

WESTPEAK RESEARCH ASSOCIATION

Select Medical Holdings (NYSE: SEM)

Health Care – Health Care Facilities

Holdings of Post-Acute Empire

March 19, 2019

Select Medical is the largest operators of critical illness recovery hospitals, outpatient rehabilitation clinics and occupational health centers, and the second largest operator of rehabilitation hospitals in the United States.

Thesis

Select's fundamentals are still strong, with growth potential in both of its Rehabilitation Hospital (IRF) and Concentra, its strong expansion in occupational healthcare market and economies of scale brought by its size. Being the largest operator in specialty hospital, Select owns a well-diversified portfolio of post-acute care facilities, which position them well in case of drastic changes in Medicare reimbursement as compared to its peers.

Drivers

From 2019 to 2024, the number of adults aged 65 and older is estimated to be growing at 3.2% annually, which drives national healthcare spending, especially in long-term acute care hospitals and inpatient rehabilitation facilities. Also, while economy remains robust and unemployment rate remains low, we expect higher healthcare plan coverage ratio given increasing level of disposable income and employer-sponsored health care plans.

Valuation

We initiate a buy rating on Select with a target price of \$19, representing a 27% upside. We used a discounted cash flow analysis of the company and sum of the parts comparable company analysis and assigned 60% weight to discounted cash flow analysis and 40% comparable company analysis.

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Equity Research U.S.

Price Target	US\$19.00
Rating	Buy
Share Price (Mar 19 Close)	US\$ 14.62
Total Return	27%

Key Statistics

52 Week H/L	\$13.83/\$21.60
Market Capitalization	\$1.9B
Average Daily Trading Volume	701K
Net Debt	\$3.3B
Enterprise Value	\$6.0B
Net Debt/EBITDA	5.08x
Diluted Shares Outstanding	130.3M
Free Float	82%
Dividend Yield	0%

WestPeak's Forecast

	2019E	2020E	2021E
Revenue	\$5.21B	\$5.36B	\$5.47B
EBITDA	\$624M	\$654M	\$748M
Net Income	\$175M	\$173M	\$197M
EPS	\$0.90	\$1.32	\$1.50
P/E	14.1x	13.0x	11.9x
EV/EBITDA	8.85x	8.45x	8.08x

1-Year Price Performance

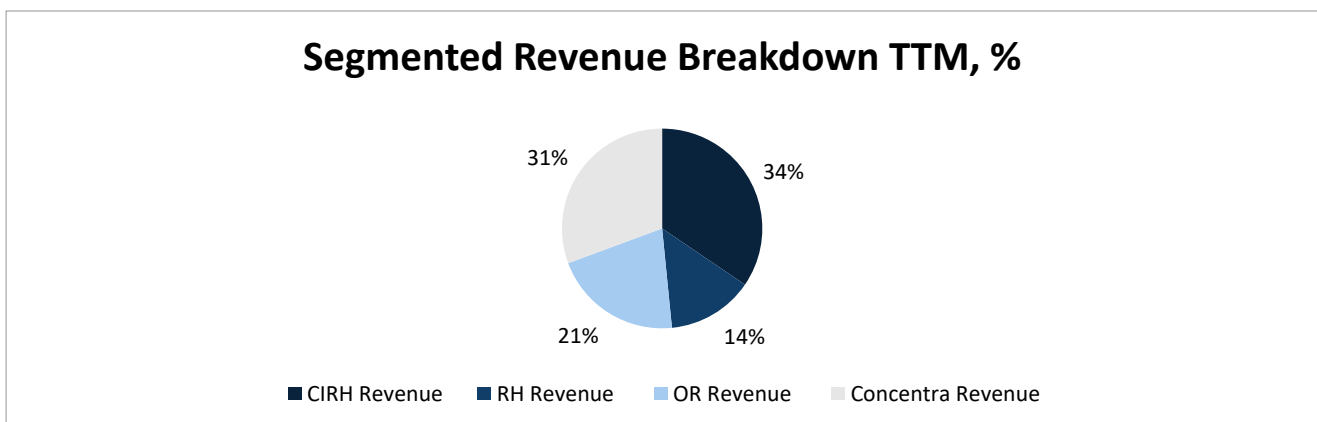


Business Overview/Fundamentals

Business Overview

Select Medical provides healthcare service through its portfolio of hospitals, rehabilitation clinics and occupational health centers. Select Medical is the largest operators of critical illness recovery hospitals, outpatient rehabilitation clinics and occupational health centers, and the second largest operator of rehabilitation hospitals in the United States. Starting 2018, the company reallocated and re-segmented its business into the four segments: critical illness recovery hospital segment (CIRH), rehabilitation hospital (IRF), outpatient rehabilitation and Concentra. It operates 96 critical illness recovery hospitals in 27 states, 26 rehabilitation hospitals in 11 states and 1,662 outpatient rehabilitation clinics in 37 states and the District of Columbia. Concentra, which is operated through a joint venture subsidiary, operated 524 occupational health centers in 41 states as of December 31, 2018.

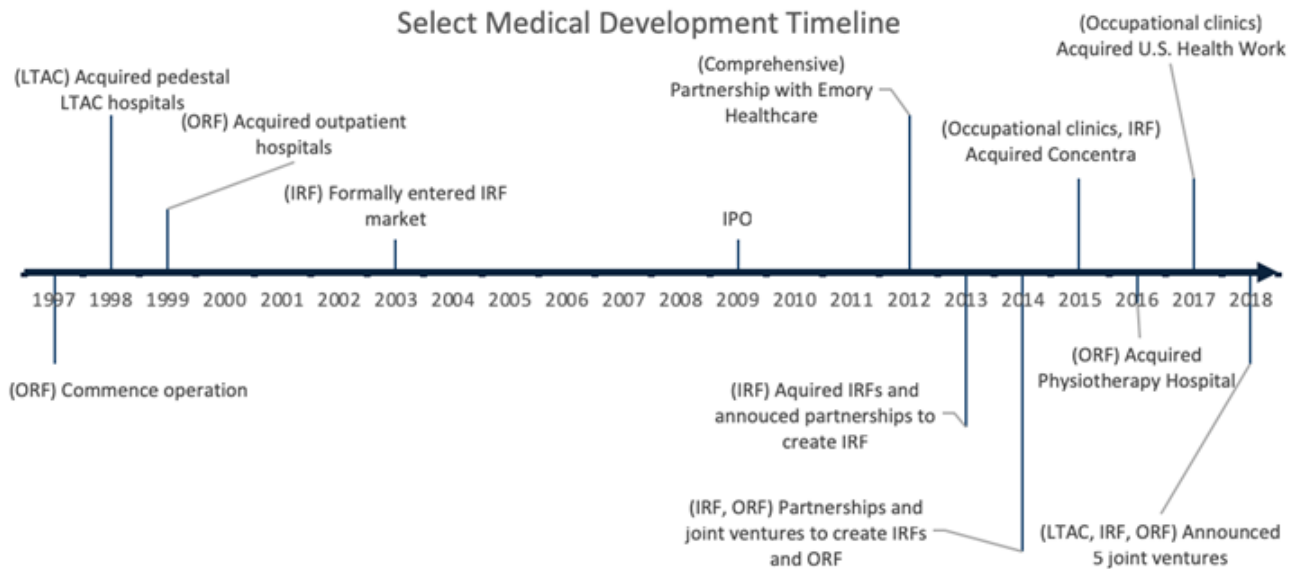
Revenue Breakdown for Segments



(Source: Company filings)

Company Development Timeline

Co-founded by its current chairman and vice chairman in 1996, Robert Ortenzio and Rocco Ortenzio, Select began its operation in 1997 as a regional provider of outpatient rehabilitation hospital in the United States. In 1998, Select made several pedestal acquisitions of long-term acute care (LTAC) hospitals. Five years later, in 2003, Select enters the medical rehabilitation hospital segment. By 2007, Select doubled its outpatient rehabilitation segment in size. In 2015, Select acquired Concentra through joint venture with private equity firm, Welsh Carson Anderson & Stowe LP, in \$1.06 billion cash. In 2018, Select acquired U.S. Health Work, an occupational healthcare clinic. Throughout the process of healthcare service diversification, Select has been able to capture market share in each of its operating segment.



