KINDRED HEALTHCARE, INC
Form 10-Q
August 07, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2015

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the transition period from to .

Commission file number: 001-14057

KINDRED HEALTHCARE, INC.

(Exact name of registrant as specified in its charter)

Delaware	61-1323993
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

680 South Fourth Street Louisville, KY	40202-2412
(Address of principal executive offices)	(Zip Code)

(502) 596-7300

(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	¨

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

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

Class of Common Stock	Outstanding at July 31, 2015
Common stock, $0.25 par value	83,876,488 shares

KINDRED HEALTHCARE, INC.

FORM 10-Q

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS

(Unaudited)

(In thousands, except per share amounts)

	Three months ended		Six months ended	
	June 30, 2015	2014	June 30, 2015	2014
Revenues	$1,833,475	$1,261,397	$3,509,442	$2,534,007
Salaries, wages and benefits	935,687	606,095	1,782,780	1,224,789
Supplies	98,237	71,585	191,508	144,550
Rent	96,402	77,699	188,542	156,229
Other operating expenses	212,117	172,674	409,844	342,204
General and administrative expenses (exclusive of depreciation and amortization expense included below)	334,805	244,746	740,907	476,018
Other income	(569)	(122)	(1,049)	(334)
Litigation contingency expense	3,925	4,600	98,925	4,600
Impairment charges	–	–	6,726	–
Depreciation and amortization	38,625	39,172	77,560	78,264
Interest expense	57,170	80,530	119,688	106,329
Investment income	(1,030)	(2,449)	(1,771)	(2,631)
	1,775,369	1,294,530	3,613,660	2,530,018
Income (loss) from continuing operations before income taxes	58,106	(33,133)	(104,218)	3,989
Provision (benefit) for income taxes	24,396	(12,683)	(3,340)	1,512
Income (loss) from continuing operations	33,710	(20,450)	(100,878)	2,477
Discontinued operations, net of income taxes:				
Loss from operations	(589)	(8,768)	(4,013)	(16,210)
Gain (loss) on divestiture of operations	983	(2,018)	983	(5,024)
Income (loss) from discontinued operations	394	(10,786)	(3,030)	(21,234)
Net income (loss)	34,104	(31,236)	(103,908)	(18,757)
(Earnings) loss attributable to noncontrolling interests:				
Continuing operations	(11,735)	(4,828)	(20,582)	(9,357)
Discontinued operations	2	253	31	323
	(11,733)	(4,575)	(20,551)	(9,034)
Income (loss) attributable to Kindred	$22,371	$(35,811)	$(124,459)	$(27,791)
Amounts attributable to Kindred stockholders:				
Income (loss) from continuing operations	$21,975	$(25,278)	$(121,460)	$(6,880)
Income (loss) from discontinued operations	396	(10,533)	(2,999)	(20,911)
Net income (loss)	$22,371	$(35,811)	$(124,459)	$(27,791)
Earnings (loss) per common share:				
Basic:				

Income (loss) from continuing operations	$0.25	$(0.47)	$(1.47)	$(0.13)
Discontinued operations:				
Loss from operations	(0.01)	(0.16)	(0.05)	(0.30)
Gain (loss) on divestiture of operations	0.01	(0.04)	0.01	(0.09)
Income (loss) from discontinued operations	–	(0.20)	(0.04)	(0.39)
Net income (loss)	$0.25	$(0.67)	$(1.51)	$(0.52)
Diluted:				
Income (loss) from continuing operations	$0.25	$(0.47)	$(1.47)	$(0.13)
Discontinued operations:				
Loss from operations	(0.01)	(0.16)	(0.05)	(0.30)
Gain (loss) on divestiture of operations	0.01	(0.04)	0.01	(0.09)
Income (loss) from discontinued operations	–	(0.20)	(0.04)	(0.39)
Net income (loss)	$0.25	$(0.67)	$(1.51)	$(0.52)
Shares used in computing earnings (loss) per common share:				
Basic	86,045	53,714	82,828	53,180
Diluted	86,402	53,714	82,828	53,180
Cash dividends declared and paid per common share	$0.12	$0.12	$0.24	$0.24

