
Other current assets	29,822	31,383	29,822	31,383
Total Current Assets	483,410	496,356	483,410	496,356
Property and equipment, net	510,028	492,781	510,028	492,781
Goodwill	1,631,716	1,631,461	1,631,716	1,631,461
Other identifiable intangibles	72,123	71,783	72,123	71,783
Assets held for sale	2,742	2,742	2,742	2,742
Other assets	72,128	84,514	70,719	83,291
<b>Total Assets</b>	<b>\$ 2,772,147</b>	<b>\$ 2,779,637</b>	<b>\$ 2,770,738</b>	<b>\$ 2,778,414</b>
<b>LIABILITIES AND EQUITY</b>				
Current Liabilities:				
Bank overdrafts	\$ 16,609	\$ 20,348	\$ 16,609	\$ 20,348
Current portion of long-term debt and notes payable	10,848	11,785	10,848	11,785
Accounts payable	95,618	90,132	95,618	90,132
Accrued payroll	82,888	73,712	82,888	73,712
Accrued vacation	51,250	56,208	51,250	56,208
Accrued interest	15,096	26,945	11,980	23,746
Accrued restructuring	5,027	3,038	5,027	3,038
Accrued other	101,076	99,583	106,316	104,823
Due to third party payors	5,526	7,264	5,526	7,264
Total Current Liabilities	383,938	389,015	386,062	391,056
Long-term debt, net of current portion	1,385,950	1,342,134	1,218,650	1,174,834
Non-current deferred tax liability	82,028	82,911	82,028	82,911
Other non-current liabilities	64,905	68,649	64,905	68,649
<b>Total Liabilities</b>	<b>1,916,821</b>	<b>1,882,709</b>	<b>1,751,645</b>	<b>1,717,450</b>
Stockholders' Equity:				
Common stock of Holdings, \$0.001 par value, 700,000,000 shares authorized, 145,268,190 shares and 139,863,119 shares issued and outstanding in 2011 and 2012, respectively	145	140		

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Common stock of Select, \$0.01 par value, 100 shares issued and outstanding			0	0
Capital in excess of par	493,828	469,410	848,844	853,506
Retained earnings	328,882	393,961	137,778	174,041
Total Select Medical Holdings Corporation and Select Medical Corporation Stockholders Equity	822,855	863,511	986,622	1,027,547
Non-controlling interest	32,471	33,417	32,471	33,417
Total Equity	855,326	896,928	1,019,093	1,060,964
<b>Total Liabilities and Equity</b>	<b>\$ 2,772,147</b>	<b>\$ 2,779,637</b>	<b>\$ 2,770,738</b>	<b>\$ 2,778,414</b>

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

Table of Contents**Consolidated Statements of Operations****(unaudited)****(in thousands, except per share amounts)**

	<b>Select Medical Holdings Corporation</b>		<b>Select Medical Corporation</b>	
	<b>For the Three Months Ended June 30,</b>		<b>For the Three Months Ended June 30,</b>	
	<b>2011</b>	<b>2012</b>	<b>2011</b>	<b>2012</b>
Net operating revenues	\$ 698,749	\$ 750,193	\$ 698,749	\$ 750,193
Costs and expenses:				
Cost of services	569,666	612,669	569,666	612,669
General and administrative	16,115	18,554	16,115	18,554
Bad debt expense	13,943	10,029	13,943	10,029
Depreciation and amortization	17,999	15,428	17,999	15,428
Total costs and expenses	617,723	656,680	617,723	656,680
Income from operations	81,026	93,513	81,026	93,513
Other income and expense:				
Loss on early retirement of debt	(31,018)		(20,385)	
Equity in earnings (losses) of unconsolidated subsidiaries	(251)	2,752	(251)	2,752
Interest income	111		111	
Interest expense	(25,296)	(23,798)	(19,694)	(20,957)
Income before income taxes	24,572	72,467	40,807	75,308
Income tax expense	10,915	27,651	16,597	28,646
Net income	13,657	44,816	24,210	46,662
Less: Net income attributable to non-controlling interests	1,938	1,644	1,938	1,644
Net income attributable to Select Medical Holdings Corporation and Select Medical Corporation	\$ 11,719	\$ 43,172	\$ 22,272	\$ 45,018
Income per common share:				
Basic	\$ 0.08	\$ 0.31		
Diluted	\$ 0.08	\$ 0.31		

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

Table of Contents**Consolidated Statements of Operations****(unaudited)****(in thousands, except per share amounts)**

	<b>Select Medical Holdings Corporation</b>		<b>Select Medical Corporation</b>	
	<b>For the Six Months Ended June 30,</b>		<b>For the Six Months Ended June 30,</b>	
	<b>2011</b>	<b>2012</b>	<b>2011</b>	<b>2012</b>
Net operating revenues	\$ 1,391,935	\$ 1,494,214	\$ 1,391,935	\$ 1,494,214
Costs and expenses:				
Cost of services	1,127,082	1,224,288	1,127,082	1,224,288
General and administrative	32,681	32,778	32,681	32,778
Bad debt expense	28,293	20,404	28,293	20,404
Depreciation and amortization	35,221	31,627	35,221	31,627
Total costs and expenses	1,223,277	1,309,097	1,223,277	1,309,097
Income from operations	168,658	185,117	168,658	185,117
Other income and expense:				
Loss on early retirement of debt	(31,018)		(20,385)	
Equity in earnings (losses) of unconsolidated subsidiaries	(324)	5,217	(324)	5,217
Interest income	167		167	
Interest expense	(50,960)	(47,720)	(38,356)	(42,207)
Income before income taxes	86,523	142,614	109,760	148,127
Income tax expense	37,479	55,226	45,611	57,156
Net income	49,044	87,388	64,149	90,971
Less: Net income attributable to non-controlling interests	3,653	2,674	3,653	2,674
Net income attributable to Select Medical Holdings Corporation and Select Medical Corporation	\$ 45,391	\$ 84,714	\$ 60,496	\$ 88,297
Income per common share:				
Basic	\$ 0.29	\$ 0.60		
Diluted	\$ 0.29	\$ 0.59		

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



Table of Contents**Select Medical Holdings Corporation****Consolidated Statement of Changes in Equity and Income****(unaudited)****(in thousands)**

	<b>Select Medical Holdings Corporation Stockholders</b>						
	<b>Total</b>	<b>Common Stock Issued</b>	<b>Common Stock Par Value</b>	<b>Capital in Excess of Par</b>	<b>Retained Earnings</b>	<b>Non-controlling Interests</b>	
Balance at December 31, 2011	\$ 855,326	145,268	\$ 145	\$ 493,828	\$ 328,882	\$ 32,471	
Net income	87,388				84,714	2,674	
Issuance and vesting of restricted stock	1,998	194	0	1,998			
Exercise of stock options	547	127	0	547			
Stock option expense	601			601			
Repurchase of common shares	(46,790)	(5,726)	(5)	(27,150)	(19,635)		
Distributions to non-controlling interests	(1,681)					(1,681)	
Other	(461)			(414)		(47)	
Balance at June 30, 2012	\$ 896,928	139,863	\$ 140	\$ 469,410	\$ 393,961	\$ 33,417	

**Select Medical Corporation****Consolidated Statement of Changes in Equity and Income****(unaudited)****(in thousands)**

	<b>Select Medical Corporation Stockholders</b>						
	<b>Total</b>	<b>Common Stock Issued</b>	<b>Common Stock Par Value</b>	<b>Capital in Excess of Par</b>	<b>Retained Earnings</b>	<b>Non-controlling Interests</b>	
Balance at December 31, 2011	\$ 1,019,093	0	\$ 0	\$ 848,844	\$ 137,778	\$ 32,471	
Net income	90,971				88,297	2,674	
Federal tax benefit of losses contributed by Holdings	1,930			1,930			
Additional investment by Holdings	547			547			
Dividends declared and paid to Holdings	(52,034)				(52,034)		
Distributions to non-controlling interests	(1,681)					(1,681)	
Other	(461)			(414)		(47)	

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Contribution related to  
restricted stock awards and  
stock option issuances by

Stock Option Issuances by Holdings		2,599				2,599					
Balance at June 30, 2012	\$	1,060,964	0	\$	0	\$	853,506	\$	174,041	\$	33,417

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

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

(unaudited)

(in thousands)

	<b>Select Medical Holdings Corporation</b>		<b>Select Medical Corporation</b>	
	<b>For the Six Months Ended June 30,</b>		<b>For the Six Months Ended June 30,</b>	
	<b>2011</b>	<b>2012</b>	<b>2011</b>	<b>2012</b>
<b>Operating activities</b>				
Net income	\$ 49,044	\$ 87,388	\$ 64,149	\$ 90,971
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	35,221	31,627	35,221	31,627
Provision for bad debts	28,293	20,404	28,293	20,404
Loss on early retirement of debt	31,018		20,385	
Gain from disposal or sale of assets	(5,201)	(3,604)	(5,201)	(3,604)
Non-cash stock compensation expense	1,780	2,599	1,780	2,599
Amortization of debt discount	962	622	103	622
Changes in operating assets and liabilities, net of effects from acquisition of businesses:				
Accounts receivable	(81,240)	(30,520)	(81,240)	(30,520)
Other current assets	(1,511)	(1,612)	(1,511)	(1,612)
Other assets	2,724	(653)	2,469	(839)
Accounts payable	8,107	(5,486)	8,107	(5,486)
Due to third-party payors	(464)	1,738	(464)	1,738
Accrued expenses	6,775	6,423	13,008	6,340
Income and deferred taxes	8,019	9,879	16,151	11,809
Net cash provided by operating activities	83,527	118,805	101,250	124,049
<b>Investing activities</b>				
Purchases of property and equipment	(23,696)	(27,934)	(23,696)	(27,934)
Proceeds from sale of assets	7,879	16,511	7,879	16,511
Investment in business	(13,514)	(10,014)	(13,514)	(10,014)
Acquisition of businesses, net of cash acquired	1,921	(206)	1,921	(206)
Net cash used in investing activities	(27,410)	(21,643)	(27,410)	(21,643)
<b>Financing activities</b>				
Borrowings on revolving credit facilities	435,000	340,000	435,000	340,000
Payments on revolving credit facilities	(395,000)	(380,000)	(395,000)	(380,000)
Borrowings on 2011 credit facility term loan, net of discount	841,500		841,500	
Payments on 2011 credit facility term loan		(4,250)		(4,250)
Payments on 2005 credit facility term loans, net of call premium	(484,633)		(484,633)	
Repurchase of 10% senior subordinated notes	(150,000)			
Repurchase of 7 5/8% senior subordinated notes, net of tender premium	(273,941)		(273,941)	
Borrowings of other debt	5,496	5,835	5,496	5,835
Principal payments on other debt	(3,480)	(5,085)	(3,480)	(5,085)
Debt issuance costs	(18,556)		(18,556)	
Dividends paid to Holdings			(171,008)	(52,034)
Repurchase of common stock	(3,285)	(46,790)		

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Proceeds from issuance of common stock	169	547		
Equity investment by Holdings			169	547
Proceeds from bank overdrafts	2,102	3,739	2,102	3,739
Distributions to non-controlling interests	(2,270)	(1,681)	(2,270)	(1,681)
Net cash used in financing activities	(46,898)	(87,685)	(64,621)	(92,929)
Net increase in cash and cash equivalents	9,219	9,477	9,219	9,477
Cash and cash equivalents at beginning of period	4,365	12,043	4,365	12,043
Cash and cash equivalents at end of period	\$ 13,584	\$ 21,520	\$ 13,584	\$ 21,520
<b>Supplemental Cash Flow Information</b>				
Cash paid for interest	\$ 59,289	\$ 32,378	\$ 41,572	\$ 27,136
Cash paid for taxes	\$ 29,435	\$ 45,344	\$ 29,435	\$ 45,344

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

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**SELECT MEDICAL HOLDINGS CORPORATION AND SELECT MEDICAL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**1. Basis of Presentation**

Select Medical Corporation ( Select ) was formed in December 1996 and commenced operations during February 1997 upon the completion of its first acquisition. Select Medical Holdings Corporation ( Holdings ) was formed in October 2004 for the purpose of affecting a leveraged buyout of Select, which was a publicly traded entity. On February 24, 2005, Select merged with a subsidiary of Holdings, which resulted in Select becoming a wholly-owned subsidiary of Holdings (the Merger ). On September 30, 2009 Holdings completed its initial public offering of common stock. Generally accepted accounting principles ( GAAP ) require that any amounts recorded or incurred (such as goodwill and compensation expense) by the parent as a result of the Merger or for the benefit of the subsidiary be pushed down and recorded in Select's consolidated financial statements. Holdings and Select and their subsidiaries are collectively referred to as the Company. The consolidated financial statements of Holdings include the accounts of its wholly-owned subsidiary Select. Holdings conducts substantially all of its business through Select and its subsidiaries.

The unaudited condensed consolidated financial statements of the Company as of June 30, 2012 and for the three and six month periods ended June 30, 2011 and 2012 have been prepared in accordance with GAAP. In the opinion of management, such information contains all adjustments, which are normal and recurring in nature, necessary for a fair statement of the financial position, results of operations and cash flow for such periods. All significant intercompany transactions and balances have been eliminated. The results of operations for the three and six months ended June 30, 2012 are not necessarily indicative of the results to be expected for the full fiscal year ending December 31, 2012.

Certain information and disclosures normally included in the notes to consolidated financial statements have been condensed or omitted consistent with the rules and regulations of the Securities and Exchange Commission (the SEC ), although the Company believes the disclosure is adequate to make the information presented not misleading. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2011 contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 2, 2012.

**2. Accounting Policies**

**Use of Estimates**

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



Table of Contents**Recent Accounting Pronouncements**

In June 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) 2011-05, Comprehensive Income (Topic 220) Presentation of Comprehensive Income ( Update 2011-05 ) that improves the comparability, consistency and transparency of financial reporting and increases the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. Update 2011-05 requires that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Under either method, adjustments must be displayed for items that are reclassified from other comprehensive income ( OCI ) to net income, in both net income and OCI. Update 2011-05 does not change the current option for presenting components of OCI gross or net of the effect of income taxes, provided that such tax effects are presented in the statement in which OCI is presented or disclosed in the notes to the financial statements. Additionally, Update 2011-05 does not affect the calculation or reporting of earnings per share. Update 2011-05 was effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and is to be applied retrospectively. The Company adopted Update 2011-05 on January 1, 2012. Update 2011-05 had no effect on the Company's presentation of other comprehensive income for the three and six months ended June 30, 2011 and 2012 because the Company did not have any items of other comprehensive income during these periods.

**3. Intangible Assets**

The Company's intangible assets consist of the following:

	As of June 30, 2012	
	Gross Carrying Amount	Accumulated Amortization
	(in thousands)	
<u>Amortized intangible assets:</u>		
Non-compete agreements	\$ 25,909	\$ (25,909)
<u>Indefinite-lived intangible assets:</u>		
Goodwill	\$ 1,631,461	
Trademarks	57,709	
Certificates of need	11,914	
Accreditations	2,160	
Total	\$ 1,703,244	

The Company's accreditations and trademarks have renewal terms. The costs to renew these intangibles are expensed as incurred. At June 30, 2012, the accreditations and trademarks have a weighted average time until next renewal of approximately 1.5 years and 8.0 years, respectively.