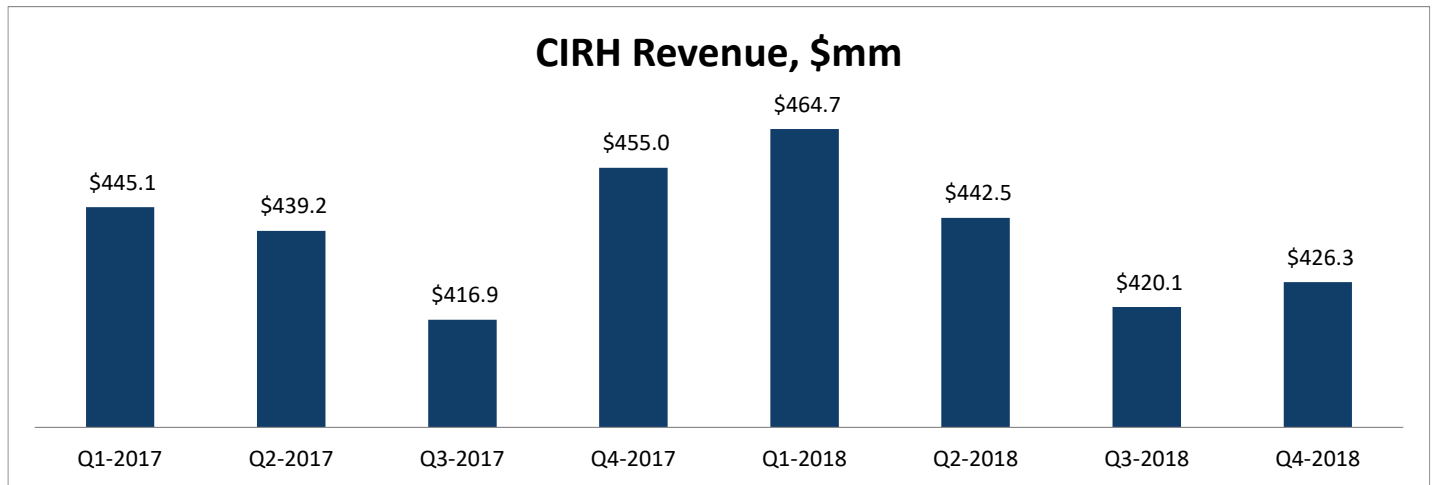
(Source: Company filings)

Segment Information – Critical Illness Recovery Hospitals

Select is the largest operator of CIRH hospitals in the United States. As of December 2018, the company owns 96 CIRH. Patients are usually admitted to CIRH on a referral basis from general acute care hospital, likely following an intensive care unit or coronary care unit stay. Patient admitted to CIRH have longer period of stay, compared to general acute care hospitals. Select benefits from the patient referral, given its good business relationships between and geographical adjacency to general acute hospitals. Select focuses on matching up with specialized patient needs, providing high-quality service and controlling operating costs.

A pre-determined fix amount Medicare payment is reimbursed to IRF depending on the diagnosed-related group of the patient after patient discharge. Further detail will be discussed in Industry section regarding the payment system (Long Term Acute Hospital Perspective Payment System).

For the years ended December 31, 2016, 2017 and 2018, approximately 53%, 52% and 51% of the net operating revenue of CIRH are generated from Medicare reimbursement. The key to CIRH operation success is its adaption to changes in Medicare policy.

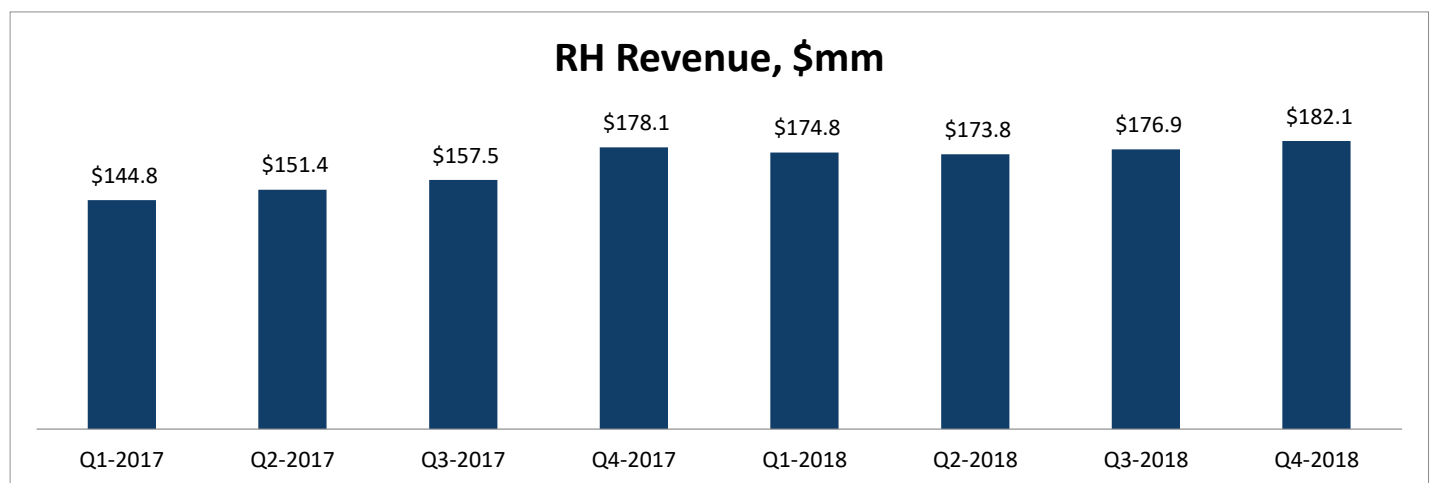


(Source: Company Filings)

Segment Information – Rehabilitation Hospitals

Select is the second largest inpatient rehabilitation hospital operators in the United States. As of December 2018, the company owns 17 and manages 9 inpatient rehabilitation hospitals. The rehabilitation hospitals provide comprehensive physical medicine, as well as rehabilitation programs that aim to improve the quality of lives of those who suffered from long term acute illness. Patients admitted to IRF often suffer from complex and serious health deficiencies that require prolonged rehabilitation services, and therefore they have longer periods of stay as compared to general acute hospitals. The operating strategy of IRF is to focus on specialized needs, provide high-quality service and control operating costs.

Inpatient rehabilitation hospital is reimbursed under Medicare under a similar scheme as LTCH. For further discussion, please refer to the Industry Analysis section under Industry Regulation.