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)

(Unaudited)

(In thousands)

	Three months ended June 30, 2015	Three months ended June 30, 2014	Six months ended June 30, 2015	Six months ended June 30, 2014
Net income (loss)	$34,104	$(31,236)	$(103,908)	$(18,757)
Other comprehensive income (loss):				
Available-for-sale securities (Note 9):				
Change in unrealized investment gains (losses)	(144)	347	137	484
Reclassification of (gains) losses realized in net income (loss)	5	(2,095)	–	(2,103)
Net change	(139)	(1,748)	137	(1,619)
Interest rate swaps (Note 1):				
Change in unrealized gains (losses)	728	(1,966)	(1,264)	(3,046)
Reclassification of ineffectiveness realized in net income (loss)	32	52	29	84
Reclassification of (gains) losses realized in net income (loss), net of payments	12	802	(12)	797
Net change	772	(1,112)	(1,247)	(2,165)
Income tax expense (benefit) related to items of other comprehensive income (loss)	(237)	1,358	450	1,737
Other comprehensive income (loss)	396	(1,502)	(660)	(2,047)
Comprehensive income (loss)	34,500	(32,738)	(104,568)	(20,804)
Earnings attributable to noncontrolling interests	(11,733)	(4,575)	(20,551)	(9,034)
Comprehensive income (loss) attributable to Kindred	$22,767	$(37,313)	$(125,119)	$(29,838)

See accompanying notes.

KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED BALANCE SHEET

(Unaudited)

(In thousands, except per share amounts)

	June 30, 2015	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$119,536	$164,188
Insurance subsidiary investments	104,534	99,951
Accounts receivable less allowance for loss of $52,441 – June 30, 2015 and $52,855 – December 31, 2014	1,253,218	944,219
Inventories	27,120	25,702
Deferred tax assets	92,786	82,391
Income taxes	15,996	8,575
Interest deposit on senior unsecured notes held in escrow	–	23,438
Other	78,172	41,598
	1,691,362	1,390,062
Property and equipment	2,084,349	1,978,153
Accumulated depreciation	(1,134,817)	(1,076,049)
	949,532	902,104
Goodwill	2,643,328	997,597
Intangible assets less accumulated amortization of $80,759 – June 30, 2015 and $68,043 – December 31, 2014	799,902	400,700
Assets held for sale	2,384	3,475
Insurance subsidiary investments	198,410	166,045
Deferred tax assets	–	11,174
Proceeds from senior unsecured notes held in escrow	–	1,350,000
Acquisition deposit	–	195,000
Other	321,009	236,807
Total assets (a)	$6,605,927	$5,652,964
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable	$183,843	$175,725
Salaries, wages and other compensation	467,693	358,857
Due to third party payors	44,490	43,957
Professional liability risks	61,550	64,137
Other accrued liabilities	347,230	189,980
Long-term debt due within one year	32,354	24,607
	1,137,160	857,263
Long-term debt	3,222,443	2,852,531

Professional liability risks	267,503	243,614
Deferred tax liabilities	8,422	–
Deferred credits and other liabilities	298,124	213,584
Commitments and contingencies (Note 12)		
Equity:		
Stockholders' equity:		
Common stock, $0.25 par value; authorized 175,000 shares; issued 83,693 shares – June 30, 2015 and 69,977 shares – December 31, 2014	20,923	17,494
Capital in excess of par value	1,747,585	1,586,692
Accumulated other comprehensive loss	(3,211)	(2,551)
Accumulated deficit	(286,357)	(159,768)
	1,478,940	1,441,867
Noncontrolling interests	193,335	44,105
Total equity	1,672,275	1,485,972
Total liabilities (a) and equity	$6,605,927	$5,652,964

(a) The Company's consolidated assets as of June 30, 2015 include total assets of variable interest entities of $367.1 million, which can only be used to settle the obligations of the variable interest entities. The Company's consolidated liabilities as of June 30, 2015 include total liabilities of variable interest entities of $32.0 million. See note 1 of the notes to unaudited condensed consolidated financial statements.