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Amortization expense for the Company's intangible assets with finite lives follows:

	<b>Three Months Ended June 30,</b>		<b>Six Months Ended June 30,</b>	
	<b>2011</b>	<b>2012</b>	<b>2011</b>	<b>2012</b>
	<b>(in thousands)</b>		<b>(in thousands)</b>	
Amortization expense	\$ 327	\$ 85	\$ 653	\$ 340

Amortization expense for the Company's intangible assets primarily relates to the amortization of the value associated with the non-compete agreement entered into in connection with the acquisition of the outpatient rehabilitation division of HealthSouth Corporation. The useful life of the outpatient rehabilitation division of HealthSouth Corporation's non-compete was five years.

The changes in the carrying amount of goodwill for the Company's reportable segments for the six months ended June 30, 2012 are as follows:

	<b>Specialty Hospitals</b>	<b>Outpatient Rehabilitation (in thousands)</b>	<b>Total</b>
Balance as of December 31, 2011	\$ 1,333,553	\$ 298,163	\$ 1,631,716
Other	(333)		(333)
Goodwill acquired during the period		78	78
Balance as of June 30, 2012	\$ 1,333,220	\$ 298,241	\$ 1,631,461

#### 4. Restructuring Reserves

In connection with the acquisition of substantially all of the outpatient rehabilitation division of HealthSouth Corporation, the Company recorded an estimated liability of \$18.7 million in 2007 for business restructuring which was accounted for as additional purchase price. This reserve primarily included costs associated with workforce reductions and lease termination costs in accordance with the Company's restructuring plan.

In connection with the acquisition of all the issued and outstanding equity securities of Regency Hospital Company, L.L.C. (Regency), an operator of long term acute care hospitals, the Company recorded an estimated liability of \$4.3 million in 2010 for business restructuring related to lease termination costs.

The following summarizes the Company's restructuring activity:

	<b>Lease Termination Costs (in thousands)</b>
Balance as of December 31, 2011	\$ 5,027



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Amounts paid in 2012		(845)
Accretion expense		157
Revision of estimate		(1,301)
Balance as of June 30, 2012	\$	3,038

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The Company expects to pay out the remaining lease termination costs through 2014 for the acquisition of the outpatient rehabilitation division of HealthSouth Corporation and through 2015 for the Regency acquisition.

**5. Fair Value**

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

The carrying value of Select's senior secured credit facility was \$878.0 million and \$834.3 million at December 31, 2011 and June 30, 2012, respectively. The fair value of Select's senior secured credit facility was \$823.3 million and \$815.6 million at December 31, 2011 and June 30, 2012, respectively. The fair value of Select's senior secured credit facility was based on quoted market prices for this debt in the syndicated loan market.

The carrying value of Select's 7 5/8% senior subordinated notes was \$345.0 million at both December 31, 2011 and June 30, 2012. The fair value of Select's 7 5/8% senior subordinated notes was \$326.4 million and \$346.3 million at December 31, 2011 and June 30, 2012, respectively. The fair value of this registered debt was based on quoted market prices.

The carrying value of Holdings' senior floating rate notes was \$167.3 million at both December 31, 2011 and June 30, 2012. The fair value of Holdings' senior floating rate notes was \$143.9 million and \$160.6 million at December 31, 2011 and June 30, 2012, respectively. The fair value of this registered debt was based on quoted market prices.

The Company considers the inputs in the valuation process of its debt instruments to be Level 2 in the fair value hierarchy. Level 2 in the fair value hierarchy is defined as inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.

Table of Contents**6. Segment Information**

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

The following tables summarize selected financial data for the Company's reportable segments for the three and six months ended June 30, 2011 and 2012. The segment results of Holdings are identical to those of Select with the exception of total assets:

	Specialty Hospitals	Three Months Ended June 30, 2011 Outpatient Rehabilitation (in thousands)	All Other	Total
Net operating revenue	\$ 520,261	\$ 178,473	\$ 15	\$ 698,749
Adjusted EBITDA	91,081	24,467	(15,623)	99,925
Total assets:				
Select Medical Corporation	2,202,994	471,175	112,264	2,786,433
Select Medical Holdings Corporation	2,202,994	471,175	113,853	2,788,022
Capital expenditures	6,130	2,801	1,845	10,776

	Specialty Hospitals	Three Months Ended June 30, 2012 Outpatient Rehabilitation (in thousands)	All Other	Total
Net operating revenue	\$ 557,130	\$ 193,050	\$ 13	\$ 750,193
Adjusted EBITDA	102,166	25,837	(17,724)	110,279
Total assets:				
Select Medical Corporation	2,184,743	437,591	156,080	2,778,414
Select Medical Holdings Corporation	2,184,743	437,591	157,303	2,779,637
Capital expenditures	12,631	2,922	630	16,183

	Six Months Ended June 30, 2012			
	Specialty Hospitals	Outpatient Rehabilitation (in thousands)	All Other	Total
Net operating revenue	\$ 1,110,168	\$ 383,949	\$ 97	\$ 1,494,214
Adjusted EBITDA	202,120	48,315	(31,092)	219,343
Total assets:				
Select Medical Corporation	2,184,743	437,591	156,080	2,778,414
Select Medical Holdings Corporation	2,184,743	437,591	157,303	2,779,637
Capital expenditures	19,682	6,713	1,539	27,934

	Three Months Ended June 30, 2011		
	(in thousands)		
	Specialty Hospitals	Outpatient Rehabilitation	All Other
Adjusted EBITDA	\$ 91,081	\$ 24,467	\$ (15,623)
Depreciation and amortization	(13,047)	(4,227)	(725)
Stock compensation expense			(900)

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Three Months Ended June 30, 2012 (in thousands)					
	Specialty Hospitals	Outpatient Rehabilitation	All Other	Select Medical Holdings Corporation	Select Medical Corporation
Adjusted EBITDA	\$ 102,166	\$ 25,837	\$ (17,724)		
Depreciation and amortization	(11,479)	(3,232)	(717)		
Stock compensation expense			(1,338)		
Income (loss) from operations	\$ 90,687	\$ 22,605	\$ (19,779)	\$ 93,513	\$ 93,513
Equity in earnings of unconsolidated subsidiaries				2,752	2,752
Interest expense, net				(23,798)	(20,957)
Income before income taxes				\$ 72,467	\$ 75,308

Six Months Ended June 30, 2011 (in thousands)					
	Specialty Hospitals	Outpatient Rehabilitation	All Other	Select Medical Holdings Corporation	Select Medical Corporation
Adjusted EBITDA	\$ 191,434	\$ 45,873	\$ (31,648)		
Depreciation and amortization	(25,093)	(8,686)	(1,442)		
Stock compensation expense			(1,780)		
Income (loss) from operations	\$ 166,341	\$ 37,187	\$ (34,870)	\$ 168,658	\$ 168,658
Loss on early retirement of debt				(31,018)	(20,385)
Equity in losses of unconsolidated subsidiaries				(324)	(324)
Interest expense, net				(50,793)	(38,189)
Income before income taxes				\$ 86,523	\$ 109,760

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Six Months Ended June 30, 2012 (in thousands)					
	Specialty Hospitals	Outpatient Rehabilitation	All Other		
Adjusted EBITDA	\$ 202,120	\$ 48,315	\$ (31,092)		
Depreciation and amortization	(23,322)	(6,882)	(1,423)		
Stock compensation expense			(2,599)		
				Select Medical Holdings Corporation	Select Medical Corporation
Income (loss) from operations	\$ 178,798	\$ 41,433	\$ (35,114)	\$ 185,117	\$ 185,117
Equity in earnings of unconsolidated subsidiaries				5,217	5,217
Interest expense, net				(47,720)	(42,207)
Income before income taxes				\$ 142,614	\$ 148,127

**7. Income per Common Share**

The Company applies the two-class method for calculating and presenting income per common share. The two-class method is an earnings allocation formula that determines earnings per share for each class of stock participation rights in undistributed earnings. Effective January 1, 2009 the Financial Accounting Standards Board ( FASB ) clarified that share based payment awards that have not yet vested meet the definition of a participating security provided the right to receive the dividend is non-forfeitable and non-contingent. Participating securities are defined as securities that participate in dividends with common stock according to a predetermined formula. These participating securities should be included in the computation of basic earnings per share under the two class method. Based upon the clarification made by FASB, the Company concluded that its non-vested restricted stock awards meet the definition of a participating security and should be included in the Company's computation of basic earnings per share.

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The following table sets forth for the periods indicated the calculation of net income per share in the Company's consolidated statement of operations and the differences between basic weighted average shares outstanding and diluted weighted average shares outstanding used to compute basic and diluted earnings per share, respectively:

	For the Three Months Ended June 30,		For the Six Months Ended June, 30	
	2011	2012	2011	2012
	(in thousands, except per share data)			
Numerator:				
Net income attributable to Select Medical Holdings Corporation	\$ 11,719	\$ 43,172	\$ 45,391	\$ 84,714
Less: Earnings allocated to unvested restricted stockholders	125	707	486	1,338
Net income available to common stockholders	\$ 11,594	\$ 42,465	\$ 44,905	\$ 83,376
Denominator:				
Weighted average shares basic	152,603	138,456	152,720	139,941
Effect of dilutive securities:				
Stock options	278	229	231	221
Weighted average shares diluted	152,881	138,685	152,951	140,162
Basic income per common share	\$ 0.08	\$ 0.31	\$ 0.29	\$ 0.60
Diluted income per common share	\$ 0.08	\$ 0.31	\$ 0.29	\$ 0.59

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2011	2012	2011	2012
	(in thousands)			
Stock options	1,691	1,684	2,400	1,699

## 8. Commitments and Contingencies

### Litigation

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





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aggregate, have a material adverse effect on the Company's business, financial position, results of operations and liquidity.

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

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

During April 2012, the Company's long term acute care hospital in Evansville, Indiana (SSH - Evansville) received two subpoenas from the Office of Attorney General for the State of Indiana. One subpoena demanded certain patient medical records of SSH - Evansville. The second subpoena demanded reports and documents related to SSH - Evansville for various periods beginning in 2006, including certain financial, statistical, billing and quality reports; certain policies and procedures, joint venture board meeting minutes, and documents related to certain complaints and internal investigations. SSH - Evansville subsequently received a Request for Information or Assistance from the Office of Inspector General of the U.S. Department of Health and Human Services (Indianapolis, Indiana Field Office) covering the period beginning in 2007 seeking substantially the same records demanded by the Indiana Attorney General's Office, additional patient medical records of SSH - Evansville and additional documents and information of SSH - Evansville, including documents concerning SSH - Evansville's relationships with its joint venture partner and seven other identified persons and entities. During May 2012, the Evansville (Indiana) Police Department executed a search warrant at SSH - Evansville purporting to seek evidence pertaining to the crime of theft. At the Company's request, the Vanderburgh (Indiana) Superior Court ordered the release of the probable cause affidavit supporting that search warrant. According to the affidavit, confidential informants, some of whom are purportedly current or former employees of SSH-Evansville, alleged, among other things, that a physician on the medical staff at SSH-Evansville improperly manipulated patient diagnoses to raise the diagnosis related group (DRG) and lengths-of-stay to enhance reimbursement and, on one occasion, discontinued treatments to a patient based on financial motivation and without regard to the patient's end of life instructions resulting in the patient's death, and that a second physician on the medical staff at SSH-Evansville performed bronchoscopes that were medically unnecessary and resulted in at least two patient deaths. The affidavit also makes allegations that imply that the Company may not have provided complete or accurate documents called for in the Indiana Attorney General's Office subpoenas which were received during April 2012. In August 2012, the Company received a subpoena from the Office of Inspector General of the U.S. Department of Health and Human Services (Chicago Regional Office) demanding additional documents covering the period beginning in March 2007 relating to the Company and SSH - Evansville, including contracts with SSH - Evansville's joint venture partner, contracts and other documents relating to financial relationships with physicians practicing at SSH - Evansville, records of payments to and hours worked by physicians practicing at SSH - Evansville, documents relating to actual or expected physician referrals and admissions to SSH - Evansville, documents relating to billing for services furnished by the Company's long term acute care hospitals (LTCHs), such as government program guidance and staff training materials, information relating to case manager duties and responsibilities at the Company's LTCHs, reports on patient admissions, discharges, DRG, length-of-stay and transfers at SSH - Evansville, and documents relating to criteria used by the Company or SSH - Evansville for patient admissions, discharges and eligibility for service. The Company has produced and will continue to produce documents in response to, and intends to fully cooperate with, these governmental investigations. At this time, the Company is unable to predict the timing and outcome of this matter.



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**Construction Commitments**

At June 30, 2012, the Company had outstanding commitments under construction contracts related to new construction, improvements and renovations at the Company's long term acute care properties and inpatient rehabilitation facilities totaling approximately \$9.3 million.

**9. Financial Information for Subsidiary Guarantors and Non-Guarantor Subsidiaries under Select's 7 5/8% Senior Subordinated Notes**

Select's 7 5/8% senior subordinated notes are fully and unconditionally guaranteed, except for customary limitations, on a senior subordinated basis by all of Select's wholly-owned subsidiaries (the "Subsidiary Guarantors"). Certain of Select's subsidiaries did not guarantee the 7 5/8% senior subordinated notes (the "Non-Guarantor Subsidiaries").

Select conducts a significant portion of its business through its subsidiaries. Presented below is condensed consolidating financial information for Select, the Subsidiary Guarantors and the Non-Guarantor Subsidiaries at December 31, 2011 and June 30, 2012 and for the three and six months ended June 30, 2011 and 2012.

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

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**Select Medical Corporation**  
**Condensed Consolidating Balance Sheet**  
**June 30, 2012**  
**(unaudited)**

	<b>Select Medical Corporation (Parent Company Only)</b>	<b>Subsidiary Guarantors</b>	<b>Non-Guarantor Subsidiaries (in thousands)</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>Assets</b>					
Current Assets:					
Cash and cash equivalents	\$ 18,100	\$ 2,798	\$ 622	\$	\$ 21,520
Accounts receivable, net		367,585	56,274		423,859
Current deferred tax asset	8,774	3,262	3,497		15,533
Prepaid income taxes	4,061				4,061
Other current assets	7,654	20,339	3,390		31,383
Total Current Assets	38,589	393,984	63,783		496,356
Property and equipment, net	14,754	422,031	55,996		492,781
Investment in affiliates	2,861,419	78,736		(2,940,155)(a)(b)	
Goodwill		1,631,461			1,631,461
Other identifiable intangibles		71,783			71,783
Assets held for sale	2,742				2,742
Other assets	24,335	58,224	732		83,291
<b>Total Assets</b>	<b>\$ 2,941,839</b>	<b>\$ 2,656,219</b>	<b>\$ 120,511</b>	<b>\$ (2,940,155)</b>	<b>\$ 2,778,414</b>
<b>Liabilities and Equity</b>					
Current Liabilities:					
Bank overdrafts	\$ 20,348	\$	\$	\$	\$ 20,348
Current portion of long-term debt and notes payable	10,236	370	1,179		11,785
Accounts payable	6,679	72,709	10,744		90,132
Intercompany accounts	1,036,057	(944,178)	(91,879)		
Accrued payroll	13	73,528	171		73,712
Accrued vacation	4,319	44,964	6,925		56,208
Accrued interest	22,920	826			23,746
Accrued restructuring		3,038			3,038
Accrued other	45,069	52,856	6,898		104,823
Due to third party payors		4,106	3,158		7,264
Total Current Liabilities	1,145,641	(691,781)	(62,804)		391,056
Long-term debt, net of current portion	723,251	392,423	59,160		1,174,834
Non-current deferred tax liability	(3,960)	78,164	8,707		82,911
Other non-current liabilities	49,360	18,909	380		68,649
<b>Total Liabilities</b>	<b>1,914,292</b>	<b>(202,285)</b>	<b>5,443</b>		<b>1,717,450</b>
Stockholder's Equity:					
Common stock	0				0
Capital in excess of par	853,506				853,506
Retained earnings	174,041	724,340	22,366	(746,706)(b)	174,041
Subsidiary investment		2,134,164	59,285	(2,193,449)(a)	
Total Select Medical Corporation Stockholder's Equity	1,027,547	2,858,504	81,651	(2,940,155)	1,027,547

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Non-controlling interest			33,417		33,417
Total Equity	1,027,547	2,858,504	115,068	(2,940,155)	1,060,964
<b>Total Liabilities and Equity</b>	<b>\$ 2,941,839</b>	<b>\$ 2,656,219</b>	<b>\$ 120,511</b>	<b>\$ (2,940,155)</b>	<b>\$ 2,778,414</b>

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(a) Elimination of investments in consolidated subsidiaries.