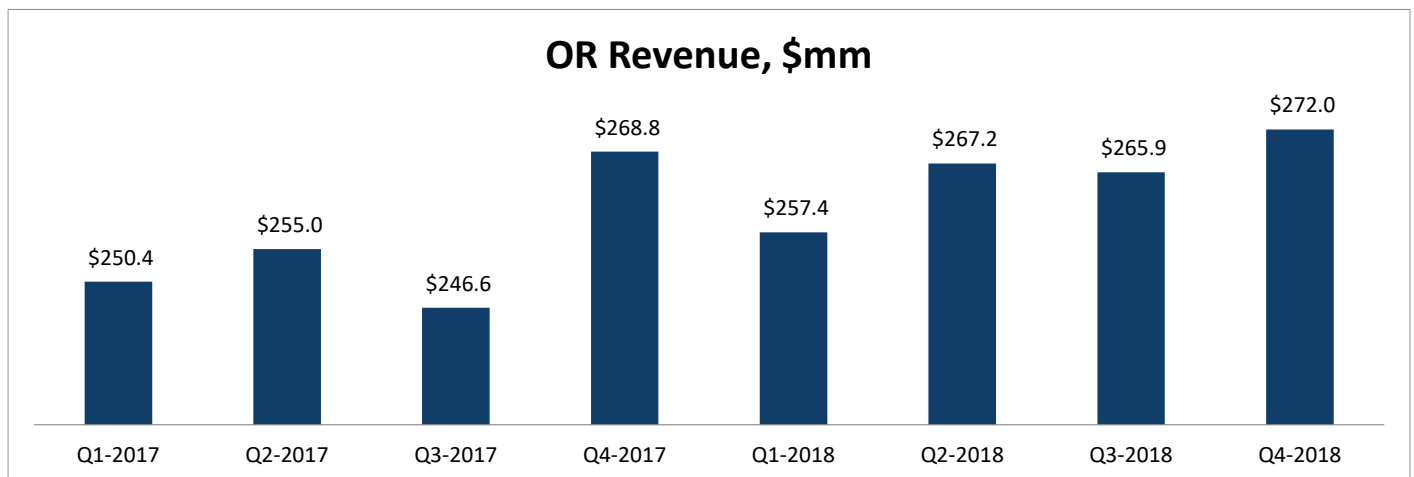


(Source: Company Filings)

Segment Information – Outpatient Rehabilitation

Select is the largest outpatient rehabilitation operators in the U.S. As of December 2018, the company owns 1,423 and manages 239 outpatient rehabilitation clinics. The outpatient rehabilitation clinics are usually located in a medical complex or in a retail location. The clinics provide physical, occupational and speech rehabilitation services and programs.

Patients are usually directed or referred by a physician, employer or health insurer. In most recent years, several states in the U.S. enacted laws that allow individuals to seek outpatient rehabilitation without a physician order; however, the population of those patients are not significant. The outpatient rehabilitation segment strives to provide high-quality service, increase its market share, expand rehabilitation programs, optimize payor contract reimbursement, maintain strong community and employer relations, and pursue opportunist acquisitions.



(Source: Company Filings)

Segment Information – Concentra

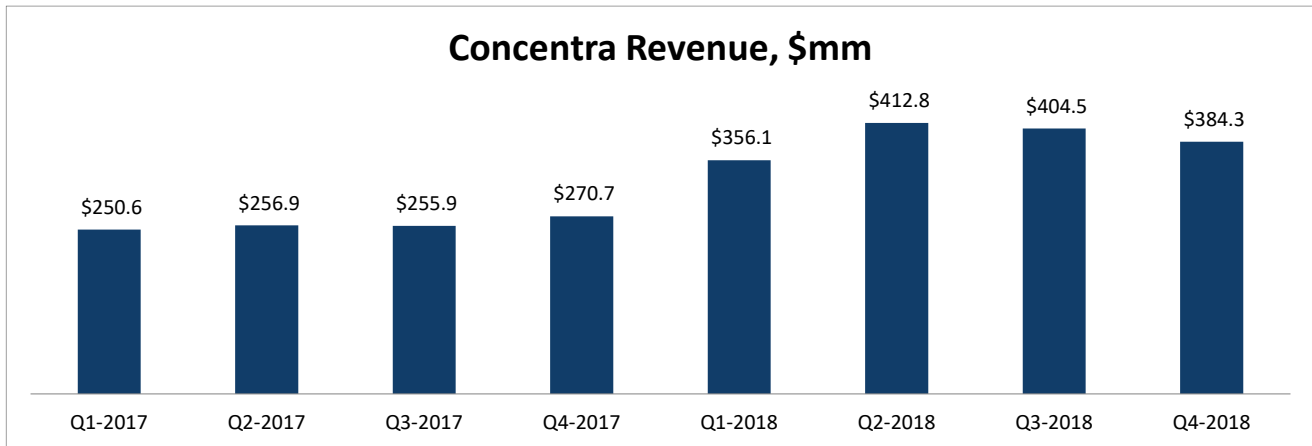
Concentra was acquired in \$1.1 billion cash by Select in 2015 in a joint venture effort with Welsh Carson LLC, a private equity fund primarily focused in the healthcare and technology sector. Note that the fund, Welsh Carson, bought out Select in an LBO transaction and took Select private in \$2.1 billion cash in 2005. The fund at the time issued around \$980 million debt under Select. Four years later, Select filed for IPO again in 2009 and raised \$336 million in the IPO. This indicates that Welsh Carson is familiar with Select's operation and its industry, and it has been successful in managing specialty hospital operation. In February 2018, Select closed the merger between Concentra and U.S. Health Work, a subsidiary under Digital Health. U.S. Health Work provides occupational healthcare and urgent health clinic services.

Concentra offers a range of occupational and consumer health services through medical care centres and onsite clinics. It provides contract services at employer worksites and Department of Veteran Affairs community-based Outpatient Clinics. The operating strategies are to provide high-quality service, focus on occupational medicine, pursue direct employer relationships, increase market presence, and pursue opportunistic acquisitions.

Workers' compensation is a government insurance program that requires employers to fund or insure against medical expense, lost benefits and wages from work-related injuries. Occupational services to work-related injuries are law mandate of worker's compensation benefits. This means that contracts of Select with third-party insurers or the

employers are more likely to reoccur and sticky. For the year ended December 31, 2018, approximately 58% of the Concentra operating revenue came from workers' compensation payments.

Work-related injuries occur more often in manufacturing-based workplaces. This means that employment rate, economic conditions and workplace illness rate are drivers of this segment. We have seen improvement in workplace safety awareness over time and more employer-sponsored protection methods are put into use. Concentra is primarily focused on expanding its market share to seek growth.



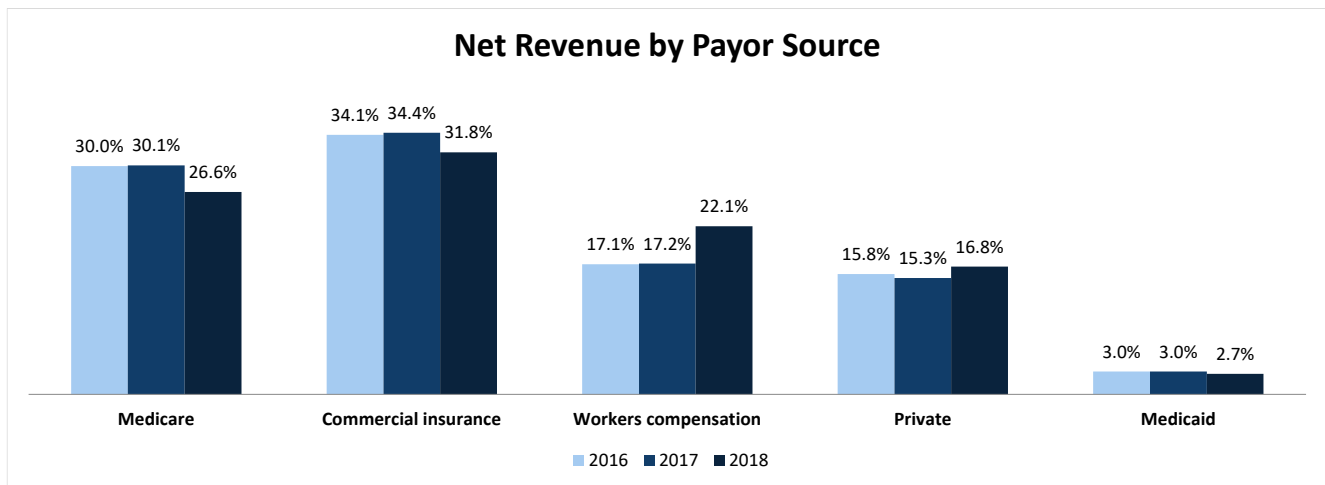
(Source: Company Filings)

Segment Discussion Summary

Select operates in four business segments: Critical Illness Recovery Hospitals (CIRH), Rehabilitation Hospitals (IRF), Outpatient Rehabilitation and Concentra. Critical Illness Recovery Hospitals and Rehabilitation Hospitals segments are government reimbursement dependent while Rehabilitation Hospital and Concentra are less so.