See accompanying notes.

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KINDRED HEALTHCARE, INC.

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(Unaudited)

(In thousands)

	Three months ended June 30, 2015	Three months ended June 30, 2014	Six months ended June 30, 2015	Six months ended June 30, 2014
Cash flows from operating activities:				
Net income (loss)	$34,104	$(31,236)	$(103,908)	$(18,757)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:				
Depreciation and amortization	38,849	40,922	77,926	82,226
Amortization of stock-based compensation costs	6,746	6,378	12,570	8,963
Amortization of deferred financing costs	3,539	16,832	6,601	19,229
Payment of capitalized lender fees related to debt issuance	–	(19,125)	(28,012)	(19,125)
Provision for doubtful accounts	10,511	12,133	18,803	20,893
Deferred income taxes	21,130	17,528	(4,450)	21,503
Impairment charges	–	220	6,726	664
(Gain) loss on divestiture of discontinued operations	(983)	2,018	(983)	5,024
Other	4,975	70	6,972	2,114
Change in operating assets and liabilities:				
Accounts receivable	(7,733)	(41,066)	(39,389)	(112,895)
Inventories and other assets	(17,608)	(3,769)	35,414	(9,987)
Accounts payable	(12,900)	(5,425)	(12,435)	(18,877)
Income taxes	1,923	(40,476)	(3,845)	(11,063)
Due to third party payors	(3,554)	(12,354)	(18,973)	(14,367)
Other accrued liabilities	21,380	7,387	7,760	(21,262)
Net cash provided by (used in) operating activities	100,379	(49,963)	(39,223)	(65,717)
Cash flows from investing activities:				
Routine capital expenditures	(24,500)	(24,485)	(45,269)	(46,162)
Development capital expenditures	(518)	(372)	(6,306)	(1,123)
Acquisitions, net of cash acquired	(2,684)	(1,383)	(661,755)	(24,098)
Acquisition deposit	–	–	195,000	–
Sale of assets	2,229	8,927	3,177	13,961
Proceeds from senior unsecured notes offering held in escrow	–	–	1,350,000	–
Interest in escrow for senior unsecured notes	–	–	23,438	–
Purchase of insurance subsidiary investments	(16,911)	(13,179)	(42,829)	(23,293)
Sale of insurance subsidiary investments	12,764	17,758	34,793	26,520
Net change in insurance subsidiary cash and cash equivalents	(5,205)	(4,957)	(5,763)	(11,556)
Change in other investments	175	70	199	710
Other	(798)	17	(793)	(534)
Net cash provided by (used in) investing activities	(35,448)	(17,604)	843,892	(65,575)
Cash flows from financing activities:				
Proceeds from borrowings under revolving credit	347,700	648,315	1,155,150	1,157,015
Repayment of borrowings under revolving credit	(360,100)	(943,715)	(970,150)	(1,369,515)

Proceeds from issuance of term loan, net of discount	–	997,500	199,000	997,500
Proceeds from issuance of senior unsecured notes	–	500,000	–	500,000
Repayment of Gentiva debt	–	–	(1,177,363)	–
Repayment of senior unsecured notes	–	(550,000)	–	(550,000)
Repayment of term loan	(6,005)	(781,594)	(6,005)	(783,563)
Repayment of other long-term debt	(459)	(67)	(900)	(157)
Payment of deferred financing costs	(445)	(2,378)	(2,983)	(2,648)
Equity offering, net of offering costs	–	203,977	–	203,977
Issuance of common stock in connection with employee benefit plans	139	883	205	4,687
Payment of costs associated with issuance of common stock and tangible equity units	–	–	(915)	–
Payment of dividend for mandatory redeemable preferred stock	(2,654)	–	(5,432)	–
Dividends paid	(10,027)	(6,572)	(20,002)	(13,086)
Distributions to noncontrolling interests	(10,119)	(2,662)	(21,138)	(5,595)
Other	50	248	1,212	2,121
Net cash provided by (used in) financing activities	(41,920)	63,935	(849,321)	140,736
Change in cash and cash equivalents	23,011	(3,632)	(44,652)	9,444
Cash and cash equivalents at beginning of period	96,525	49,048	164,188	35,972
Cash and cash equivalents at end of period	$119,536	$45,416	$119,536	$45,416
Supplemental information:				
Interest payments	$31,640	$68,065	$66,450	$79,666
Income tax payments (refunds)	909	4,329	1,139	(21,565)
Issuance of common stock in Gentiva Merger (see Note 2)	2,353	–	177,441	–