(b) Elimination of investments in consolidated subsidiaries earnings.

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**Select Medical Corporation**  
**Condensed Consolidating Statement of Operations**  
**For the Three Months Ended June 30, 2012**  
(unaudited)

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non- Guarantor Subsidiaries (in thousands)	Eliminations	Consolidated
Net operating revenues	\$ 13	\$ 649,628	\$ 100,552	\$	\$ 750,193
Costs and expenses:					
Cost of services	521	527,479	84,669		612,669
General and administrative	19,345	(791)			18,554
Bad debt expense		8,832	1,197		10,029
Depreciation and amortization	718	12,410	2,300		15,428
Total costs and expenses	20,584	547,930	88,166		656,680
Income (loss) from operations	(20,571)	101,698	12,386		93,513
Other income and expense:					
Intercompany interest and royalty fees	(763)	754	9		
Intercompany management fees	27,755	(23,159)	(4,596)		
Equity in earnings of unconsolidated subsidiaries		2,739	13		2,752
Interest expense	(13,173)	(6,712)	(1,072)		(20,957)
Income (loss) from operations before income taxes	(6,752)	75,320	6,740		75,308
Income tax expense	2,211	26,377	58		28,646
Equity in earnings of subsidiaries	53,981	5,612		(59,593)(a)	
Net income	45,018	54,555	6,682	(59,593)	46,662
Less: Net income attributable to non-controlling interests			1,644		1,644
Net income attributable to Select Medical Corporation	\$ 45,018	\$ 54,555	\$ 5,038	\$ (59,593)	\$ 45,018

(a) Elimination of equity in earnings of subsidiaries.

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<b>Select Medical Corporation</b> <b>Condensed Consolidating Statement of Operations</b> <b>For the Six Months Ended June 30, 2012</b> <b>(unaudited)</b>					
	<b>Select Medical Corporation (Parent Company Only)</b>	<b>Subsidiary Guarantors</b>	<b>Non-Guarantor Subsidiaries (in thousands)</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net operating revenues	\$ 97	\$ 1,293,953	\$ 200,164	\$	\$ 1,494,214
Costs and expenses:					
Cost of services	1,010	1,052,944	170,334		1,224,288
General and administrative	33,455	(677)			32,778
Bad debt expense		17,674	2,730		20,404
Depreciation and amortization	1,423	25,580	4,624		31,627
Total costs and expenses	35,888	1,095,521	177,688		1,309,097
Income (loss) from operations	(35,791)	198,432	22,476		185,117
Other income and expense:					
Intercompany interest and royalty fees	(1,556)	1,539	17		
Intercompany management fees	57,129	(48,242)	(8,887)		
Equity in earnings of unconsolidated subsidiaries		5,194	23		5,217
Interest expense	(26,147)	(13,910)	(2,150)		(42,207)
Income (loss) from operations before income taxes	(6,365)	143,013	11,479		148,127
Income tax expense	1,976	54,904	276		57,156
Equity in earnings of subsidiaries	96,638	9,111		(105,749)(a)	
Net income	88,297	97,220	11,203	(105,749)	90,971
Less: Net income attributable to non-controlling interests			2,674		2,674
Net income attributable to Select Medical Corporation	\$ 88,297	\$ 97,220	\$ 8,529	\$ (105,749)	\$ 88,297

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(a) Elimination of equity in earnings of subsidiaries.

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**Select Medical Corporation**  
**Condensed Consolidating Statement of Cash Flows**  
**For the Six Months Ended June 30, 2012**  
(unaudited)

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non- Guarantor Subsidiaries (in thousands)	Eliminations	Consolidated
<b>Operating activities</b>					
Net income	\$ 88,297	\$ 97,220	\$ 11,203	\$ (105,749)(a)	\$ 90,971
Adjustments to reconcile net income to net cash provided by operating activities:					
Depreciation and amortization	1,423	25,580	4,624		31,627
Provision for bad debts		17,674	2,730		20,404
Loss (gain) from disposal of assets		(3,606)	2		(3,604)
Non-cash stock compensation expense	2,599				2,599
Amortization of debt discount	622				622
Changes in operating assets and liabilities, net of effects from acquisition of businesses:					
Equity in earnings of subsidiaries	(96,638)	(9,111)		105,749(a)	
Intercompany	46,380	(40,086)	(6,294)		
Accounts receivable		(15,938)	(14,582)		(30,520)
Other current assets	(1,314)	(983)	685		(1,612)
Other assets	4,051	(5,011)	121		(839)
Accounts payable	(674)	(3,498)	(1,314)		(5,486)
Due to third-party payors		(9,527)	11,265		1,738
Accrued expenses	8,717	(2,587)	210		6,340
Income and deferred taxes	11,809				11,809
Net cash provided by operating activities	65,272	50,127	8,650		124,049
<b>Investing activities</b>					
Purchases of property and equipment	(1,536)	(20,684)	(5,714)		(27,934)
Proceeds from sale of assets		16,511			16,511
Investment in businesses		(10,014)			(10,014)
Acquisition of businesses, net of cash acquired		(206)			(206)
Net cash used in investing activities	(1,536)	(14,393)	(5,714)		(21,643)
<b>Financing activities</b>					
Borrowings on revolving credit facility	340,000				340,000
Payments on revolving credit facility	(380,000)				(380,000)
Payments on 2011 credit facility term loan	(4,250)				(4,250)
Borrowings of other debt	5,557		278		5,835
Principal payments on other debt	(4,179)	(220)	(686)		(5,085)
Dividends paid to Holdings	(52,034)				(52,034)
Equity investment by Holdings	547				547
Proceeds from bank overdrafts	3,739				3,739
Intercompany debt reallocation	33,557	(32,716)	(841)		



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Distributions to non-controlling interests			(1,681)	(1,681)
Net cash used in financing activities	(57,063)	(32,936)	(2,930)	(92,929)
Net increase in cash and cash equivalents	6,673	2,798	6	9,477
Cash and cash equivalents at beginning of period	11,427		616	12,043
Cash and cash equivalents at end of period	\$ 18,100	\$ 2,798	\$ 622	\$ 21,520

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

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Select Medical Corporation  
Condensed Consolidating Balance Sheet  
December 31, 2011  
(unaudited)

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non-Guarantor Subsidiaries (in thousands)	Eliminations	Consolidated
<b>Assets</b>					
Current Assets:					
Cash and cash equivalents	\$ 11,427	\$	\$ 616	\$	\$ 12,043
Accounts receivable, net		369,321	44,422		413,743
Current deferred tax asset	11,415	3,221	3,669		18,305
Prepaid income taxes	9,497				9,497
Other current assets	6,340	19,407	4,075		29,822
Total Current Assets	38,679	391,949	52,782		483,410
Property and equipment, net	14,641	440,736	54,651		510,028
Investment in affiliates	2,751,776	83,772		(2,835,548)(a)(b)	
Goodwill		1,631,716			1,631,716
Other identifiable intangibles		72,123			72,123
Assets held for sale	2,742				2,742
Other assets	28,386	41,480	853		70,719
<b>Total Assets</b>	<b>\$ 2,836,224</b>	<b>\$ 2,661,776</b>	<b>\$ 108,286</b>	<b>\$ (2,835,548)</b>	<b>\$ 2,770,738</b>
<b>Liabilities and Equity</b>					
Current Liabilities:					
Bank overdrafts	\$ 16,609	\$	\$	\$	\$ 16,609
Current portion of long-term debt and notes payable	8,853	390	1,605		10,848
Accounts payable	7,353	76,207	12,058		95,618
Intercompany accounts	975,809	(880,537)	(95,272)		
Accrued payroll	229	82,518	141		82,888
Accrued vacation	3,703	41,305	6,242		51,250
Accrued interest	11,843	137			11,980
Accrued restructuring		5,027			5,027
Accrued other	47,829	51,086	7,401		106,316
Due to third party payors		13,633	(8,107)		5,526
Total Current Liabilities	1,072,228	(610,234)	(75,932)		386,062
Long-term debt, net of current portion	733,328	425,315	60,007		1,218,650
Non-current deferred tax liability	(2,509)	75,750	8,787		82,028
Other non-current liabilities	46,555	17,970	380		64,905
<b>Total Liabilities</b>	<b>1,849,602</b>	<b>(91,199)</b>	<b>(6,758)</b>		<b>1,751,645</b>
Stockholder's Equity:					
Common stock	0				0
Capital in excess of par	848,844				848,844
Retained earnings	137,778	627,120	23,154	(650,274)(b)	137,778
Subsidiary investment		2,125,855	59,419	(2,185,274)(a)	
Total Select Medical Corporation Stockholder's Equity	986,622	2,752,975	82,573	(2,835,548)	986,622

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Non-controlling interest			32,471		32,471
Total Equity	986,622	2,752,975	115,044	(2,835,548)	1,019,093
<b>Total Liabilities and Equity</b>	<b>\$ 2,836,224</b>	<b>\$ 2,661,776</b>	<b>\$ 108,286</b>	<b>\$ (2,835,548)</b>	<b>\$ 2,770,738</b>

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(a) Elimination of investments in consolidated subsidiaries.

(b) Elimination of investments in consolidated subsidiaries earnings.

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<b>Select Medical Corporation</b> <b>Condensed Consolidating Statement of Operations</b> <b>For the Three Months Ended June 30, 2011</b> <b>(unaudited)</b>					
	<b>Select Medical Corporation (Parent Company Only)</b>	<b>Subsidiary Guarantors</b>	<b>Non-Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
			(in thousands)		
Net operating revenues	\$ 15	\$ 605,562	\$ 93,172	\$	\$ 698,749
Costs and expenses:					
Cost of services	194	493,059	76,413		569,666
General and administrative	16,039	76			16,115
Bad debt expense		11,908	2,035		13,943
Depreciation and amortization	654	15,099	2,246		17,999
Total costs and expenses	16,887	520,142	80,694		617,723
Income (loss) from operations	(16,872)	85,420	12,478		81,026
Other income and expense:					
Intercompany interest and royalty fees	(1,000)	994	6		
Intercompany management fees	44,391	(39,901)	(4,490)		
Loss on early retirement of debt	(20,385)				(20,385)
Equity in earnings (losses) of unconsolidated subsidiaries		(260)	9		(251)
Interest income	34	77			111
Interest expense	(9,011)	(9,370)	(1,313)		(19,694)
Income (loss) from operations before income taxes	(2,843)	36,960	6,690		40,807
Income tax expense	362	16,224	11		16,597
Equity in earnings of subsidiaries	25,477	4,784		(30,261)(a)	
Net income	22,272	25,520	6,679	(30,261)	24,210
Less: Net income attributable to non-controlling interests			1,938		1,938
Net income attributable to Select Medical Corporation	\$ 22,272	\$ 25,520	\$ 4,741	\$ (30,261)	\$ 22,272

(a) Elimination of equity in earnings of subsidiaries.

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<b>Select Medical Corporation</b> <b>Condensed Consolidating Statement of Operations</b> <b>For the Six Months Ended June 30, 2011</b> <b>(unaudited)</b>					
	<b>Select Medical Corporation (Parent Company Only)</b>	<b>Subsidiary Guarantors</b>	<b>Non-Guarantor Subsidiaries</b> (in thousands)	<b>Eliminations</b>	<b>Consolidated</b>
Net operating revenues	\$ 86	\$ 1,205,815	\$ 186,034	\$	\$ 1,391,935
Costs and expenses:					
Cost of services	832	974,281	151,969		1,127,082
General and administrative	32,494	187			32,681
Bad debt expense		24,909	3,384		28,293
Depreciation and amortization	1,300	29,455	4,466		35,221
Total costs and expenses	34,626	1,028,832	159,819		1,223,277
Income (loss) from operations	(34,540)	176,983	26,215		168,658
Other income and expense:					
Intercompany interest and royalty fees	(1,995)	1,980	15		
Intercompany management fees	67,863	(59,131)	(8,732)		
Loss on early retirement of debt	(20,385)				(20,385)
Equity in earnings (losses) of unconsolidated subsidiaries		(348)	24		(324)
Interest income	65	101	1		167
Interest expense	(16,376)	(19,319)	(2,661)		(38,356)
Income (loss) from operations before income taxes	(5,368)	100,266	14,862		109,760
Income tax expense	1,288	44,044	279		45,611
Equity in earnings of subsidiaries	67,152	10,581		(77,733)(a)	
Net income	60,496	66,803	14,583	(77,733)	64,149
Less: Net income attributable to non-controlling interests			3,653		3,653
Net income attributable to Select Medical Corporation	\$ 60,496	\$ 66,803	\$ 10,930	\$ (77,733)	\$ 60,496

(a) Elimination of equity in earnings of subsidiaries.