Medicare payment takes up less proportion of Select's revenue from 2016 to 2018. Combined with Select's most recent acquisitions records, we believe that Select is diversifying its healthcare service portfolio from being Medicare dependent. This is in line with management's operating strategy where they adjust for changes in Medicare reimbursement and standards. Meanwhile, the percentage of revenue brought by workers' compensation increased. Given Select's Concentra and U.S. Health Work acquisition effort, we believe that Select's current strategy is to expand its market in occupational healthcare services while diversifying away from its dependency on government sponsor and reimbursement.

Other than Medicare and Medicaid, other revenue payors of Select are less government policy dependent. The report will talk about Medicare payment system and changes in the following Industry Analysis section.



(Source: Company filings)

Industry Analysis – Specialty Hospitals

The industry is moderately competitive given the high barrier to entry and heavy regulation. Companies in this industry provides long-term acute care services, inpatient and outpatient rehabilitation services to patients. Higher labor cost in recent years, decreased Medicare reimbursement level and different patient standards are all pressuring the industry's margin. Reimbursement cuts have led to a decline in profit of the industry in 2018 as compared to other periods.

Medicare Dependency

In terms of specialty healthcare facilities, the government regulating arm is the Centers for Medicare and Medicaid Services ("CMS"). CMS administers the Medicare program and partially the Medicaid program, where those two programs provides significant reimbursements to specialty hospitals. Medicare program, the largest payor of the specialty hospital industry, is a national health insurance program that provides health insurance for Americans aged 65 and older. Medicare has gone through intensive reform since 2016 while the direction of the reform remains a trend of cutting annual increase amount of reimbursement to LTCHs. Medicare is the largest payor of revenue for most specialty hospitals.

All Medicare payments to LTCH are made in accordance with prospective payment system specific to long-term care hospital. Each patient is assigned to a distinct Medicare severity long-term care diagnosed-related group ("MS-LTC-DRG") after discharge. LTCHs are reimbursed a single pre-determined fixed payment depending on the patient's MS-LTC-DRG (adjusted for area wage difference). CMS is the government body that designs a base rate (the standard federal payment rate) and assigns weights for different MS-LTC-DRG to the base rate. The payment amount of each group reflects the relative amount of medical care resources the group uses on average. Generally, the more medical resources used during patient care, the higher the reimbursement.

Patient will be reimbursed at standard federal rate if the patient meets the Patient Criteria. Patient Criteria are mainly restriction on if the patient has received general acute care before long-term acute care, length of general acute care stay

period etc. If the patient does not meet the Patient Criteria, LTCH is reimbursed at 50% blended rate of site-neutral and standard federal rate (based on MS-LTC-DRG) and will be reimbursed at 100% “site-neutral” payment from October 1st, 2019 onward. Site-neutral payment is the lower of 1) the IPPS comparable per-diem payment rate capped at the MS-DRG payment rate plus any outlier payments; or 2) 100 percent of the estimated costs for services. Site-neutral payment is materially lower than the standard federal rate.

LTAC hospitals receive fixed amount of prospective payment per LTAC patient based on CMS estimates. This makes it hard for the specialty hospitals to pass costs onto patients. Proposed rules specifically related to LTCHs are published in May, finalized in August and effective on October of each year.

- FY 2019 CMS Final Rule for LTCHs Reimbursement and Rules

As per the effective rule FY 2019 published in August 2018, CMS eliminated the proposed 25 Percent Rule, which rule has been postponed for many years due to industry concerns. The 25 Percent Rule dictates that if a LTCH received more than 25% of its patient from a single general acute hospital referral, LTCH would receive a lower reimbursement rate for patients admitted above the 25% proportion. The reduced payment would be 50% to 60% compared to what LTCH would have received. CMS estimated that elimination of such rule will increase approximately \$35 million reimbursement in FY 2019, \$33 million in FY 2020, \$28 million in FY 2021. To stay budget neutral, CMS took a haircut on the federal standard rate. Each year, CMS updates the rate for 1.35% increase. Starting from FY 2019 onward, the federal standard rate is reimbursed multiplying a one-time factor of around 0.99, meaning a 0.9% cut.

Under the final rule, standard rate will increase by a net of 1% (\$35 million), and site-neutral payment rate will increase by a net of 0.4% (\$4 million).

Aging U.S. Population

The baby boomers are aging. In the recent years, the baby boomers entered the healthcare age threshold of 65 years old. According to IBIS World, the number of U.S. population to reach 65 years old and older is expected to reach 63.4 million individuals over the five years to 2024. This drives the national healthcare spending and increasing the size of pie of the healthcare industry, and we believe it remains one of the key drivers of this industry

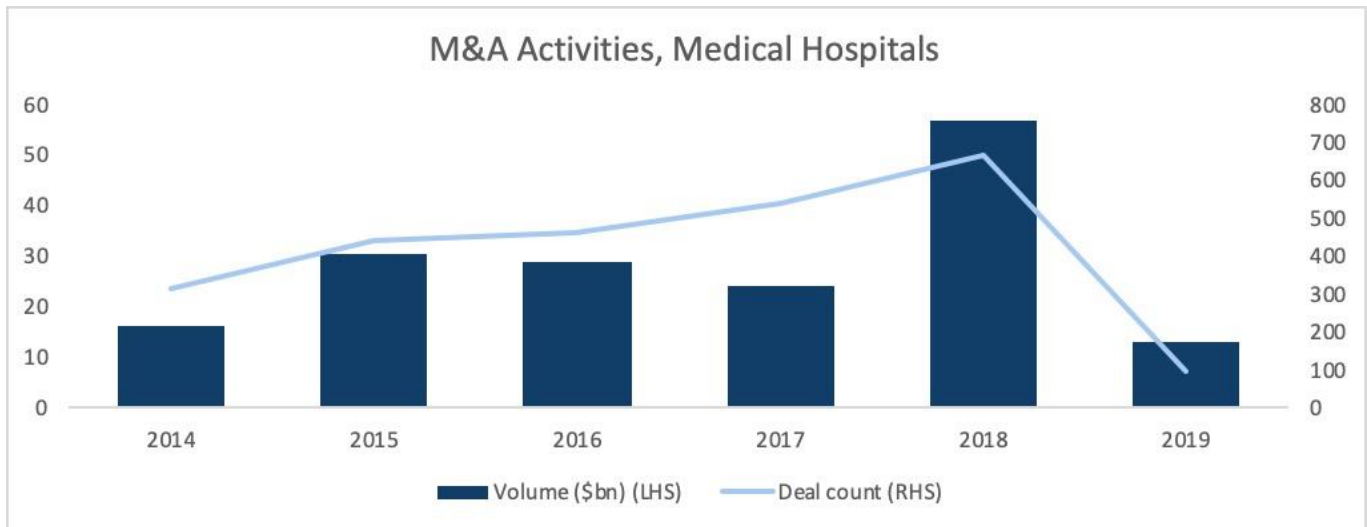
Growing Demand for Home-Based Care Services

There has been an increasing demand for home-based care services from the aging population and this industry has been growing rapidly given higher disposable income level that more people can afford home-based service and the convenience the service provides. This trend takes a cut from the size of the pie of specialty hospitals.