See accompanying notes.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 – BASIS OF PRESENTATION

Business

Kindred Healthcare, Inc. is a healthcare services company that through its subsidiaries operates transitional care ("TC") hospitals, a home health, hospice and community care business, inpatient rehabilitation hospitals ("IRFs"), a contract rehabilitation services business, nursing centers and assisted living facilities across the United States (collectively, the "Company" or "Kindred"). At June 30, 2015, the Company's hospital division operated 96 TC hospitals (certified as long-term acute care ("LTAC") hospitals under the Medicare program) in 22 states. The Company's Kindred at Home division (formerly known as the care management division) primarily provided home health, hospice and community care services from 656 sites of service in 41 states. The Company's rehabilitation division (now known as Kindred Rehabilitation Services) provided rehabilitation services primarily in hospitals and long-term care settings and operated 16 IRFs. The Company's nursing center division operated 90 nursing centers and seven assisted living facilities in 18 states.

Gentiva Merger

On October 9, 2014, the Company entered into an Agreement and Plan of Merger (the "Gentiva Merger Agreement") with Gentiva Health Services, Inc. ("Gentiva"), providing for the Company's acquisition of Gentiva (the "Gentiva Merger"). On February 2, 2015, the Company consummated the Gentiva Merger, with Gentiva continuing as the surviving company and the Company's wholly owned subsidiary.

Discontinued operations

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

Assets held for sale at June 30, 2015 have been measured at the lower of carrying value or estimated fair value less costs of disposal and have been classified as held for sale in the accompanying unaudited condensed consolidated balance sheet. See Note 4 for a summary of discontinued operations.

Recently issued accounting requirements

In April 2015, the Financial Accounting Standards Board (the "FASB") issued authoritative guidance on accounting for fees paid in a cloud computing arrangement. The new provisions will help entities determine whether a cloud computing arrangement contains a software license that should be accounted for as internal-use software and capitalized or as a service contract. For public companies, the new standard is effective for annual periods, including interim periods, beginning after December 15, 2015. Early adoption is permitted and transition may be elected retrospectively or prospectively. The Company is still assessing this guidance.

In April 2015, the FASB issued authoritative guidance which changes the balance sheet presentation requirements for debt issuance costs. To simplify presentation of debt issuance costs, the amendments require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. This guidance is effective for annual and interim periods beginning on or after December 15, 2015. The new guidance should be applied on a retrospective basis, and early adoption is permitted. The adoption of this standard is not expected to have a material impact on the Company's business, financial position, results of operations or liquidity.

In February 2015, the FASB issued authoritative guidance which changes the evaluation of certain legal entities for consolidation. Specifically, the guidance (i) modifies the evaluation of whether limited partnerships and similar legal entities are variable interest entities ("VIEs") or voting interest entities, (ii) eliminates the presumption that a general partner should consolidate a limited partnership, (iii) affects the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships and (iv) provides a scope exception from consolidation guidance for reporting entities with interest in legal entities in certain investment funds. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2015. Early adoption is permitted for all entities. The guidance is not expected to have an impact on the Company's business, financial position, results of operations or liquidity.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 – BASIS OF PRESENTATION (Continued)

Recently issued accounting requirements (Continued)

In January 2015, the FASB issued authoritative guidance which eliminated from United States generally accepted accounting principles (“GAAP”) the concept of extraordinary items. The FASB issued this update as part of its initiative to reduce complexity in accounting standards, also referred to as the Simplification Initiative. The guidance is effective for all interim and annual reporting periods beginning after December 15, 2015. Early adoption is permitted for all entities. The guidance is not expected to have an impact on the Company’s business, financial position, results of operations or liquidity.