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**Select Medical Corporation**  
**Condensed Consolidating Statement of Cash Flows**  
**For the Six Months Ended June 30, 2011**  
**(unaudited)**

	<b>Select Medical Corporation (Parent Company Only)</b>	<b>Subsidiary Guarantors</b>	<b>Non-Guarantor Subsidiaries (in thousands)</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>Operating activities</b>					
Net income	\$ 60,496	\$ 66,803	\$ 14,583	\$ (77,733)(a)	\$ 64,149
Adjustments to reconcile net income to net cash provided by operating activities:					
Depreciation and amortization	1,300	29,455	4,466		35,221
Provision for bad debts		24,909	3,384		28,293
Loss on early retirement of debt	20,385				20,385
Loss (gain) from disposal of assets	10	(5,225)	14		(5,201)
Non-cash stock compensation expense	1,780				1,780
Amortization of debt discount	103				103
Changes in operating assets and liabilities, net of effects from acquisition of businesses:					
Equity in earnings of subsidiaries	(67,152)	(10,581)		77,733(a)	
Intercompany	53,735	(46,683)	(7,052)		
Accounts receivable		(73,715)	(7,525)		(81,240)
Other current assets	(2,096)	245	340		(1,511)
Other assets	(4,203)	6,564	108		2,469
Accounts payable	2,758	4,531	818		8,107
Due to third-party payors		6,599	(7,063)		(464)
Accrued expenses	9,410	4,606	(1,008)		13,008
Income and deferred taxes	16,151				16,151
Net cash provided by operating activities	92,677	7,508	1,065		101,250
<b>Investing activities</b>					
Purchases of property and equipment	(1,178)	(18,898)	(3,620)		(23,696)
Investment in business		(13,514)			(13,514)
Acquisition of businesses, net of cash acquired		1,921			1,921
Proceeds from sale of assets		7,879			7,879
Net cash used in investing activities	(1,178)	(22,612)	(3,620)		(27,410)
<b>Financing activities</b>					
Borrowings on revolving credit facilities	435,000				435,000
Payments on revolving credit facilities	(395,000)				(395,000)
Borrowings on 2011 credit facility term loan, net of discount	841,500				841,500
Payments on 2005 credit facility term loans, net of call premium	(484,633)				(484,633)
Repurchase of 7 5/8% senior subordinated notes, net of tender premium	(273,941)				(273,941)
Borrowings of other debt	5,496				5,496

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Principal payments on other debt	(2,581)	(899)		(3,480)
Debt issuance costs	(18,556)			(18,556)
Proceeds from bank overdrafts	2,102			2,102
Equity investment by Holdings	169			169
Dividends paid to Holdings	(171,008)			(171,008)
Intercompany debt reallocation	(20,061)	15,372	4,689	
Distributions to non-controlling interests			(2,270)	(2,270)
Net cash provided by (used in) financing activities	(81,513)	14,473	2,419	(64,621)
Net increase (decrease) in cash and cash equivalents	9,986	(631)	(136)	9,219
Cash and cash equivalents at beginning of period	149	3,567	649	4,365
Cash and cash equivalents at end of period	\$ 10,135	\$ 2,936	\$ 513	\$ 13,584

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

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

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

**Forward-Looking Statements**

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

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

- additional changes in government reimbursement for our services, including changes that will result from the expiration of the moratorium for long term acute care hospitals established by the Medicare, Medicaid, and SCHIP Extension Act of 2007, the American Recovery and Reinvestment Act, and the Patient Protection and Affordable Care Act may result in a reduction in net operating revenues, an increase in costs and a reduction in profitability;
- the failure of our specialty hospitals to maintain their Medicare certifications may cause our net operating revenues and profitability to decline;
- the failure of our facilities operated as hospitals within hospitals to qualify as hospitals separate from their host hospitals may cause our net operating revenues and profitability to decline;
- a government investigation or assertion that we have violated applicable regulations may result in sanctions or reputational harm and increased costs;



- 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;

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- the failure to maintain established relationships with the physicians in the areas we serve could reduce our net operating revenues and profitability;
- shortages in qualified nurses or therapists could increase our operating costs significantly;
- competition may limit our ability to grow and result in a decrease in our net operating revenues and profitability;
- the loss of key members of our management team could significantly disrupt our operations;
- the effect of claims asserted against us could subject us to substantial uninsured liabilities; and
- other factors discussed from time to time in our filings with the Securities and Exchange Commission (the "SEC"), including factors discussed under the heading "Risk Factors" for the year ended December 31, 2011 contained in our annual report on Form 10-K filed with the SEC on March 2, 2012.

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

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

**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, 2012, we operated 111 long term acute care hospitals and 12 acute medical rehabilitation hospitals in 28 states, and 956 outpatient rehabilitation clinics in 32 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. As of June 30, 2012 we had operations in 44 states and the District of Columbia.

We manage our Company through two business segments, our specialty hospital segment and our outpatient rehabilitation segment. We had net operating revenues of \$1,494.2 million for the six months ended June 30, 2012. Of this total, we earned approximately 74% of our net operating revenues from our specialty hospitals and approximately 26% from our outpatient rehabilitation business. 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 are typically admitted to our specialty hospitals from general acute care hospitals. These patients have specialized needs, and serious and often complex medical conditions such as respiratory failure, neuromuscular disorders, traumatic brain and spinal cord injuries, strokes,

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non-healing wounds, cardiac disorders, renal disorders and cancer. Our outpatient rehabilitation segment 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.

**Significant 2012 Events**

***Stock Repurchase Program***

On February 22, 2012, the Company's board of directors authorized an increase of \$100.0 million in the capacity of its common stock repurchase program from \$150.0 million to \$250.0 million. The program will remain in effect until March 31, 2013, unless extended by the board of directors. Stock repurchases under this program may be made in the open market or through privately negotiated transactions, and at times and in such amounts as the Company deems appropriate. The timing of purchases of stock will be based upon market conditions and other factors. The Company is funding this program with cash on hand or borrowings under its revolving credit facility. The Company repurchased 2,522,090 shares at a cost of \$21.1 million and 5,725,782 shares at a cost of \$46.8 million, which includes transaction costs, during the three months ended June 30, 2012 and the six months ended June 30, 2012, respectively. Since the inception of the program through June 30, 2012, the Company has repurchased 22,490,389 shares at a cost of \$163.6 million, or \$7.28 per share, which includes transaction costs.

**Summary Financial Results**

***Second Quarter Ended June 30, 2012***

For the three months ended June 30, 2012, our net operating revenues increased \$51.4 million or 7.4% to \$750.2 million compared to \$698.7 million for the three months ended June 30, 2011. Our specialty hospital revenues increased \$36.9 million or 7.1% and our outpatient rehabilitation revenues increased \$14.6 million or 8.2%. We had income from operations for the three months ended June 30, 2012 of \$93.5 million compared to \$81.0 million for the three months ended June 30, 2011. We had net income attributable to Holdings for the three months ended June 30, 2012 of \$43.2 million compared to \$11.7 million for the three months ended June 30, 2011. Our Adjusted EBITDA for the three months ended June 30, 2012 was \$110.3 million compared to \$99.9 million for the three months ended June 30, 2011. See the section entitled

*Results of Operations* for a reconciliation of net income to Adjusted EBITDA. The increase in our income from operations and Adjusted EBITDA is principally due to increases in operating performance in our specialty hospital segment. We were able to increase our specialty hospital income from operations \$12.7 million or 16.2% and our specialty hospital Adjusted EBITDA \$11.1 million or 12.2% for the three months ended June 30, 2012 from the same period prior year. These increases principally occurred in our Regency hospitals that were acquired in 2010.

Net income attributable to Holdings increased \$31.5 million to \$43.2 million for the three months ended June 30, 2012 compared to \$11.7 million for the three months ended June 30, 2011. The increase resulted primarily from an increase in our income from operations described above, increases in our equity in earnings of unconsolidated subsidiaries principally related to our investment in our joint venture with the Baylor Health Care System that was formed on April 1, 2011 (Baylor JV) and a reduction in our interest expense. We also incurred a loss on early retirement of debt related to the refinancing completed June 1, 2011 that reduced our net income in the three months ended June 30, 2011.

For the six months ended June 30, 2012, our net operating revenues increased 7.3% to \$1,494.2 million compared to \$1,391.9 million for the six months ended June 30, 2011. Our specialty hospital revenues

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increased \$70.0 million or 6.7% and our outpatient rehabilitation revenues increased \$32.3 million or 9.2%. We had income from operations for the six months ended June 30, 2012 of \$185.1 million compared to \$168.7 million for the six months ended June 30, 2011. We had net income attributable to Holdings for the six months ended June 30, 2012 of \$84.7 million compared to \$45.4 million for the six months ended June 30, 2011. Our Adjusted EBITDA for the six months ended June 30, 2012 was \$219.3 million compared to \$205.7 million for the six months ended June 30, 2011. See the section entitled *Results of Operations* for a reconciliation of net income to Adjusted EBITDA. The increases in our income from operations and Adjusted EBITDA is principally due to increases in our operating performance of our specialty hospital segment. We were able to increase our specialty hospital income from operations \$12.5 million or 7.5% and our specialty hospital Adjusted EBITDA \$10.7 million or 5.6% for the six months ended June 30, 2012 as compared to the six months ended June 30, 2011. These increases principally occurred in our Regency hospitals that were acquired in 2010.

Net income attributable to Holdings increased \$39.3 million to \$84.7 million for the six months ended June 30, 2012 compared to \$45.4 million for the six months ended June 30, 2011. The increase resulted primarily from an increase in our income from operations described above, increases in our equity in earnings of unconsolidated subsidiaries principally related to our Baylor JV, and a reduction of interest expense. We also incurred a loss on early retirement of debt related to the refinancing completed June 1, 2011 that reduced our net income in the six months ended June 30, 2011.

Cash flow from operations provided \$118.8 million of cash for the six months ended June 30, 2012 for Holdings and \$124.0 million of cash for the six months ended June 30, 2012 for Select. The difference in cash flow from operations between Holdings and Select primarily relates to interest payments on Holdings' senior floating rate notes.

## **Regulatory Changes**

In the past few years, there have been significant regulatory changes that have affected our net operating revenues and, in some cases, caused us to change our operating models and strategies. The following is a discussion of recent regulatory changes that are affecting our results of operations in 2012 or may have an effect on our future results of operations. Our Annual Report on Form 10-K for the year ended December 31, 2011 filed with the Securities and Exchange Commission ( SEC ) on March 2, 2012 contains a more detailed discussion of the regulations that affect our business in Part I Business Government Regulations, and the information below should be read in connection with that more detailed discussion.

### ***Healthcare Reform Legislation***

Federal agencies, including the Centers for Medicare & Medicaid Services ( CMS ), continue to implement provisions of the Patient Protection and Affordable Care Act ( PPACA ). The PPACA expands access to health insurance through subsidies, coverage mandates and other insurance market reforms. In addition, PPACA makes dramatic changes to the Medicare and Medicaid programs by adopting numerous initiatives addressing, among other things, reductions in healthcare spending, patient safety incentives and protections against fraud and abuse of federal healthcare programs. The PPACA adopts significant changes to the Medicare program that are particularly relevant to long term acute care hospitals ( LTCHs ), inpatient rehabilitation facilities ( IRFs ) and outpatient rehabilitation services. As part of healthcare reform legislation, President Obama also signed the Health Care and Education Affordability Reconciliation Act of 2010, which made some limited but important changes to the PPACA.

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A number of states attorneys general and other parties filed legal challenges to the PPACA seeking to block its implementation on constitutional grounds. On June 28, 2012 the U.S. Supreme Court upheld the PPACA finding that the individual health insurance mandate does not violate the Constitution because it may be viewed

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as a permissible tax on individuals who do not obtain health insurance. The only provision of the law that the Court invalidated is a Medicaid provision that threatened states with the loss of existing Medicaid funding if they decline to comply with the PPACA's Medicaid coverage extension. Federal and state agencies are expected to continue to implement provisions of the PPACA following the Court's decision.

We have included in our Annual Report on Form 10-K for the year ended December 31, 2011 a discussion of the PPACA provisions that affect our business, as well as regulatory initiatives adopted by CMS in response to particular provisions of the PPACA.

***Budget Control Act of 2011***

Beginning in January 2013, the Budget Control Act of 2011 will automatically reduce federal spending by approximately \$1.2 trillion split evenly between domestic and defense spending. Payments to Medicare providers are subject to these automatic spending reductions, subject to a 2% cap. Unless further legislation is enacted, we believe this will generally result in a 2% reduction to Medicare payments, beginning in January 2013.

***Medicare Payment of Long Term Acute Care Hospitals during Fiscal Year 2012***

On August 18, 2011, CMS published the policies and payment rates for LTCH-PPS for fiscal year 2012 (affecting discharges and cost reporting periods beginning on or after October 1, 2011 through September 30, 2012). The standard federal rate for fiscal year 2012 is \$40,222, an increase from the fiscal year 2011 standard federal rate of \$39,600. The final rule establishes a fixed-loss amount for high cost outlier cases for fiscal year 2012 of \$17,931, which is a decrease from the fixed-loss amount in the 2011 fiscal year of \$18,785.

The labor-related share of the LTCH-PPS standard federal rate is adjusted annually to account for geographic differences in area wage levels by applying the applicable LTCH-PPS wage index. CMS adopted a decrease in the labor-related share from 75.271% to 70.199% under the LTCH-PPS for fiscal year 2012.

In addition, CMS applied an area wage level budget neutrality factor to the standard federal rate to make annual changes to the area wage level adjustment budget neutral. Previously, there was no statutory or regulatory requirement that these adjustments to the area wage level be made in a budget neutral manner. The final rule creates a regulatory requirement that any adjustments or updates to the area wage level adjustment be made in a budget neutral manner such that estimated aggregate LTCH-PPS payments are not affected.

An LTCH must have an average inpatient length of stay for Medicare patients (including both Medicare covered and non-covered days) of greater than 25 days. In the preamble to the final rule for fiscal year 2012, CMS clarified its policy on the calculation of the average length of stay by specifying that all data on all Medicare inpatient days, including Medicare Advantage days, must be included in the average length of stay calculation effective for cost reporting periods beginning on or after January 1, 2012.



*Medicare Payment of Long Term Acute Care Hospitals during Fiscal Year 2013*

On August 1, 2012, CMS published the final rule updating the policies and payment rates for LTCH-PPS for fiscal year 2013 (affecting discharges and cost reporting periods beginning on or after October 1, 2012 through September 30, 2013). Two different standard federal rates apply during fiscal year 2013. The standard federal rate for discharges on or after October 1, 2012 and before December 29, 2012 is set at \$40,916, an increase from \$40,222 applicable during fiscal year 2012. The standard federal rate for discharges on or after December 29, 2012 and the remainder of fiscal year 2013 is set at \$40,398. The increase through December 28, 2012

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is based on a market basket increase of 2.6% less a productivity adjustment of 0.7% and less an additional reduction of 0.1% mandated by the PPACA. The market basket increase for the period of December 29, 2012 through the remainder of fiscal 2013 is further reduced by a portion of the one-time budget neutrality adjustment, as discussed below. The fixed loss amount for high cost outlier cases is set at \$15,408, a decrease from the fixed loss amount in the 2012 fiscal year of \$17,931.

***Very Short Stay Outlier Policy***

CMS established a different 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 that particular MS-LTC-DRG, referred to as a short stay outlier, or SSO. The SSO rule was further revised adding a category referred to as a very short stay outlier for discharges occurring after July 1, 2007. For cases with a length of stay that is equal to or less than one standard deviation from the geometric average length of stay for the same MS-DRG under IPPS, referred to as the so-called IPPS comparable threshold, the rule lowers the LTCH payment to a rate based on the general acute care hospital IPPS per diem. SSO cases with covered lengths of stay that exceed the IPPS comparable threshold would continue to be paid under the SSO payment policy. The SCHIP Extension Act, as amended by the PPACA, prevented CMS from applying the very short-stay outlier policy before December 29, 2012. Under existing regulations Medicare payments for very short-stay cases will be generally lowered to a rate based on the general acute care hospital IPPS per diem beginning with discharges on or after December 29, 2012.

***25 Percent Rule***

The 25 Percent Rule is a downward payment adjustment that applies to Medicare patients discharged from LTCHs who were admitted from a co-located hospital or a non-co-located hospital and caused the LTCH to exceed the applicable percentage thresholds of discharged Medicare patients. The SCHIP Extension Act as amended by the American Recovery and Reinvestment Act, or ARRA, and the PPACA limited the full application of the Medicare percentage threshold and, in some cases, postponed application of the percentage threshold until cost reporting periods beginning on or after July 1, 2012 or October 1, 2012.