Active Consolidation Activities

The industry has seen active consolidation in the past years. The industry seeks mergers and acquisitions for both revenue and cost synergies, mainly from increasing patient referral and geographical reach. We saw a peak in mergers and acquisition activities in 2018. We attribute this peak to the need to increase resources and expertise, expand geographical reach, and adapt to the changes in payment model and care delivery. Several mega-acquisitions including Maryland’s Bon

Secours Health Systems with Mercy Health in September 2018 hiked up the volume of deals. Despite the ongoing need for acquisition, given that acquisitions are generally financed through debt, we expect the acquisition pace to slow down due to late business cycle risk.



(Source: Bloomberg, 2019 amount is quoted at YTD)

Management Team

Mr. David Chernow – President and Chief Executive Officer

David Chernow has been with the company since 2005. He has served as President and CEO since 2014. He has served in various positions in the company prior to CEO, including President from 2010 to 2014, Chief Administrative Officer from 2012 to 2013, Chief Development and Strategy Officer from 2011 to 2012, and Chief Strategy Officer in 2010. He also served on the Company's Board of Directors from 2005 to 2010. He owns 0.61% of the total shares outstanding.

Mr. Martin Jackson – Chief Financial Officer

Martin Jackson is CFO and Executive VP of Select. He has been with the company since 1999. He has served as Executive VP and CFO since 2007, also as Senior VP and CFO from 1999 to 2007. He sits on the board of Concentra Group Holdings Parent. Previously, Mr. Jackson served as a Managing Director in the Health Care Investment Banking Group for CIBC Oppenheimer from 1997 to 1999. Prior to this, he served as Senior Vice President, Health Care Finance with McDonald & Company Securities, Inc. from 1994 to 1997. He owns 1.18% of total shares outstanding.

Management Summary

All the officers, independent directors and board members have extensive experience in the health care field, either in health care companies or financial companies covering the health care sector. Writing down goodwill or impairing equity investment has been minimum - the only impairment since 2013 was in 2016 Q1 for \$5.3 million, triggered by a planned

sale of the investee by the controlling interest. This indicates that the company has been successful with its acquisitions and divestitures to diversify business portfolio, gaining growth momentum in different fields of the hospital and healthcare facilities industry. With the experienced management team and board of directors, we believe that the company is in a good shape to capture the industry trend and grow the business.

Management team does not own significant number of total shares outstanding, which could be concerning considering their return to shareholder is not tied to their compensation.

Shareholder Base, Liquidity, Market Depth

Shareholder Base

Shares of Select are mostly owned by institutional investors, with top ten institutional advisor owns around 63% of the shares outstanding. Total institutional investors hold 77% of the total shares outstanding, which is a good sign for a stock.

Public Ownership Summary		
Type	Common Stock Equivalent Held	% of Total Shares Outstanding
Institutions	104,185,256	76.99
Corporations (Private)	30,601	0.02
Individuals/Insiders	26,122,641	19.30
Public and Other	4,993,366	3.69
Total	135,331,864	100.00

Top 10 Holder	Common Stock Equivalent Held	% of CSO	Insider?
T. Rowe Price Group, Inc. (NasdaqGS: TROW)	20,134,993	14.88%	No
BlackRock, Inc. (NYSE: BLK)	16,163,430	11.94%	No
The Vanguard Group, Inc.	10,514,877	7.77%	No
Ortenzio, Rocco A.	10,108,591	7.47%	Yes
Ortenzio, Robert A.	9,094,712	6.72%	Yes
Dimensional Fund Advisors L.P.	7,540,980	5.57%	No
Fisher Investments	4,260,599	3.15%	No
State Street Global Advisors, Inc.	3,218,794	2.38%	No
Invesco Ltd. (NYSE:IVZ)	2,674,351	1.98%	No
Carson, Russell L.	2,187,553	1.62%	Yes
	85,898,880	63.48%	

(Source: S&P CapIQ)

Liquidity

For the 2018, the average daily trading volume for Select is 632,578 and the 20-day moving average trading volume is 614,704. The average of 20-day volume weighted average price for SPDR S&P 500 ETF Trust (NYSEARCA: SPY) is 95,981,867. The stock liquidity can be implied by the ratio of trading volume of Select and the market, at 0.6%.

Valuation

We used a discounted cash flow analysis and sum-of-the-parts analysis for intrinsic and relative valuation of Select. We assigned 60% and 40% weight on them respectively. We used a SOTP analysis since the company operates in segments that are relatively independent to each other. Due to vastly different leverage levels of comparable companies and limited comparables in the Concentra segment, we assigned a lower weight on SOTP analysis and more on DCF valuation. We arrived at a stock price of \$19, representing a 27% upside of Select's price as of March 19th, 2019 at \$14.62.

Discounted Cash Flow Analysis

- Operating Assumptions

Q3 is a seasonally weak quarter in terms of top and bottom line for Select as seen historically and recognized by management. We have highlighted key operating assumptions in the following paragraph. We arrived at the stock price of \$17.40 from our DCF analysis and assigned 60% weight on it.

Revenue Growth: As for CIRH segment, we took into account the overall trend of slowing increase of Medicare reimbursement to LTCHs. Also, management talked about the outlook that they expect their CIRH operation to remain stable in FY 2019. Therefore, we assigned a closed-to-neutral growth rate in net revenue per patient day five years into 2023. Given Select's market share and scale in LTCH operation, we expect the patient volume to grow at a CAGR rate of 1.5% five years into 2023, mainly driven by aging population.

For Rehabilitation Hospital and Outpatient Rehabilitation segment, given market basket inflationary increase for RH and OR, offset by slow reimbursement increase, we expect single-low digit growth in patient days and net revenue per patient day.

As for Concentra, we expect high organic volume growth given continuously high employment rate in the next two years. We also took into account U.S. HealthWork residual acquisition growth in Q1 2019. From 2021 onward, growth number is expected to be in line with management's forecast of 2% to 3% organic growth in the Concentra segment.

With our expectations of revenue growth in each segment, five-year CAGR revenue growth rate of the company into 2023 is 3%, which is in line our expectation of the stable and steady growth of the industry overall.

COGS Margin: The COGS margin is forecasted to be in the range of 85% to 86%, which range is slightly higher than historical average gives rising labor cost and gradual recovery from hospitals loss from Hurricane Michael. From 2020 onward, the COGS margin is forecasted to be slightly lower at 85% as we expect the company will be able to recover from those short-term challenges and fully realize cost synergies from acquisition (Select has been investing into integration for the past years and they are seeing vast progress).

SG&A Margin: SG&A margin is forecasted to be in line with historical. We do not expect significant deviation from historical average given current level of information.

Income Tax Rate: For FY 2019, our forecast is in line with the management forecasted income tax amount, in range between \$64 million and \$74 million. From 2020 onward, we used a 25% income tax rate.

As implied with our operating assumptions, we expect Select to operate at EBITDA margin between 11% and 12% in the next two years. From 2021 onward, we expect Select's EBITDA margin around 13%.

- *WACC and Terminal Multiples Assumptions*

Pre-tax Cost of Debt: We used a pre-tax cost of debt at 6.2%, which is higher than the rate Select issued its debt at previously to account for its already-high leverage. We expect the company will have to issue debt at a higher rate than historical rates.

Income Tax Rate: We used a 25% tax rate as forecasted by management.

WACC: The weighted average cost of capital (WACC) was calculated to be 7.1%. The risk-free rate of the U.S. Ten-year T-Bill is 2.69%. We used a beta of 1.2, expected annualized U.S. market premium of 9.5%; effective tax rate at 25% (as forecasted by management), and pre-tax cost of debt at 6.2%.

Perpetuity Growth Rate: We expect slow and stable growth of free cash flow generation from Select, growing at 2.3%. This number is in line with inflationary increase of the overall economy.

Terminal Multiple: We used one-year forward multiple at 9.1 times from a comparable companies analysis.

Sum of the Parts Comparable Companies Analysis

We used a sum of the parts analysis for our relative analysis. Select operates in four segments, CIRH, RH, OR, and Concentra. The following is the companies we used for each segment. In selecting those comparable companies, we looked at size of the company, market it operates in, its business model and Medicare dependency. We assigned 40% weight on the SOTP analysis. The lower weight was a result from the vastly different leverage ratio across companies in the industry.

Note that there are no direct public comparable companies to Concentra. Most of the comparable companies to Concentra in occupational healthcare facilities are private. To our knowledge, Concentra competes with general healthcare providers and healthcare clinics. Therefore, we pegged Concentra against diversified general acute and healthcare companies operating in several lines of post-acute facilities.

Critical Illness Recovery Hospital:

(Figures in mm USD)

Company	Ticker	Equity Value	Enterprise Value	EV/EBITDA Multiple					
				2018A EBITDA	2019E EBITDA	2020E EBITDA	2018A EV/EBITDA	2019E EV/EBITDA	2020E EV/EBITDA
CIRH Comps									
HCA Health Care	NYSE: HCA	46,930.6	81,281.6	8,920.0	9,580.1	10,137.7	8.9 x	8.3 x	7.8 x
Universal Health	NYSE: UHS	11,312.1	15,306.3	1,761.8	1,833.6	1,923.1	8.6 x	8.3 x	7.9 x
Community Healt	NYSE: CYH	513.7	14,497.7	1,620.0	1,646.3	1,672.9	9.0 x	8.8 x	8.7 x
Select Medical NYSE: SEM			1,959.5	201.6	219.1	229.5	9.7 x	8.9 x	8.5 x
Median								8.3 x	7.9 x
Mean								8.5 x	8.1 x

Rehabilitation Hospital:

(Figures in mm USD)

Company	Ticker	Equity Value	Enterprise Value	EV/EBITDA Multiple					
				2018A EBITDA	2019E EBITDA	2020E EBITDA	2018A EV/EBITDA	2019E EV/EBITDA	2020E EV/EBITDA
RH Comps									
Encompass Heal	NYSE: EHC	6,576.8	9,563.9	885.4	937.6	966.8	10.8 x	10.2 x	9.9 x
Acadia Healthcar	NYSE: ACHC	2,558.5	5,753.6	593.6	612.6	651.1	9.7 x	9.4 x	8.8 x
Select Medical NYSE: SEM			869.2	90.4	98.2	102.8	9.6 x	8.8 x	8.5 x
Median								9.8 x	9.4 x
Mean								9.8 x	9.4 x

Outpatient Rehabilitation Hospital:

(Figures in mm USD)

Company	Ticker	Equity Value	Enterprise Value	EV/EBITDA Multiple					
				2018A EBITDA	2019E EBITDA	2020E EBITDA	2018A EV/EBITDA	2019E EV/EBITDA	2020E EV/EBITDA
ORF Comps									
Brookdale Senior	NYSE: BKD	1,295.0	5,396.0	509.6	408.8	445.3	10.6 x	13.2 x	12.1 x
Centric Health Cc	TSE: CHH	69.6	151.5	11.7	14.8	19.3	12.9 x	10.3 x	7.8 x
Select Medical NYSE: SEM			1,133.2	117.8	128.0	134.1	9.6 x	8.8 x	8.5 x
Median								11.7 x	10.0 x
Mean								11.7 x	10.0 x

Concentra:

(Figures in mm USD)

Company	Ticker	Equity Value	Enterprise Value	EV/EBITDA Multiple					
				2018A EBITDA	2019E EBITDA	2020E EBITDA	2018A EV/EBITDA	2019E EV/EBITDA	2020E EV/EBITDA
Concentra Comparable Companies									
Magellan Health I	NYSE: MGLN	1,592.7	1,690.7	198.5	271.3	306.0	8.3 x	6.0 x	5.4 x
Tenet Healthcare	NYSE: THC	2,251.8	18,811.8	2,560.0	2,670.0	2,758.0	7.3 x	7.0 x	6.8 x
Hanger Inc	NYSE: HNGR	670.0	1,085.5	120.7	124.3	134.3	9.7 x	9.4 x	8.7 x
Select Medical NYSE: SEM			2,031.8	209.1	227.2	237.9	9.7 x	8.9 x	8.5 x
Median								7.0 x	6.8 x
Mean								7.5 x	7.0 x

Recommendation

In the light of CMS and Medicare patient criteria reform, investor expected that Medicare-reimbursement dependent companies might take a big hit in revenue growth. While Medicare still pays around 27% of its operating revenue, we are seeing that Select’s diversification effort has enabled the company to seek revenue growth in occupational healthcare. Select has diversified itself to own a “empire” portfolio of post-acute facilities, and few companies in this industry as diversified as Select. This helps Select for hedging further negative changes in Medicare LTCH-PPS.

Macroenvironment wise, we expect the demand driver for Select including aging population and rising disposable income. In terms of the industry, industry growth has been steady and stable. Given there is no close substitute for long-term acute care hospitals, we expect the industry revenue to grow continuously.

Taking a closer look at Select’s fast-growing segment Concentra, around 50% of Concentra revenue comes from Workers’ Compensation. Workers’ Compensation is a law mandate. Given that the third-party insurer and employers do not have the power to alter the policy, we expect stickiness of contract revenue generation from Concentra. Meanwhile, Concentra is the largest operator of occupational healthcare clinics in the U.S. We believe that, with its growth potential, stickiness of revenue and economies of scale, Concentra positions itself to generate above-expectation cash flow for Select.

Select has been able to grow their top and bottom line effectively and steadily. With industry and macro outlook looking firm, we expect Select will continue its growth momentum and explore its potential in the occupational healthcare field. Given its scale and cost advantage, we believe Select will be successful in further capturing market shares and returning value to shareholders.

Risks

High Leverage

Select is highly levered, at 5.08 times debt to EBITDA as of FY 2018. The leverage comes from Concentra debt financing, Select's long-term debt and revolver loans. As we are late in the cycle, we worry that Select might suffer from its leverage and affects its business operation and repayment ability. Despite the high leverage, Select has been able to generate abundant cash flow to repay more than repayment requirement amount. Also, in Q3 2018, Select was able to refinance its debt to a lower interest rate. We believe that these two mitigations alleviate the risk of having high leverage.

Uncertainty of Patient Protection and Affordable Care Act Reform

Despite Select's effort to diversify away from Medicare reimbursement dependent segments, Medicare is still a large payor of the company. In 2018, 27% of the revenue came from Medicare reimbursement. The Medicare program is undergoing intensive reform – a reform size the industry hasn't seen in almost 20 years.

Select is changing operating model and strategy in accordance to the legislative change to the industry. Concentra and U.S HealthWork acquisition in 2015 and 2018 were Select's effort to steer away from Medicare dependency. Select has been investing in programs to realize synergies from these two acquisitions, and both brought satisfying results. We see this as a strategic move of the company and a successful one. Also, effective November 1, 2018, Select brought Ms. Marilyn Travenner to its board, who previously led CMS and America's Health Insurance Plans, and has over 20 years of national health care industry experience. We believe that Ms. Travenner will help Select in dealing with the CMS and Medicare reform.