In the update to the Medicare policies and payment rates for fiscal year 2013, CMS adopted through regulations a one-year extension of relief granted by the SCHIP Extension Act from the full application of Medicare admission thresholds. As a result, full implementation of the Medicare admission thresholds will not go into effect until cost reporting periods beginning on or after October 1, 2013, except for certain LTCHs with cost reporting periods that begin between July 1, 2012 and September 30, 2012. Specifically, those freestanding facilities, grandfathered HIHs and grandfathered satellites with cost reporting periods beginning on or after July 1, 2012 and before October 1, 2012 are subject to a modified 25 Percent Rule for discharges occurring in a three month period between July 1, 2012 and September 30, 2012.

In the preamble to the proposed update to the Medicare policies and payment rates for fiscal year 2013, CMS indicates that within the near future it may recommend revisions to the payment policies addressing MedPAC's recommendations for the development of patient-level and facility-level criteria. CMS also indicates that these recommendations may render unnecessary the existing payment reductions for Medicare patients admitted from a general acute care hospital in excess of the applicable admission thresholds.

***One-Time Budget Neutrality Adjustment***

Congress required that the LTCH-PPS payment rates maintain budget neutrality during the first year of the prospective payment system with total expenditures that would have been made under the previous reasonable cost-based payment system. The LTCH-PPS regulations give CMS the ability to make a one-time adjustment to

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the standard federal rate to correct any significant difference between actual payments and estimated payments for the first year of LTCH-PPS. The SCHIP Extension Act, as amended by the PPACA, precluded CMS from implementing the one-time prospective adjustment to the LTCH standard federal rate before December 29, 2012.

In the update to the Medicare policies and payment rates for fiscal year 2013, CMS adopted a one-time budget neutrality adjustment that results in a permanent negative adjustment of 3.75% to the LTCH base rate. CMS is implementing the adjustment over a three-year period by applying a factor of 0.98734 to the standard federal rate in fiscal years 2013, 2014 and 2015, except that the adjustment would not apply to payments for discharges occurring on or after October 1, 2012 through December 28, 2012.

***Medicare Market Basket Adjustments for Long Term Acute Care Hospitals***

In the update to the Medicare policies and payment rates for fiscal year 2013, CMS adopted for the first time an LTCH-specific market basket based entirely on Medicare cost report data from LTCHs. The LTCH-specific market basket replaces the rehabilitation, psychiatric and long-term care hospital market basket previously used to determine the annual update to the LTCH-PPS. For fiscal year 2013 CMS adopted an LTCH-specific market basket update of 1.8% based on an estimate of the LTCH-specific market basket update of 2.6% less a productivity adjustment of 0.7% and less an additional reduction of 0.1% mandated by the PPACA and as further adjusted by the one-time budget neutrality adjustment described above.

The PPACA institutes a market basket payment adjustment for LTCHs. For fiscal years 2012 and 2013, the reduction is 0.1%. For fiscal year 2014, the reduction is 0.3%. For fiscal years 2015 and 2016, the reduction is 0.2%. For fiscal years 2017 through fiscal year 2019, the reduction is 0.75%.

***Medicare Payment of Inpatient Rehabilitation Facilities during Fiscal Year 2012***

On August 5, 2011, CMS published the policies and payment rates for IRF-PPS for fiscal year 2012 (affecting discharges and cost reporting periods beginning on or after October 1, 2011 through September 30, 2012). The standard payment conversion factor for discharges for fiscal year 2012 is \$14,076, an increase from the fiscal year 2011 standard payment conversion factor of \$13,860. CMS initially decreased the outlier threshold amount for fiscal year 2012 to \$10,660 from \$11,410 for fiscal year 2011. In a notice published September 26, 2011, CMS corrected its calculation of the outlier threshold amount for fiscal year 2012 to \$10,713.

***Medicare Payment of Inpatient Rehabilitation Facilities during Fiscal Year 2013***

On July 30, 2012, CMS published the policies and payment rates for IRF-PPS for fiscal year 2013 (affecting discharges and cost reporting periods beginning on or after October 1, 2012 through September 30, 2013). The standard payment conversion factor for discharges for fiscal year 2013 is \$14,343, an increase from the fiscal year 2012 standard payment conversion factor of \$14,076. The standard payment conversion factor for fiscal year 2013 includes a market basket payment reduction adjustment for IRFs as mandated by the PPACA. The outlier



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threshold amount for fiscal year 2013 is set at \$10,466, a decrease from the outlier threshold amount in the 2012 fiscal year of \$10,713.

***Medicare Market Basket Adjustments for Inpatient Rehabilitation Facilities***

The PPACA instituted a market basket payment reduction adjustment for IRFs. For fiscal years 2012 and 2013, the reduction is 0.1%. For fiscal year 2014, the reduction is 0.3%. For fiscal years 2015 and 2016, the reduction is 0.2%. For fiscal years 2017 - 2019, the reduction is 0.75%.

***Medicare Payment of Outpatient Rehabilitation Services***

***Medicare Physician Fee Schedule Sustainable Growth Rate Update***

The Medicare program reimburses outpatient rehabilitation providers based on the Medicare physician fee schedule. The Medicare physician fee schedule rates are automatically updated annually based on the sustainable growth rate ( SGR ) formula contained in legislation. The SGR formula has resulted in automatic reductions in rates in every year since 2002; however, for each year through 2012 CMS or Congress has taken action to prevent the SGR formula reductions. The Middle Class Tax Relief and Job Creation Act of 2012 froze Medicare physician fee schedule rates at 2011 levels through December 31, 2012, temporarily averting a scheduled 27.4% cut as a result of the SGR formula that would have taken effect on March 1, 2012. In the proposed 2013 Medicare physician fee schedule rule, CMS has estimated a 27.0% reduction in the Medicare physician fee schedule payment rates beginning on January 1, 2013, unless Congress again takes legislative action to prevent the SGR formula reductions from going into effect. This reduction would be in addition to any sequestration being enacted which would cut all of Medicare by 2%. If the 27.0% SGR and 2% sequestration cuts are averted by Congress, the projected impact of other changes in the proposed 2013 Medicare physician fee schedule rule on outpatient physical therapy services in aggregate would be a 3% increase in 2013. This positive change is primarily due to the phase in of the final year of the 4-year transition to the new practice expense relative value units based on data from the Physician Practice Information Survey.

On October 6, 2011, MedPAC recommended that Congress repeal and replace the statutory SGR formula. The MedPAC proposal, which would require Congressional approval, would freeze current Medicare physician fee schedule rates for primary care services for 10 years, while other services would be subject to annual payment reductions of 5.9% for 3 years, followed by a freeze on payments for the next seven years. MedPAC offered a list of options for Congress to consider if it decides to offset SGR repeal costs (estimated at about \$200 billion over 10 years) within the Medicare program.

In addition to the SGR proposal, MedPAC recommended that Congress direct CMS to collect data on provider service volume and work time to establish more accurate relative value unit payment rates and to identify and reduce overpriced fee schedule services. Similarly, the PPACA requires CMS to identify and review potentially misvalued codes and make appropriate adjustments to the relative values of those services identified as being misvalued. In the final update to the Medicare physician fee schedule for calendar year 2012, CMS identified several CPT codes used by physical therapists as codes they will review.

*Therapy Caps*

Beginning on January 1, 1999, the Balanced Budget Act of 1997 subjected certain outpatient therapy providers reimbursed under the Medicare physician fee schedule to annual limits for therapy expenses. Effective January 1, 2012, the annual limit on outpatient therapy services is \$1,880 for combined physical and speech language pathology services and \$1,880 for occupational therapy services. The per beneficiary caps were \$1,870 for calendar year 2011. The annual limits for therapy expenses do not apply to services furnished and billed by outpatient hospital departments. However, beginning no later than October 1, 2012 and expiring on December 31, 2012, the Middle Class Tax Relief and Job Creation Act of 2012 will apply the annual limits on therapy expenses to hospital outpatient department settings. The application of annual limits to hospital outpatient department settings will sunset at the end of 2012 unless extended by Congress. We operated 956

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outpatient rehabilitation clinics at June 30, 2012, of which 135 are provider-based outpatient rehabilitation clinics operated as departments of the inpatient rehabilitation hospitals.

In the Deficit Reduction Act of 2005, Congress implemented an exceptions process to the annual limit for therapy expenses. Under this process, a Medicare enrollee (or person acting on behalf of the Medicare enrollee) is able to request an exception from the therapy caps if the provision of therapy services was deemed to be medically necessary. Therapy cap exceptions have been available automatically for certain conditions and on a case-by-case basis upon submission of documentation of medical necessity. The Middle Class Tax Relief and Job Creation Act of 2012 extended the exceptions process for outpatient therapy caps through December 31, 2012. Unless Congress extends the exceptions process, the therapy caps will apply to all outpatient therapy services beginning January 1, 2013, except those services furnished and billed by outpatient hospital departments.

The Middle Class Tax Relief and Job Creation Act of 2012 made several changes to the exceptions process to the annual limit for therapy expenses. For any claim above the annual limit, the claim must contain a modifier, such as the KX modifier, indicating that the services are medically necessary and justified by appropriate documentation in the medical record. Effective October 1, 2012, all claims exceeding \$3,700 will be subject to a manual medical review process. The \$3,700 threshold will be applied separately to the combined physical therapy/speech therapy cap and the occupational therapy cap. Effective October 1, 2012, all therapy claims, whether above or below the annual limit, must include the national provider identifier (NPI) of the physician responsible for certifying and periodically reviewing the plan of care.

In the proposed 2013 Medicare physician fee schedule rule, CMS will implement a claims-based data collection process to gather additional data on patient function during the course of therapy in order to better understand patient conditions and outcomes. All practice settings that provide outpatient therapy services must include this data on the claim form. Beginning on January 1, 2013, therapists will be required to report new codes and modifiers on the claim form that reflect a patient's functional limitations and goals at initial evaluation, periodically throughout care, and at discharge. For claims submitted after July 1, 2013, CMS proposes to return claims as unpaid if the required data is not included in the claim.

Several government agencies are expected to release reports on aspects of the Medicare payment system for therapy services. In the final 2011 Medicare physician fee schedule rule, CMS indicated the agency is evaluating alternative payment methodologies that would provide appropriate payment for medically necessary and effective therapy services furnished to Medicare beneficiaries based on patient needs rather than the current therapy caps. The Middle Class Tax Relief and Job Creation Act of 2012 directs the MedPAC to submit a report to Congress by June 15, 2013 making recommendations on how to reform the payment system to better reflect acuity, condition, and the therapy needs of the patient. The MedPAC report is to include an examination of private sector initiatives related to therapy benefits. In addition, the GAO is directed to issue a report no later than May 1, 2013 regarding implementation of the manual medical review process instituted by the Middle Class Tax Relief and Job Creation Act of 2012. The report must detail the number of beneficiaries subject to the process, the number of reviews conducted, and the outcome of the reviews.

*Multiple Procedure Payment Reduction*

CMS adopted a multiple procedure payment reduction for therapy services in the final update to the Medicare physician fee schedule for calendar year 2011. Under the policy, the Medicare program pays 100% of the practice expense component of the therapy procedure or unit of service with the highest relative value unit and then reduces the payment for the practice expense component by 20% in office and other non-institutional





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settings and 25% in institutional settings for the second and subsequent therapy procedures or units of service furnished during the same day for the same patient, regardless of whether those therapy services are furnished in separate sessions. This multiple procedure payment reduction policy became effective January 1, 2011 and applies to all outpatient therapy services paid under Medicare Part B. Furthermore, the multiple procedure payment reduction policy applies across all therapy disciplines – occupational therapy, physical therapy and speech language pathology. Our outpatient rehabilitation therapy services are primarily offered in institutional settings and, as such, are subject to the applicable 25% payment reduction in the practice expense component for the second and subsequent therapy services furnished by us to the same patient on the same day. In the 2012 Medicare physician fee schedule rule, CMS indicated that over the next year it will continue to review whether specific CPT codes billed under the fee schedule are overvalued or undervalued, including certain specific CPT codes used by physical therapists.

***Medicare Quality Reporting Program for LTCHs and IRFs***

The PPACA requires that CMS establish new quality data reporting programs for LTCHs and IRFs by fiscal year 2014. CMS has adopted a quality data reporting program requiring LTCHs to submit data from three quality measures in order to receive the full payment update in fiscal year 2014, including measures related to (1) catheter-associated urinary tract infections, (2) central line catheter-associated blood stream infection, and (3) pressure ulcers that are new or have worsened. In addition to the foregoing measures, CMS has adopted the following quality measures for LTCH reporting beginning in fiscal year 2016: (1) percent of nursing home residents who were assessed and appropriately given the seasonal influenza vaccine, and (2) influenza vaccination coverage among healthcare personnel. CMS adopted a quality data reporting program requiring IRFs to submit data from two quality measures in order to receive the full payment update in fiscal year 2014, including measures related to (1) catheter-associated urinary tract infections and (2) pressure ulcers that are new or have worsened. Under the PPACA and CMS regulations, if an LTCH or IRF fails to report on the selected quality measures, its reimbursement will be reduced by 2.0% of the annual market basket update. The reduction can result in payment rates less than the prior year. However, the reduction will not carry over into the subsequent fiscal years.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2012	2011	2012
<b>Specialty hospital data(1):</b>				
Number of hospitals owned - start of period	116	117	116	115
Number of hospitals acquired			1	1
Number of hospital start-ups				1
Number of hospitals closed/sold	(1)		(2)	
Number of hospitals owned - end of period	115	117	115	117
Number of hospitals managed - end of period	4	6	4	6
Total number of hospitals (all) - end of period	119	123	119	123
Long term acute care hospitals	110	111	110	111
Rehabilitation hospitals	9	12	9	12
Available licensed beds (2)	5,135	5,205	5,135	5,205
Admissions (2)	13,556	13,872	27,366	27,927
Patient days (2)	327,001	336,016	660,857	679,037
Average length of stay (days) (2)	24	24	24	24
Net revenue per patient day (2)(3)	\$ 1,505	\$ 1,554	\$ 1,510	\$ 1,539
Occupancy rate (2)	70%	71%	71%	72%
Percent patient days - Medicare (2)	64%	64%	64%	65%
<b>Outpatient rehabilitation data:</b>				
Number of clinics owned - start of period	874	848	875	850
Number of clinic start-ups	7	10	15	18
Number of clinics closed/sold	(32)	(6)	(41)	(16)
Number of clinics owned - end of period	849	852	849	852
Number of clinics managed - end of period	103	104	103	104
Total number of clinics (all) - end of period	952	956	952	956
Number of visits (2)	1,143,854	1,166,550	2,282,554	2,318,759
Net revenue per visit (2)(4)	\$ 102	\$ 102	\$ 102	\$ 103

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

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

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

(4) Net revenue per visit is calculated by dividing outpatient rehabilitation clinic 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:

	<b>Select Medical Holdings Corporation Three Months Ended June 30,</b>		<b>Select Medical Corporation Three Months Ended June 30,</b>	
	<b>2011</b>	<b>2012</b>	<b>2011</b>	<b>2012</b>
Net operating revenues	100.0%	100.0%	100.0%	100.0%
Cost of services(1)	81.5	81.7	81.5	81.7
General and administrative	2.3	2.5	2.3	2.5
Bad debt expense	2.0	1.3	2.0	1.3
Depreciation and amortization	2.6	2.0	2.6	2.0
Income from operations	11.6	12.5	11.6	12.5
Loss on early retirement of debt	(4.4)		(2.9)	
Equity in earnings (losses) of unconsolidated subsidiaries	(0.0)	0.3	(0.0)	0.3
Interest expense, net	(3.6)	(3.1)	(2.8)	(2.8)
Income before income taxes	3.6	9.7	5.9	10.0
Income tax expense	1.6	3.7	2.4	3.8
Net income	2.0	6.0	3.5	6.2
Net income attributable to non-controlling interest	0.3	0.2	0.3	0.2
Net income attributable to Holdings and Select	1.7%	5.8%	3.2%	6.0%

	<b>Select Medical Holdings Corporation Six Months Ended June 30,</b>		<b>Select Medical Corporation Six Months Ended June 30,</b>	
	<b>2011</b>	<b>2012</b>	<b>2011</b>	<b>2012</b>
Net operating revenues	100.0%	100.0%	100.0%	100.0%
Cost of services(1)	81.0	81.9	81.0	81.9
General and administrative	2.4	2.2	2.4	2.2
Bad debt expense	2.0	1.4	2.0	1.4
Depreciation and amortization	2.5	2.1	2.5	2.1
Income from operations	12.1	12.4	12.1	12.4
Loss on early retirement of debt	(2.2)		(1.5)	
Equity in earnings (losses) of unconsolidated subsidiaries	(0.0)	0.3	(0.0)	0.3
Interest expense, net	(3.7)	(3.2)	(2.7)	(2.8)
Income before income taxes	6.2	9.5	7.9	9.9
Income tax expense	2.7	3.7	3.3	3.8
Net income	3.5	5.8	4.6	6.1
Net income attributable to non-controlling interest	0.3	0.2	0.3	0.2
Net income attributable to Holdings and Select	3.2%	5.6%	4.3%	5.9%

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

	Select Medical Holdings Corporation Three Months Ended June 30,					Select Medical Corporation Three Months Ended June 30,				
	2011		2012	%		2011		2012	%	
	(in thousands)			Change		(in thousands)			Change	
Net operating revenues:										
Specialty hospitals	\$	520,261	\$	557,130	7.1%	\$	520,261	\$	557,130	7.1%
Outpatient rehabilitation		178,473		193,050	8.2		178,473		193,050	8.2
Other(2)		15		13	(13.3)		15		13	(13.3)
Total company	\$	698,749	\$	750,193	7.4%	\$	698,749	\$	750,193	7.4%
Income (loss) from operations:										
Specialty hospitals	\$	78,034	\$	90,687	16.2%	\$	78,034	\$	90,687	16.2%
Outpatient rehabilitation		20,240		22,605	11.7		20,240		22,605	11.7
Other(2)		(17,248)		(19,779)	(14.7)		(17,248)		(19,779)	(14.7)
Total company	\$	81,026	\$	93,513	15.4%	\$	81,026	\$	93,513	15.4%
Adjusted EBITDA:(3)										
Specialty hospitals	\$	91,081	\$	102,166	12.2%	\$	91,081	\$	102,166	12.2%
Outpatient rehabilitation		24,467		25,837	5.6		24,467		25,837	5.6
Other(2)		(15,623)		(17,724)	(13.4)		(15,623)		(17,724)	(13.4)
Total company	\$	99,925	\$	110,279	10.4%	\$	99,925	\$	110,279	10.4%
Adjusted EBITDA margins:(3)										
Specialty hospitals		17.5%		18.3%			17.5%		18.3%	
Outpatient rehabilitation		13.7		13.4			13.7		13.4	
Other(2)		N/M		N/M			N/M		N/M	
Total company		14.3%		14.7%			14.3%		14.7%	
Total assets:										
Specialty hospitals	\$	2,202,994	\$	2,184,743		\$	2,202,994	\$	2,184,743	
Outpatient rehabilitation		471,175		437,591			471,175		437,591	
Other(2)		113,853		157,303			112,264		156,080	
Total company	\$	2,788,022	\$	2,779,637		\$	2,786,433	\$	2,778,414	
Purchases of property and equipment:										
Specialty hospitals	\$	6,130	\$	12,631		\$	6,130	\$	12,631	
Outpatient rehabilitation		2,801		2,922			2,801		2,922	
Other(2)		1,845		630			1,845		630	
Total company	\$	10,776	\$	16,183		\$	10,776	\$	16,183	

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Select Medical Holdings Corporation Six Months Ended June 30,				Select Medical Corporation Six Months Ended June 30,			
	2011	2012	% Change		2011	2012	% Change
	(in thousands)				(in thousands)		
Net operating revenues:							
Specialty hospitals	\$ 1,040,185	\$ 1,110,168	6.7%	\$ 1,040,185	\$ 1,110,168	6.7%	
Outpatient rehabilitation	351,664	383,949	9.2	351,664	383,949	9.2	
Other(2)	86	97	12.8	86	97	12.8	
Total company	\$ 1,391,935	\$ 1,494,214	7.3%	\$ 1,391,935	\$ 1,494,214	7.3%	
Income (loss) from operations:							
Specialty hospitals	\$ 166,341	\$ 178,798	7.5%	\$ 166,341	\$ 178,798	7.5%	
Outpatient rehabilitation	37,187	41,433	11.4	37,187	41,433	11.4	
Other(2)	(34,870)	(35,114)	(0.7)	(34,870)	(35,114)	(0.7)	
Total company	\$ 168,658	\$ 185,117	9.8%	\$ 168,658	\$ 185,117	9.8%	
Adjusted EBITDA:(3)							
Specialty hospitals	\$ 191,434	\$ 202,120	5.6%	\$ 191,434	\$ 202,120	5.6%	
Outpatient rehabilitation	45,873	48,315	5.3	45,873	48,315	5.3	
Other(2)	(31,648)	(31,092)	1.8	(31,648)	(31,092)	1.8	
Total company	\$ 205,659	\$ 219,343	6.7%	\$ 205,659	\$ 219,343	6.7%	
Adjusted EBITDA margins:(3)							
Specialty hospitals	18.4%	18.2%		18.4%	18.2%		
Outpatient rehabilitation	13.0	12.6		13.0	12.6		
Other(2)	N/M	N/M		N/M	N/M		
Total company	14.8%	14.7%		14.8%	14.7%		
Total assets:							
Specialty hospitals	\$ 2,202,994	\$ 2,184,743		\$ 2,202,994	\$ 2,184,743		
Outpatient rehabilitation	471,175	437,591		471,175	437,591		
Other(2)	113,853	157,303		112,264	156,080		
Total company	\$ 2,788,022	\$ 2,779,637		\$ 2,786,433	\$ 2,778,414		
Purchases of property and equipment:							
Specialty hospitals	\$ 16,617	\$ 19,682		\$ 16,617	\$ 19,682		
Outpatient rehabilitation	4,982	6,713		4,982	6,713		
Other(2)	2,097	1,539		2,097	1,539		
Total company	\$ 23,696	\$ 27,934		\$ 23,696	\$ 27,934		

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N/M Not Meaningful.

(1) Cost of services includes salaries, wages and benefits, operating supplies, lease and rent expense and other operating costs.

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

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

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

	Select Medical Holdings Corporation				Select Medical Corporation			
	Three Months Ended June 30,		Three Months Ended June 30,		Three Months Ended June 30,		Three Months Ended June 30,	
	2011	2012	2011	2012	2011	2012	2011	2012
	(in thousands)		(in thousands)		(in thousands)		(in thousands)	
Net income	\$	13,657	\$	44,816	\$	24,210	\$	46,662
Income tax expense		10,915		27,651		16,597		28,646
Interest expense, net of interest income		25,185		23,798		19,583		20,957
Loss on early retirement of debt		31,018				20,385		
Equity in (earnings) losses of unconsolidated subsidiaries		251		(2,752)		251		(2,752)
Stock compensation expense:								
Included in general and administrative		478		817		478		817
Included in cost of services		422		521		422		521
Depreciation and amortization		17,999		15,428		17,999		15,428
Adjusted EBITDA	\$	99,925	\$	110,279	\$	99,925	\$	110,279

	Select Medical Holdings Corporation				Select Medical Corporation			
	Six Months Ended June 30,		Six Months Ended June 30,		Six Months Ended June 30,		Six Months Ended June 30,	
	2011	2012	2011	2012	2011	2012	2011	2012
	(in thousands)		(in thousands)		(in thousands)		(in thousands)	
Net income	\$	49,044	\$	87,388	\$	64,149	\$	90,971



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Income tax expense	37,479	55,226	45,611	57,156
Interest expense, net of interest income	50,793	47,720	38,189	42,207
Loss on early retirement of debt	31,018		20,385	
Equity in (earnings) losses of unconsolidated subsidiaries	324	(5,217)	324	(5,217)
Stock compensation expense:				
Included in general and administrative	948	1,589	948	1,589
Included in cost of services	832	1,010	832	1,010
Depreciation and amortization	35,221	31,627	35,221	31,627
Adjusted EBITDA	\$ 205,659	\$ 219,343	\$ 205,659	\$ 219,343

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**Three Months Ended June 30, 2012 Compared to Three Months Ended June 30, 2011**

In the following discussion, we address the results of operations of Select and Holdings. With the exception of loss on early retirement of debt, interest expense and income taxes, the results of operations of Holdings are identical to those of Select. Therefore, the discussion related to net operating revenues, operating expenses, Adjusted EBITDA, income from operations, equity in earnings (losses) of unconsolidated subsidiaries and non-controlling interest is identical for Holdings and Select.

***Net Operating Revenues***

Our net operating revenues increased by 7.4% to \$750.2 million for the three months ended June 30, 2012 compared to \$698.7 million for the three months ended June 30, 2011.

*Specialty Hospitals.* Our specialty hospital net operating revenues increased 7.1% to \$557.1 million for the three months ended June 30, 2012 compared to \$520.3 million for the three months ended June 30, 2011. The growth in net operating revenue primarily resulted from increases in patient volumes, increases in non-Medicare rates and revenues that are generated from contracted labor services provided to the Baylor JV. Our patient days increased 2.8% to 336,016 days for the three months ended June 30, 2012 compared to the three months ended June 30, 2011 resulting from equal increases in both Medicare and non-Medicare patient days. Our specialty hospital occupancy increased to 71% for the three months ended June 30, 2012 compared to 70% for the three months ended June 30, 2011. Our average net revenue per patient day was \$1,554 for the three months ended June 30, 2012 compared to \$1,505 for the three months ended June 30, 2011. The increase in our net revenue per patient day was principally due to increases in our average non-Medicare net revenue per patient day, resulting principally from Medicaid bonus payments we received during the quarter.

*Outpatient Rehabilitation.* Our outpatient rehabilitation net operating revenues increased 8.2% to \$193.1 million for the three months ended June 30, 2012 compared to \$178.5 million for the three months ended June 30, 2011. The net operating revenues generated by our outpatient rehabilitation clinics for the three months ended June 30, 2012 increased 2.9% to \$142.8 million for the three months ended June 30, 2012 compared to \$138.7 million for the three months ended June 30, 2011. The increase was related to volume growth in our owned outpatient clinics and revenues we generated from contracted labor services provided to the Baylor JV. The number of patient visits in our owned outpatient rehabilitation clinics increased 2.0% for the three months ended June 30, 2012 to 1,166,550 visits compared to 1,143,854 visits for the three months ended June 30, 2011. Net revenue per visit in our clinics was \$102 for both the three months ended June 30, 2012 and 2011. Our contract services business increased net operating revenues by 26.6% to \$50.3 million for the three months ended June 30, 2012 compared to \$39.8 million for the three months ended June 30, 2011, which primarily resulted from the addition of new contracts in the fourth quarter of 2011.

***Operating Expenses***

Our operating expenses include our cost of services, general and administrative expense and bad debt expense. Our operating expenses increased 6.9% to \$641.3 million for the three months ended June 30, 2012 compared to \$599.7 million for the three months ended June 30, 2011. As a percentage of our net operating revenues, our operating expenses were 85.5% for the three months ended June 30, 2012 compared to 85.8% for the three months ended June 30, 2011. Our cost of services, a major component of which is labor expense, were \$612.7 million or

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81.7% of net operating revenue for the three months ended June 30, 2012 compared to \$569.7 million or 81.5% of net operating revenue for the three months ended June 30, 2011. The increase in cost of

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services as a percentage of net operating revenue resulted primarily from increased relative labor costs in our outpatient rehabilitation segment. This increase in relative labor costs for the three months ended June 30, 2012 resulted from increased labor costs associated with the Baylor JV services agreement, increased staffing in our rehabilitation clinics, and lower productivity in our contract services business. Facility rent expense, which is a component of cost of services, was \$31.3 million for three months ended June 30, 2012 compared to \$29.6 million for the three months ended June 30, 2011. General and administrative expenses were 2.5% of net operating revenue or \$18.6 million for the three months ended June 30, 2012 compared to 2.3% of net operating revenue or \$16.1 million for the three months ended June 30, 2011. The increase in our general and administrative expenses resulted from increased administrative costs principally related to executive compensation and the write-off of costs related to a withdrawn financing transaction. Our bad debt expense was \$10.0 million or 1.3% of net operating revenues for the three months ended June 30, 2012 compared to \$13.9 million or 2.0% of net operating revenues for the three months ended June 30, 2011. The decline in our bad debt expense was attributed to our favorable collections experience of accounts receivable in both our operating segments for the three months ended June 30, 2012 as compared to the three months ended June 30, 2011.

***Adjusted EBITDA***

*Specialty Hospitals.* Our Adjusted EBITDA for our specialty hospitals increased 12.2% to \$102.2 million for the three months ended June 30, 2012 compared to \$91.1 million for the three months ended June 30, 2011. Our Adjusted EBITDA margins for the segment increased to 18.3% for the three months ended June 30, 2012 from 17.5% for the three months ended June 30, 2011. The increase in the Adjusted EBITDA for our specialty hospitals was primarily the result of operating improvements in the Regency hospitals we acquired in 2010, lower bad debt expense and the Medicaid bonus payments we received during the quarter.

*Outpatient Rehabilitation.* Our Adjusted EBITDA for our outpatient rehabilitation segment increased 5.6% to \$25.8 million for the three months ended June 30, 2012 compared to \$24.5 million for the three months ended June 30, 2011. Our Adjusted EBITDA margins for the segment decreased to 13.4% for the three months ended June 30, 2012 from 13.7% for the three months ended June 30, 2011. The Adjusted EBITDA in our outpatient rehabilitation clinics increased by \$0.8 million to \$21.6 million and our Adjusted EBITDA margins increased to 15.1% from 15.0% for the three months ended June 30, 2012 compared to the three months ended June 30, 2011. The increase in our Adjusted EBITDA in our rehabilitation clinics was principally due to increased volumes and a reduction of bad debt expense, offset in part by increases in labor costs. The Adjusted EBITDA in our contract services business increased by \$0.6 million to \$4.3 million and the Adjusted EBITDA margins declined to 8.5% from 9.2% for the three months ended June 30, 2012 compared to the three months ended June 30, 2011. The decline in Adjusted EBITDA margins in our contract services business was principally due to increased relative labor costs associated with lower productivity related to new business.