Appendix 1: Model Summary

Summary Page											
	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18	Dec-19	Dec-20	Dec-21	Dec-22	Dec-23
(Figures in mm USD)	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Income Statement											
Revenue	2,975.6	3,065.0	3,742.7	4,286.0	4,443.6	5,081.3	5,237.1	5,363.7	5,473.1	5,663.4	5,821.5
EBITDA	403.3	397.4	439.1	465.8	538.0	645.2	627.2	654.4	695.1	719.3	739.3
Net Income	123.0	128.2	136.0	125.3	220.6	176.9	177.4	173.2	196.6	207.4	214.9
Earnings Per Share	\$ 0.82	\$ 0.91	\$ 0.99	\$ 0.87	\$ 1.33	\$ 1.02	\$ 0.90	\$ 1.32	\$ 1.50	\$ 1.59	\$ 1.64
Cash Flow Statement											
Capital Expenditures	(73.7)	(95.2)	(182.6)	(161.6)	(233.2)	(167.3)	(238.1)	(266.3)	(277.4)	(289.0)	(301.0)
Acquisitions	(34.9)	(4.6)	(2.3)	(4.7)	(12.7)	(13.5)	(63.0)	-	-	-	-
Divestitures	2.9	-	1.8	80.5	80.4	6.8	-	-	-	-	-
Dividend Payment	(42.0)	(53.4)	(13.1)	-	-	-	-	-	-	-	-
Dividend Per Share	\$ 0.20	\$ 0.40	\$ 0.10	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Dividend Payout to Earnings	34.1%	41.6%	9.7%	-	-	-	-	-	-	-	-
Dividend Payout to Core FCF	12.5%	14.2%	2.8%	-	-	-	-	-	-	-	-
Dividend Yield	2.1%	3.0%	0.7%	-	-	-	-	-	-	-	-
Balance Sheet											
Current Assets	454.4	527.6	749.2	762.9	920.8	992.5	1,224.9	1,767.7	1,932.3	2,122.4	2,312.8
Non-Current Assets	2,363.2	2,397.2	3,639.5	4,157.7	4,206.3	4,971.7	5,057.2	5,101.6	5,147.8	5,196.0	5,246.1
Assets	2,817.6	2,924.8	4,388.7	4,920.6	5,127.2	5,964.3	6,282.1	6,869.3	7,080.1	7,318.4	7,559.0
Current Liabilities	371.5	394.4	729.3	571.6	605.4	705.2	845.6	1,259.6	1,273.8	1,304.7	1,330.4
Non-Current Liabilities	1,615.9	1,744.2	2,512.7	3,020.9	2,948.3	3,562.4	3,562.4	3,562.4	3,562.4	3,562.4	3,562.4
Liabilities	1,987.4	2,138.6	3,241.9	3,592.6	3,553.7	4,267.5	4,408.0	4,822.0	4,836.2	4,867.1	4,892.7
Shareholders' Equity	797.8	750.5	1,097.5	1,237.9	1,464.2	1,583.5	1,760.9	1,934.1	2,130.7	2,338.1	2,553.1
Cash	4.3	3.4	14.4	99.0	122.5	175.2	332.9	852.5	1,000.6	1,162.3	1,328.9
Debt	1,445.3	1,553.0	2,385.9	2,699.0	2,699.9	3,293.4	3,293.4	3,293.4	3,293.4	3,293.4	3,293.4
Net Debt	1,441.0	1,549.6	2,371.5	2,600.0	2,577.4	3,118.2	2,960.5	2,440.9	2,292.7	2,131.1	1,964.4
Minority Interests	32.4	35.7	49.3	90.2	109.2	113.2	113.2	113.2	113.2	113.2	113.2
Debt/EBITDA	3.6 x	3.9 x	5.4 x	5.6 x	4.8 x	4.8 x	4.7 x	3.7 x	3.3 x	3.0 x	2.7 x
Operating Metrics											
Return on Equity (ROE)	15.4%	17.1%	12.4%	10.1%	15.1%	11.2%	10.1%	9.0%	9.2%	8.9%	8.4%
Return on Assets (ROA)	4.4%	4.4%	3.1%	2.5%	4.3%	3.0%	2.8%	2.5%	2.8%	2.8%	2.8%
Return on Invested Capital (ROIC)	6.6%	7.1%	3.8%	2.9%	4.9%	3.4%	3.4%	3.6%	4.0%	4.2%	4.3%
Valuation Metrics											
Stock Price (High)	\$ 11.89	\$ 16.17	\$ 17.20	\$ 14.30	\$ 19.77	\$ 21.65	\$ 14.16	\$ 14.16	\$ 14.16	\$ 14.16	\$ 14.16
Stock Price (Low)	\$ 7.21	\$ 10.15	\$ 10.07	\$ 7.33	\$ 12.00	\$ 15.35	\$ 14.16	\$ 14.16	\$ 14.16	\$ 14.16	\$ 14.16
Stock Price (Average)	\$ 9.55	\$ 13.16	\$ 13.64	\$ 10.82	\$ 15.89	\$ 18.50	\$ 14.16	\$ 14.16	\$ 14.16	\$ 14.16	\$ 14.16
Diluted Shares Outstanding (Average)	137.0	129.5	127.8	128.0	129.1	130.3	130.8	130.8	130.8	130.8	130.8
Market Capitalization (Average)	1,308.8	1,703.8	1,741.9	1,384.0	2,051.2	2,409.7	1,852.4	1,852.4	1,852.4	1,852.4	1,852.4
Enterprise Value (Average)	2,782.2	3,289.1	4,162.6	4,074.1	4,737.8	5,641.1	4,926.1	4,406.5	4,258.3	4,096.7	3,930.1
P/E	11.7 x	14.5 x	13.7 x	12.4 x	12.0 x	18.1 x	15.8 x	10.7 x	9.4 x	8.9 x	8.6 x
EV/EBITDA	6.9 x	8.3 x	9.5 x	8.7 x	8.8 x	8.7 x	7.9 x	6.7 x	6.1 x	5.7 x	5.3 x
FCF Yield to Market Capitalization	11.2%	4.2%	2.5%	17.8%	6.1%	19.8%	19.0%	36.2%	16.2%	16.9%	17.2%
FCF Yield to Enterprise Value	5.3%	2.2%	1.1%	6.0%	2.7%	8.5%	7.1%	15.2%	7.0%	7.6%	8.1%
Free Cash Flow											
EBIT	301.4	284.5	274.8	299.8	355.9	417.3	411.5	432.4	463.9	478.4	488.5
Tax Expense	(74.8)	(75.6)	(72.4)	(55.5)	18.2	(58.6)	(102.9)	(108.1)	(116.0)	(119.6)	(122.1)
D&A	64.4	68.4	105.0	145.3	160.0	201.7	215.7	221.9	231.2	240.8	250.8
Capital Expenditures	(73.7)	(95.2)	(182.6)	(161.6)	(233.2)	(167.3)	(238.1)	(266.3)	(277.4)	(289.0)	(301.0)
Changes in NWC	(70.5)	(109.7)	(80.8)	18.2	(175.2)	84.4	65.8	390.8	(2.2)	2.3	1.9
Unlevered Free Cash Flow	146.9	72.3	43.9	246.3	125.6	477.4	351.9	670.8	299.5	313.0	318.1
Valuation Summary											
Current Price	\$ 14.62										
Target Price	\$ 18.63										
Total Return	27.4%										
Recommendation	BUY										
DCF Valuation											
Perpetuity Growth Implied Price	\$ 18.35										
Exit Multiple Implied Price	\$ 18.46										
Comps Valuation											
Comps - EV/EBITDA Implied Price	\$ 19.04										
Comps - P/E Implied Price	\$ 19.54										

Appendix 2: DCF Analysis Summary

Discounted Cash Flow Analysis															
	Dec-13	Dec-14	Dec-15	Dec-16	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Dec-18	Dec-19	Dec-20	Dec-21	Dec-22	Dec-23
(Figures in mm USD)	FY2013	FY2014	FY2015	FY2016	FY2017	Q1-2018	Q2-2018	Q3-2018	Q4-2018	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
WACC Calculations															
Cost of Equity															
Risk-free rate	2.7%														
Expected Market Return	9.8%														
Market Risk Premium	7.1%														
Beta	1.2														
Cost of Equity	11.2%														
Cost of Debt															
Pre-tax cost of debt	6.2%														
Effective tax rate	25.0%														
Cost of Debt	4.7%														
WACC															
Market value of equity	1,850.9														
Market value of debt	3,293.4														
Total Capitalization	5,144.3														
Cost of equity	11.2%														
Cost of debt	4.7%														
WACC	7.0%														
Free Cash Flow															
EBIT	301.4	284.5	274.8	299.8	355.9	108.6	120.6	99.8	88.3	417.3	411.5	432.4	463.9	478.4	488.5
Less: Tax expense	(74.8)	(75.6)	(72.4)	(55.5)	18.2	(12.3)	(21.1)	(14.1)	(11.2)	(58.6)	(102.9)	(108.1)	(116.0)	(119.6)	(122.1)
Add: Depreciation and amortization	64.4	68.4	105.0	145.3	160.0	46.8	51.7	50.5	52.6	201.7	215.7	221.9	231.2	240.8	250.8
Less: Capital expenditures	(73.7)	(95.2)	(182.6)	(161.6)	(233.2)	(39.6)	(42.0)	(39.4)	(46.2)	(167.3)	(238.1)	(266.3)	(277.4)	(289.0)	(301.0)
Less: Change in net working capital	(70.5)	(109.7)	(80.8)	18.2	(175.2)	(44.8)	51.1	66.8	11.4	84.4	65.8	390.8	(2.2)	2.3	1.9
Unlevered Free Cash Flow	146.9	72.3	43.9	246.3	125.6	58.6	160.2	163.7	94.9	477.4	351.9	670.8	299.5	313.0	318.1
Discount factor						-	-	-	-	-	1.00	2.00	3.00	4.00	5.00
Present Value of Unlevered Free Cash Flow						-	-	-	-	-	339.1	585.7	244.4	238.7	226.7
Discounted Cash Flow Valuations															
Perpetuity Growth Method															
Perpetuity Growth Rate	2.2%														
PV sum of unlevered FCF	1,634.5														
Terminal value	4,723.0														
Enterprise Value	6,357.5														
Add: Cash	175.2														
Less: Debt	3,293.4														
Less: Other EV adjustments	893.7														
Equity Value	2,345.6														
Shares outstanding	130.3														
Implied Share Price	\$ 18.01														
Current Price	\$ 14.21														
Implied Price	\$ 18.01														
Total Return	26.7%														
Exit Multiple Method															
Terminal EV/EBITDA Multiple	9.1 x														
PV sum of unlevered FCF	1,634.5														
Terminal value	4,793.6														
Enterprise Value	6,428.1														
Add: Cash	175.2														
Less: Debt	3,293.4														
Less: Other EV adjustments	893.7														
Equity Value	2,416.2														
Shares outstanding	130.3														
Implied Share Price	\$ 18.55														
Current Price	\$ 14.16														
Implied Price	\$ 18.55														
Total Return	31.0%														
WACC Sensitivity Analysis															
Perpetuity Growth Rate	WACC														
		8.10%	7.60%	7.10%	6.60%	6.10%									
	1.50%	\$ 6.58	\$ 9.42	\$ 12.77	\$ 16.77	\$ 21.64									
	2.00%	\$ 8.64	\$ 11.91	\$ 15.82	\$ 20.57	\$ 26.47									
	2.50%	\$ 11.07	\$ 14.88	\$ 19.52	\$ 25.29	\$ 32.65									
3.00%	\$ 13.98	\$ 18.51	\$ 24.13	\$ 31.32	\$ 40.81										
3.50%	\$ 17.52	\$ 23.01	\$ 30.03	\$ 39.29	\$ 52.12										
Terminal EV/EBITDA Multiple	WACC														
		8.10%	7.60%	7.10%	6.60%	6.10%									
	7.1 x	\$ 8.73	\$ 9.52	\$ 10.32	\$ 11.15	\$ 12.00									
	8.1 x	\$ 12.58	\$ 13.45	\$ 14.35	\$ 15.27	\$ 16.22									
	9.1 x	\$ 16.42	\$ 17.39	\$ 18.38	\$ 19.40	\$ 20.44									
	10.1 x	\$ 20.27	\$ 21.32	\$ 22.41	\$ 23.52	\$ 24.66									
	11.1 x	\$ 24.11	\$ 25.26	\$ 26.43	\$ 27.64	\$ 28.89									

Appendix 3: Sum of the Parts Comparable Analysis

Comparable Company Analysis									
(Figures in mm USD)				EV/EBITDA Multiple					
Company	Ticker	Equity Value	Enterprise Value	2018A EBITDA	2019E EBITDA	2020E EBITDA	2018A EV/EBITDA	2019E EV/EBITDA	2020E EV/EBITDA
CIRH Comps									
HCA Health Care	NYSE: HCA	45,150.5	79,501.5	8,920.0	9,580.1	10,137.7	8.9 x	8.3 x	7.8 x
Universal Health S	NYSE: UHS	11,202.7	15,196.9	1,761.8	1,833.6	1,923.1	8.6 x	8.3 x	7.9 x
LHC Group Inc	NYSE: LHCG	3,504.9	3,717.5	163.0	218.9	234.1	22.8 x	17.0 x	15.9 x
Community Health	NYSE: CYH	534.6	14,518.6	1,620.0	1,646.3	1,672.9	9.0 x	8.8 x	8.7 x
Select Medical Hk NYSE: SEM		1,939.3		201.6	219.1	229.5	9.6 x	8.8 x	8.5 x
Median								8.6 x	8.3 x
Mean								10.6 x	10.1 x
RH Comps									
Encompass Health	NYSE: EHC	6,576.8	9,563.9	885.4	937.6	966.8	10.8 x	10.2 x	9.9 x
Acadia Healthcare	NYSE: ACHC	2,558.5	5,753.6	593.6	612.6	651.1	9.7 x	9.4 x	8.8 x
Select Medical Hk NYSE: SEM		869.2		90.4	98.2	102.8	9.6 x	8.8 x	8.5 x
Median								9.8 x	9.4 x
Mean								9.8 x	9.4 x
ORF Comps									
Brookdale Senior I	NYSE: BKD	1,295.0	5,396.0	509.6	408.8	445.3	10.6 x	13.2 x	12.1 x
Centric Health Cor	TSE: CHH	69.6	151.5	11.7	14.8	19.3	12.9 x	10.3 x	7.8 x
Select Medical Hk NYSE: SEM		1,133.2		117.8	128.0	134.1	9.6 x	8.8 x	8.5 x
Median								11.7 x	10.0 x
Mean								11.7 x	10.0 x
Concentra Comparable Companies									
ADDUS Homecare	NYSE: ADUS	843.7	790.5	43.9	51.0	58.2	18.0 x	15.5 x	13.6 x
Magellan Health Ir	NYSE: MGLN	1,543.2	1,641.2	198.5	271.3	306.0	8.3 x	6.0 x	5.4 x
Tenet Healthcare	NYSE: THC	2,251.8	18,811.8	2,560.0	2,670.0	2,758.0	7.3 x	7.0 x	6.8 x
Hanger Inc	NYSE: HNGR	717.8	1,133.4	120.7	124.3	134.3	9.7 x	9.4 x	8.7 x
Select Medical Hk NYSE: SEM		2,010.8		209.1	227.2	237.9	9.6 x	8.8 x	8.5 x
Median								8.2 x	7.8 x
Mean								9.5 x	8.6 x
Overall									
Select Medical Hk NYSE: SEM				645.2	672.6	704.3	8.3 x	8.0 x	7.6 x
							EV/EBITDA Implied Price		
Median								\$ 21.25	\$ 20.07
Mean								\$ 26.76	\$ 24.65
High								\$ 44.00	\$ 43.00
Low								\$ 14.26	\$ 14.20

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