*Other.* The Adjusted EBITDA loss was \$17.7 million for the three months ended June 30, 2012 compared to an Adjusted EBITDA loss of \$15.6 million for the three months ended June 30, 2011 and is primarily related to higher general and administrative expenses, as described under Operating Expenses.

***Income from Operations***

For the three months ended June 30, 2012 we had income from operations of \$93.5 million compared to \$81.0 million for the three months ended June 30, 2011. The increase in our income from operations resulted principally from increases in our operating performance of our specialty hospital segment, a reduction in bad debt expense and a reduction in depreciation and amortization expense, offset in part by an increase in general and administrative expenses.



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***Loss on Early Retirement of Debt***

*Select Medical Corporation.* On June 1, 2011 we refinanced our senior secured credit facility which now consists of an \$850.0 million term loan facility and a \$300.0 million revolving facility. A portion of the proceeds from this transaction were used to repay \$266.5 million of Select's 7 5/8% senior subordinated notes. We recognized a loss on early retirement of debt of \$20.4 million for the three months ended June 30, 2011 which included the write-off of unamortized deferred financing costs and tender premiums.

*Select Medical Holdings Corporation.* On June 1, 2011 we refinanced our senior secured credit facility which now consists of an \$850.0 million term loan facility and a \$300.0 million revolving facility. A portion of the proceeds from this transaction were used to repurchase and retire \$266.5 million of Select's 7 5/8% senior subordinated notes and \$150.0 million to repurchase and retire our 10% senior subordinated notes. As a result of this debt repayment, we recognized a loss on early retirement of debt of \$31.0 million for the three months ended June 30, 2011, which included the write-off of unamortized deferred financing costs, tender premiums and original issue discount.

***Equity in Earnings (Losses) of Unconsolidated Subsidiaries***

For the three months ended June 30, 2012 we had equity in earnings of unconsolidated subsidiaries of \$2.8 million compared to equity in losses of unconsolidated subsidiaries of \$0.3 million for the three months ended June 30, 2011. The increase in our equity in earnings of unconsolidated subsidiaries resulted principally from an increase in the contribution from the Baylor JV.

***Interest Expense***

*Select Medical Corporation.* Interest expense was \$21.0 million for the three months ended June 30, 2012 compared to \$19.7 million for the three months ended June 30, 2011. The increase in interest expense resulted primarily from the refinancing of \$150.0 million of Holdings' debt, for which Select was not previously obligated, through indebtedness incurred by Select under the new senior secured credit facility on June 1, 2011.

*Select Medical Holdings Corporation.* Interest expense was \$23.8 million for the three months ended June 30, 2012 compared to \$25.3 million for the three months ended June 30, 2011. The decrease in interest expense resulted primarily from the lower interest rates on the portions of the debt that were refinanced on June 1, 2011 and reduced borrowings for the three months ended June 30, 2012 compared to the three months ended June 30, 2011.

***Income Taxes***

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*Select Medical Corporation.* We recorded income tax expense of \$28.6 million for the three months ended June 30, 2012. The expense represented an effective tax rate of 38.0%. We recorded income tax expense of \$16.6 million for the three months ended June 30, 2011. The expense represented an effective tax rate of 40.7%. Select Medical Corporation is part of the consolidated federal tax return for Select Medical Holdings Corporation. We allocate income taxes between Select and Holdings for purposes of financial statement presentation. Because Holdings is a passive investment company incorporated in Delaware, it does not incur any state income tax expense or benefit on its specific income or loss and, as such, receives a tax allocation equal to the federal statutory rate of 35% on its specific income or loss. Based upon the relative size of Holdings' income or loss, this can cause the effective tax rate for Select to differ from the effective tax rate for the consolidated company.

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*Select Medical Holdings Corporation.* We recorded income tax expense of \$27.7 million for the three months ended June 30, 2012. The expense represented an effective tax rate of 38.2%. We recorded income tax expense of \$10.9 million for the three months ended June 30, 2011. The expense represented an effective tax rate of 44.4%. The decline in our effective tax rate is primarily a consequence of the 2011 rate having been impacted by a tax gain associated with a hospital exchange that occurred in 2011, a reduction in the provision for uncertain tax positions and a lower effective state tax rate.

***Non-Controlling Interests***

Non-controlling interests in consolidated earnings were \$1.6 million for the three months ended June 30, 2012 and \$1.9 million for the three months ended June 30, 2011.

**Six Months Ended June 30, 2012 Compared to Six Months Ended June 30, 2011**

In the following discussion, we address the results of operations of Select and Holdings. With the exception of loss on early retirement of debt, interest expense, and income taxes, the results of operations of Holdings are identical to those of Select. Therefore, the discussion related to net operating revenues, operating expenses, Adjusted EBITDA, income from operations, equity in earnings (losses) of unconsolidated subsidiaries and non-controlling interest is identical for Holdings and Select.

***Net Operating Revenues***

Our net operating revenues increased by 7.3% to \$1,494.2 million for the six months ended June 30, 2012 compared to \$1,391.9 million for the six months ended June 30, 2011.

*Specialty Hospitals.* Our specialty hospital net operating revenues increased by 6.7% to \$1,110.2 million for the six months ended June 30, 2012 compared to \$1,040.2 million for the six months ended June 30, 2011. The growth in net operating revenue primarily resulted from increases in Medicare patient volumes, increases in non-Medicare rates and revenues that are generated from contracted labor services provided to the Baylor JV. Our patient days increased 2.8% to 679,037 days for the six months ended June 30, 2012 primarily as a result of an increase in Medicare patient days. Our specialty hospital occupancy increased to 72% for the six months ended June 30, 2012 compared to 71% for the six months ended June 30, 2011. Our average net revenue per patient day was \$1,539 for the six months ended June 30, 2012 compared to \$1,510 for the six months ended June 30, 2011. The increase in our net revenue per patient day was principally due to increases in our average non-Medicare net revenue per patient day, resulting principally from Medicaid bonus payments we received during the six months ended June 30, 2012.

*Outpatient Rehabilitation.* Our outpatient rehabilitation net operating revenues increased 9.2% to \$383.9 million for the six months ended June 30, 2012 compared to \$351.7 million for the six months ended June 30, 2011. The net operating revenues generated by our outpatient rehabilitation clinics for the six months ended June 30, 2012 increased 4.0% to \$283.6 million compared to \$272.7 million for the six months ended June 30, 2011. The increase was primarily related to revenues we generated from contracted labor services provided to the Baylor JV and volume growth in our owned outpatient clinics. The number of patient visits in our owned outpatient rehabilitation clinics increased 1.6% for



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the six months ended June 30, 2012 to 2,318,759 visits compared to 2,282,554 visits for the six months ended June 30, 2011. Net revenue per visit in our clinics was \$103 for the six months ended June 30, 2012 compared to \$102 for the six months ended June 30, 2011. Our contract services business increased net operating revenues 27.1% to \$100.4 million compared to \$79.0 million for the six months ended June 30, 2011, which primarily resulted from the addition of new contracts in the fourth quarter of 2011.

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***Operating Expenses***

Our operating expenses include our cost of services, general and administrative expense and bad debt expense. Our operating expenses increased by 7.5% to \$1,277.5 million for the six months ended June 30, 2012 compared to \$1,188.1 million for the six months ended June 30, 2011. As a percentage of our net operating revenues, our operating expenses were 85.5% for the six months ended June 30, 2012 compared to 85.4% for the six months ended June 30, 2011. Our cost of services, a major component of which is labor expense, were \$1,224.3 million or 81.9% of net operating revenue for the six months ended June 30, 2012 compared to \$1,127.1 million or 81.0% of net operating revenue for the six months ended June 30, 2011. The increase in cost of services as a percentage of net operating revenue resulted primarily from increased relative labor costs in both our specialty hospital and our outpatient rehabilitation segments. Our specialty hospitals experienced an increase in relative labor costs due to the labor costs associated with the Baylor JV services agreement and increased staffing costs during six months ended June 30, 2012 compared to the six months ended June 30, 2011. Our outpatient rehabilitation segment experienced an increase in relative labor costs associated with the Baylor JV services agreement and lower productivity in our contract services business. Facility rent expense, which is a component of cost of services, was \$61.7 million for the six months ended June 30, 2012 compared to \$59.6 million for the six months ended June 30, 2011. General and administrative expenses were 2.2% of net operating revenue or \$32.8 million for the six months ended June 30, 2012 compared to 2.4% of net operating revenue or \$32.7 million for the six months ended June 30, 2011. This small increase in general and administrative expense resulted from the increases we experienced in the second quarter of 2012 and discussed above under *Three Months Ended June 30, 2012 compared to Three Months Ended June 30, 2012*. Operating Expenses offset by the gain on the sale of a building that occurred during our first quarter ended March 31, 2012. Our bad debt expense was \$20.4 million or 1.4% of net operating revenues for the six months ended June 30, 2012 compared to \$28.3 million or 2.0% for the six months ended June 30, 2011. The decline in our bad debt expense was attributed to our favorable collections experience of accounts receivable in both our operating segments for the six months ended June 30, 2012 as compared to the six months ended June 30, 2011.

***Adjusted EBITDA***

*Specialty Hospitals.* Our Adjusted EBITDA for our specialty hospitals increased by 5.6% to \$202.1 million for the six months ended June 30, 2012 compared to \$191.4 million for the six months ended June 30, 2011. Our Adjusted EBITDA margins for the segment decreased to 18.2% for the six months ended June 30, 2012 from 18.4% for the six months ended June 30, 2011. The increase in the Adjusted EBITDA for our specialty hospitals was primarily the result of increases in our net operating revenues discussed above under *Net Operating Revenues* and a reduction in bad debt expense discussed above under *Operating Expenses*. The decrease in the Adjusted EBITDA margin is due to negative margin effect of the Baylor JV services agreement and higher relative labor costs in our hospitals.

*Outpatient Rehabilitation.* Our Adjusted EBITDA for our outpatient rehabilitation segment increased 5.3% to \$48.3 million for the six months ended June 30, 2012 compared to \$45.9 million for the six months ended June 30, 2011. Our Adjusted EBITDA margins decreased to 12.6% for the six months ended June 30, 2012 from 13.0% for the six months ended June 30, 2011. The Adjusted EBITDA in our outpatient rehabilitation clinics increased by \$1.4 million to \$40.3 million for the six months ended June 30, 2012 compared to \$38.9 million for the six months ended June 30, 2011. Our Adjusted EBITDA margins for our outpatient rehabilitation clinics decreased to 14.2% for the six months ended June 30, 2012 from 14.3% for the six months ended June 30, 2011. The decline in our Adjusted EBITDA margin in our rehabilitation clinics was principally due to increased relative labor costs associated with the Baylor JV services agreement. The Adjusted EBITDA

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in our contract services business increased by \$1.0 million to \$8.0 million for the six months ended June 30, 2012 compared to \$7.0 million for the six months ended June 30, 2011. The Adjusted EBITDA margins for our contract services business declined to 8.0% for the six months ended June 30, 2012 compared to 8.9% for the six months ended June 30, 2011. The decline in Adjusted EBITDA margins was principally due to increased labor costs associated with new business and lower productivity resulting from regulatory changes that became effective on October 1, 2011.

*Other.* The Adjusted EBITDA loss was \$31.1 million for the six months ended June 30, 2012 compared to an Adjusted EBITDA loss of \$31.6 million for the six months ended June 30, 2011. The reduction in loss is primarily related to the recognition of a gain on the sale of a building that occurred during our first quarter ended March 31, 2012, offset by higher general and administrative costs in the six months ended June 30, 2012 compared to the six months ended June 30, 2011.

***Income from Operations***

For the six months ended June 30, 2012 we had income from operations of \$185.1 million compared to \$168.7 million for the six months ended June 30, 2011. The increase in our income from operations resulted principally from increases in our operating performance of our specialty hospital segment, reductions in bad debt expense and a reduction of our depreciation and amortization expenses.

***Loss on Early Retirement of Debt***

*Select Medical Corporation.* On June 1, 2011, we refinanced our senior secured credit facility which now consists of an \$850.0 million term loan facility and a \$300.0 million revolving facility. A portion of the proceeds from this transaction were used to repay \$266.5 million of Select's 7 5/8% senior subordinated notes. We recognized a loss on early retirement of debt of \$20.4 million for the six months ended June 30, 2011 which included the write-off of unamortized deferred financing costs and tender premiums.

*Select Medical Holdings Corporation.* On June 1, 2011, we refinanced our senior secured credit facility which now consists of an \$850.0 million term loan facility and a \$300.0 million revolving facility. A portion of the proceeds from this transaction were used to repurchase and retire \$266.5 million of Select's 7 5/8% senior subordinated notes and \$150.0 million to repurchase and retire our 10% senior subordinated notes. As a result of this debt repayment, we recognized a loss on early retirement of debt of \$31.0 million for the six months ended June 30, 2011, which included the write-off of unamortized deferred financing costs, tender premiums and original issue discount.

***Equity in Earnings (Losses) of Unconsolidated Subsidiaries***

For the six months ended June 30, 2012, we had equity in earnings of unconsolidated subsidiaries of \$5.2 million compared to equity in losses of unconsolidated subsidiaries of \$0.3 million for the six months ended June 30, 2011. The increase in our equity in earnings of unconsolidated subsidiaries resulted principally from an increase in the contribution from the Baylor JV.

*Interest Expense*

*Select Medical Corporation.* Interest expense was \$42.2 million for the six months ended June 30, 2012 compared to \$38.4 million for the six months ended June 30, 2011. The increase in interest expense resulted primarily from the refinancing of \$150.0 million of Holdings' debt, for which Select was not previously obligated, through indebtedness incurred by Select under the new senior secured credit facility on June 1, 2011.

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*Select Medical Holdings Corporation.* Interest expense was \$47.7 million for the six months ended June 30, 2012 compared to \$51.0 million for the six months ended June 30, 2011. The decrease in interest expense resulted primarily from the lower interest rates on the portions of the debt that were refinanced on June 1, 2011 and reduced borrowings for the six months ended June 30, 2012 compared to the six months ended June 30, 2011.

***Income Taxes***

*Select Medical Corporation.* We recorded income tax expense of \$57.2 million for the six months ended June 30, 2012. The expense represented an effective tax rate of 38.6%. We recorded income tax expense of \$45.6 million for the six months ended June 30, 2011. The expense represented an effective tax rate of 41.6%. Select Medical Corporation is part of the consolidated federal tax return for Select Medical Holdings Corporation. We allocate income taxes between Select and Holdings for purposes of financial statement presentation. Because Holdings is a passive investment company incorporated in Delaware, it does not incur any state income tax expense or benefit on its specific income or loss and, as such, receives a tax allocation equal to the federal statutory rate of 35% on its specific income or loss. Based upon the relative size of Holdings' income or loss, this can cause the effective tax rate for Select to differ from the effective tax rate for the consolidated company.

*Select Medical Holdings Corporation.* We recorded income tax expense of \$55.2 million for the six months ended June 30, 2012. The expense represented an effective tax rate of 38.7%. We recorded income tax expense of \$37.5 million for the six months ended June 30, 2011. The expense represented an effective tax rate of 43.3%. The decline in our effective tax rate is primarily a consequence of the 2011 rate having been impacted by a tax gain associated with a hospital exchange that occurred in 2011, a reduction in the provision for uncertain tax positions and a lower effective state tax rate.

***Non-Controlling Interests***

Non-controlling interests in consolidated earnings were \$2.7 million for the six months ended June 30, 2012 and \$3.7 million for the six months ended June 30, 2011.

Table of Contents**Liquidity and Capital Resources*****Cash Flows for the Six Months Ended June 30, 2012 and Six Months Ended June 30, 2011***

	Select Medical Holdings Corporation			Select Medical Corporation		
	Six Months Ended June 30,			Six Months Ended June 30,		
	2011	2012		2011	2012	
	(in thousands)			(in thousands)		
Cash flows provided by operating activities	\$ 83,527	\$ 118,805	\$	101,250	\$ 124,049	\$
Cash flows used in investing activities	(27,410)	(21,643)		(27,410)	(21,643)	
Cash flows used in financing activities	(46,898)	(87,685)		(64,621)	(92,929)	
Net increase in cash and cash equivalents	9,219	9,477		9,219	9,477	
Cash and cash equivalents at beginning of period	4,365	12,043		4,365	12,043	
Cash and cash equivalents at end of period	\$ 13,584	\$ 21,520	\$	13,584	\$ 21,520	\$

Operating activities for Holdings provided \$118.8 million and for Select provided \$124.0 million of cash flows for the six months ended June 30, 2012; and for Holdings provided \$83.5 million and for Select provided \$101.3 million of cash flows for the six months ended June 30, 2011. The operating cash flows of Select exceeded the operating cash flows of Holdings by \$5.2 million for the six months ended June 30, 2012 and by \$17.7 million for the six months ended June 30, 2011. The difference relates to interest payments on Holdings' indebtedness.

Our days sales outstanding were 51 days at June 30, 2012 compared to 53 days at June 30, 2011 and 53 days at December 31, 2011. The decrease in days sales outstanding between December 31, 2011 and June 30, 2012 is primarily related to the timing of the periodic interim payments we receive from Medicare for the services provided at our specialty hospitals.

Investing activities used \$21.6 million of cash flow for the six months ended June 30, 2012. The principal use of cash included \$27.9 million related to the purchase of property and equipment and \$10.0 million related primarily to an additional investment in the Baylor JV. This use of cash was offset by \$16.5 million in proceeds related to the sale of a building. Investing activities used \$27.4 million of cash flow for the six months ended June 30, 2011. The principal use of cash included \$23.7 million related to the purchase of property and equipment and \$13.5 million related to the purchase of the Baylor JV partnership units and working capital advances, offset by proceeds from the sale of assets of \$7.9 million which was primarily related to the sale of a building we acquired in connection with the acquisition of Regency and \$2.0 million from acquisition activities that includes the resolution of the Regency net working capital settlement with the seller.

Financing activities for Select used \$92.9 million of cash flow for the six months ended June 30, 2012. The primary uses of cash related to net payments under our senior secured credit facility of \$44.3 million, dividends paid to Holdings to fund interest payments and stock repurchases of \$52.0 million and distributions to non-controlling interests of \$1.7 million. These uses were offset by net borrowings of other debt of \$0.8 million, proceeds of \$0.5 million from the issuance of common stock and proceeds from bank overdrafts of \$3.7 million. Financing activities for Select used \$64.6 million of cash flow for the six months ended June 30, 2011. The primary use of cash related to dividends paid to Holdings of \$171.0 million to fund interest payments and the repurchase of all \$150.0 million principal amount of Holdings' 10% senior subordinated notes, \$18.6 million of



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debt issuance costs and \$2.3 million in distributions to non-controlling interests offset by net borrowings of debt of \$124.9 million and \$2.1 million in proceeds from bank overdrafts.

The difference in cash flows provided by financing activities of Holdings compared to Select of \$5.2 million for the six months ended June 30, 2012 and \$17.7 million for the six months ended June 30, 2011 related to dividends paid by Select to Holdings to service Holdings' interest obligations related to indebtedness.

***Capital Resources***

*Select Medical Corporation.* Select had net working capital of \$105.3 million at June 30, 2012 compared to a net working capital of \$97.3 million at December 31, 2011.

*Select Medical Holdings Corporation.* Holdings had net working capital of \$107.3 million at June 30, 2012 compared to a net working capital of \$99.5 million at December 31, 2011.

At June 30, 2012, we had outstanding borrowings of \$834.3 million (net of unamortized original issue discount of \$7.2 million) under the term loan and no outstanding borrowings under the revolving loan portions of our senior secured credit facilities. Also, as of June 30, 2012, we had \$265.8 million of availability under our revolving loan facility (after giving effect to \$34.2 million of outstanding letters of credit).

The applicable margin percentage for borrowings under our term loan is (1) 2.75% for alternate base rate loans and (2) 3.75% for adjusted LIBO rate loans. The adjusted LIBO rate at no time shall be less than 1.75% when used in reference to borrowings under our term loan. The applicable margin percentage for borrowings under our revolving loan is subject to change based upon the ratio of Select's leverage ratio (as defined in the credit agreement). The applicable margin percentage for revolving loans is currently (1) 2.50% for alternate base rate loans and (2) 3.50% for adjusted LIBO rate loans. The applicable margin percentage for revolving loans will decrease to (1) 2.25% for alternate base rate loans and (2) 3.25% for adjusted LIBO rate loans upon the delivery of our Form 10-Q to JP Morgan Chase Bank, N.A., as administrative agent to our senior secured credit facility.

Our senior secured credit facility requires Select to maintain certain leverage ratios (as defined in our senior secured credit facility). For the four consecutive fiscal quarters ended June 30, 2012, Select was required to maintain its leverage ratio (its ratio of total indebtedness to consolidated EBITDA) at less than 5.25 to 1.00. Select's leverage ratio was 2.97 to 1.00 as of June 30, 2012.

Holdings has authorized a program to repurchase up to \$250.0 million worth of shares of our common stock. The program will remain in effect until March 31, 2013, unless extended by the board of directors. During the six months ended June 30, 2012, Holdings has repurchased 5,725,782 shares at a cost of \$46.8 million and since the inception of the program has repurchased 22,490,389 shares under the program at a cost of \$163.6 million, which includes related transaction costs. We anticipate funding this program through available operating cash flow and borrowings under our senior secured credit facility.



We may from time to time seek to retire or purchase our outstanding debt through cash purchases and/or exchanges for equity securities, in open market purchases, privately negotiated transactions, tender offers or otherwise. Such repurchases or exchanges, if any, may be funded from operating cash flows or other sources and will depend on prevailing market conditions, our liquidity requirements, contractual restrictions and other factors. The amounts involved may be material.

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We believe our internally generated cash flows and borrowing capacity under our senior secured credit facility will be sufficient to finance operations over the next twelve months.

As a result of the SCHIP Extension Act as amended by PPACA, which prohibits the establishment and classification of new LTCHs or satellites during the five calendar years commencing on December 29, 2007, we have stopped all new LTCH development. However, we continue to evaluate opportunities to develop new joint venture relationships with significant health systems, and from time to time we may also develop new inpatient rehabilitation hospitals. We also intend to open new outpatient rehabilitation clinics in local areas that we currently serve where we can benefit from existing referral relationships and brand awareness to produce incremental growth. In addition to our development activities, we may grow our network of specialty hospitals through opportunistic acquisitions.

**Recent Accounting Pronouncements**

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income (Topic 220) Presentation of Comprehensive Income ( Update 2011-05 ) that improves the comparability, consistency and transparency of financial reporting and increases the prominence of items reported in other comprehensive income by eliminating the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. Update 2011-05 requires that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Under either method, adjustments must be displayed for items that are reclassified from other comprehensive income ( OCI ) to net income, in both net income and OCI. Update 2011-05 does not change the current option for presenting components of OCI gross or net of the effect of income taxes, provided that such tax effects are presented in the statement in which OCI is presented or disclosed in the notes to the financial statements. Additionally, Update 2011-05 does not affect the calculation or reporting of earnings per share. Update 2011-05 was effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and is to be applied retrospectively. We adopted Update 2011-05 on January 1, 2012. Update 2011-05 had no effect on our presentation of other comprehensive income for the three months ended June 30, 2011 and 2012 because we did not have any items of other comprehensive income during these periods.

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**Quantitative and Qualitative Disclosures About Market Risk**

We are subject to interest rate risk in connection with our long-term indebtedness. Our principal interest rate exposure relates to the loans outstanding under Select's senior secured credit facility and Holdings' senior floating rate notes. As of June 30, 2012, we had \$841.5 million (excluding unamortized original issue discount) in term loans outstanding under our senior secured credit facility and \$167.3 million in senior floating rate notes outstanding, which bear interest at variable rates. Each eighth point change in interest rates on the variable rate portion of our long-term indebtedness would result in a \$1.3 million annual change in interest expense on our term loans. However, because the variable interest rate for our \$841.5 million in term loans is subject to an Adjusted LIBO Rate floor of 1.75% until the Adjusted LIBO Rate exceeds 1.75%, our interest rate on this indebtedness is effectively fixed at 5.50%.

**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

We carried out an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934) as of the end of the period covered in this report. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures, including the accumulation and communication of disclosure to our principal executive officer and principal financial officer as appropriate to allow timely decisions regarding disclosure, are effective as of June 30, 2012 to provide reasonable assurance that material information required to be included in our periodic SEC reports is recorded, processed, summarized and reported within the time periods specified in the relevant SEC rules and forms.

**Changes in Internal Control Over Financial Reporting**

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Securities Exchange Act of 1934) identified in connection with the evaluation required by Rule 13a-15(d) of the Securities Exchange Act of 1934 that occurred during the second quarter ended June 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Inherent Limitations on Effectiveness of Controls**

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

### **PART II      OTHER INFORMATION**

#### **ITEM 1.      LEGAL PROCEEDINGS**

The Company is a party to various legal actions, proceedings and claims (some of which are not insured), and regulatory and other governmental audits and investigations in the ordinary course of its business. The

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Company cannot predict the ultimate outcome of pending litigation, proceedings and regulatory and other governmental audits and investigations. These matters could potentially subject the Company to sanctions, damages, recoupments, fines and other penalties. The Department of Justice, CMS or other federal and state enforcement and regulatory agencies may conduct additional investigations related to the Company's businesses in the future that may, either individually or in the aggregate, have a material adverse effect on the Company's business, financial position, results of operations and liquidity.

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

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

During April 2012, the Company's long term acute care hospital in Evansville, Indiana (SSH - Evansville) received two subpoenas from the Office of Attorney General for the State of Indiana. One subpoena demanded certain patient medical records of SSH - Evansville. The second subpoena demanded reports and documents related to SSH - Evansville for various periods beginning in 2006, including certain financial, statistical, billing and quality reports; certain policies and procedures, joint venture board meeting minutes, and documents related to certain complaints and internal investigations. SSH - Evansville subsequently received a Request for Information or Assistance from the Office of Inspector General of the U.S. Department of Health and Human Services (Indianapolis, Indiana Field Office) covering the period beginning in 2007 seeking substantially the same records demanded by the Indiana Attorney General's Office, additional patient medical records of SSH - Evansville and additional documents and information of SSH - Evansville, including documents concerning SSH - Evansville's relationships with its joint venture partner and seven other identified persons and entities. During May 2012, the Evansville (Indiana) Police Department executed a search warrant at SSH - Evansville purporting to seek evidence pertaining to the crime of theft. At the Company's request, the Vanderburgh (Indiana) Superior Court ordered the release of the probable cause affidavit supporting that search warrant. According to the affidavit, confidential informants, some of whom are purportedly current or former employees of SSH-Evansville, alleged, among other things, that a physician on the medical staff at SSH-Evansville improperly manipulated patient diagnoses to raise the diagnosis related group (DRG) and lengths-of-stay to enhance reimbursement and, on one occasion, discontinued treatments to a patient based on financial motivation and without regard to the patient's end of life instructions resulting in the patient's death, and that a second physician on the medical staff at SSH-Evansville performed bronchoscopes that were medically unnecessary and resulted in at least two patient deaths. The affidavit also makes allegations that imply that the Company may not have provided complete or accurate documents called for in the Indiana Attorney General's Office subpoenas which were received during April 2012. In August 2012, the Company received a subpoena from the Office of Inspector General of the U.S. Department of Health and Human Services (Chicago Regional Office) demanding additional documents covering the period beginning in March 2007 relating to the Company and SSH - Evansville, including contracts with SSH - Evansville's joint venture partner, contracts and other documents relating to financial relationships with physicians practicing at SSH - Evansville, records of payments to and hours worked by physicians practicing at SSH - Evansville, documents relating to actual or expected physician referrals and admissions to SSH - Evansville, documents relating to billing for services furnished by the Company's LTCHs, such as government program guidance and staff training materials, information relating to case manager duties and responsibilities at the Company's LTCHs, reports on patient admissions, discharges, DRG, length-of-stay and transfers at SSH - Evansville, and documents relating to criteria used by the Company or SSH - Evansville for patient admissions, discharges and eligibility for service. The Company has produced and will continue to



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produce documents in response to, and intends to fully cooperate with, these governmental investigations. At this time, the Company is unable to predict the timing and outcome of this matter.

**ITEM 1A. RISK FACTORS.**

There have been no material changes from our risk factors as previously reported in our Annual Report on Form 10-K for the year ended December 31, 2011.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Purchases of Equity Securities by the Issuer**

In November 2010, our board of directors authorized a stock repurchase program pursuant to which we may purchase up to \$100.0 million worth of our common stock. On August 3, 2011, our board of directors authorized an increase of \$50.0 million in the capacity of our common stock repurchase program, from \$100.0 million to \$150.0 million and on February 22, 2012 increased the capacity by an additional \$100.0 million to \$250.0 million. The other terms of the plan remain unchanged. Stock repurchases under this program may be made in the open market or through privately negotiated transactions, and at times and in such amounts as the Company deems appropriate. The program will remain in effect until March 31, 2013, unless extended by our board of directors. During the three months ended June 30, 2012, we purchased a total of 2,522,090 shares of our common stock at an average purchase price of \$8.33.

The following table sets forth the monthly purchases made under this program during the three months ended June 30, 2012:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs
April 1, 2012 to April 30, 2012	1,101,471	\$ 7.59	1,101,471	\$ 99,029,913
May 1, 2012 to May 31, 2012	961,631	\$ 8.76	961,631	\$ 90,582,480
June 1, 2012 to June 30, 2012	458,988	\$ 9.19	458,988	\$ 86,354,165
Second Quarter 2012	2,522,090	\$ 8.33	2,522,090	\$ 86,354,165

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

None.



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**ITEM 6. EXHIBITS**

The exhibits to this report are listed in the Exhibit Index appearing on page 56 hereof.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

**SELECT MEDICAL CORPORATION**

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

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

**Dated: August 7, 2012**

**SELECT MEDICAL HOLDINGS CORPORATION**

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

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

**Dated: August 7, 2012**

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EXHIBIT INDEX

Exhibit	Description
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Executive Vice President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer, and Executive Vice President and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following financial information from the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2012 formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Statements of Operations for the three and six months ended June 30, 2012 and 2011, (ii) Consolidated Balance Sheets as of June 30, 2012 and December 31, 2011, (iii) Consolidated Statements of Cash Flows for the six months ended June 30, 2012 and 2011, (iv) Consolidated Statements of Changes in Equity and Income for the six months ended June 30, 2012 and (v) Notes to Consolidated Financial Statements.*

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