In May 2014, the FASB issued authoritative guidance which changes the requirements for recognizing revenue when entities enter into contracts with customers. Under the new provisions, an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects what it expects in exchange for the goods or services. It also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In July 2015, the FASB finalized a one year deferral of the new revenue standard with an updated effective date for annual and interim periods beginning on or after December 15, 2017. Entities are not permitted to adopt the standard earlier than the original effective date, which was on or after December 15, 2016. The Company is still assessing this guidance.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 – BASIS OF PRESENTATION (Continued)

Equity

The following table sets forth the changes in equity attributable to noncontrolling interests and equity attributable to Kindred stockholders for the six months ended June 30, 2015 and 2014 (in thousands):

For the six months ended June 30, 2015:	Amounts attributable to Kindred stockholders	Noncontrolling interests	Total equity
Balance at December 31, 2014	$ 1,441,867	$ 44,105	$ 1,485,972
Comprehensive income (loss):			
Net income (loss)	(124,459)	20,551	(103,908)
Other comprehensive loss	(660)	–	(660)
	(125,119)	20,551	(104,568)
Issuance of common stock in connection with employee benefit plans	205	–	205
Shares tendered by employees for statutory tax withholdings upon issuance of common stock	(7,357)	–	(7,357)
Income tax provision in connection with the issuance of common stock under employee benefit plans	(665)	–	(665)
Stock-based compensation amortization	12,570	–	12,570
Dividends paid	(20,002)	–	(20,002)
Acquired noncontrolling interests	–	149,817	149,817
Distributions to noncontrolling interests	–	(21,138)	(21,138)
Issuance of common stock in Gentiva Merger	177,441	–	177,441
Balance at June 30, 2015	$ 1,478,940	$ 193,335	$ 1,672,275
For the six months ended June 30, 2014:			
Balance at December 31, 2013	$ 1,082,657	$ 38,559	$ 1,121,216
Comprehensive income (loss):			
Net income (loss)	(27,791)	9,034	(18,757)
Other comprehensive loss	(2,047)	–	(2,047)
	(29,838)	9,034	(20,804)
Issuance of common stock in connection with employee benefit plans	4,687	–	4,687
Shares tendered by employees for statutory tax withholdings upon issuance of common stock	(5,790)	–	(5,790)
Income tax benefit in connection with the issuance of common stock under employee benefit plans	1,311	–	1,311
Stock-based compensation amortization	8,963	–	8,963

Equity offering, net of offering costs	203,977	–	203,977
Dividends paid	(13,086)	–	(13,086)
Contribution made by noncontrolling interests	–	833	833
Distributions to noncontrolling interests	–	(5,595)	(5,595)
Balance at June 30, 2014	$ 1,252,881	$ 42,831	$ 1,295,712

Property and equipment

Beginning January 1, 2015, the Company changed the estimated useful life of certain technology and medical equipment based upon a detailed review of actual utilization. The change in estimate extended the expected useful life by two to three years depending on the equipment category and has been accounted for prospectively. The impact from this change in accounting estimate was an increase to income (loss) from continuing operations before income taxes of approximately $4 million ($2 million net of income taxes) in the second quarter of 2015 and approximately $8 million ($5 million net of income taxes) for the six months ended June 30, 2015.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 – BASIS OF PRESENTATION (Continued)

Derivative financial instruments

In December 2011, the Company entered into two interest rate swap agreements to hedge its floating interest rate on an aggregate of $225 million of debt outstanding under its senior secured term loan facility (the "Prior Term Loan Facility") entered into in June 2011. The interest rate swaps had an effective date of January 9, 2012, and will expire on January 11, 2016. The Company is required to make payments based upon a fixed interest rate of 1.8925% calculated on the notional amount of $225 million. In exchange, the Company will receive interest on $225 million at a variable interest rate that is based upon the three-month London Interbank Offered Rate ("LIBOR"), subject to a minimum rate of 1.5%. The Company determined these interest rate swaps continue to qualify for cash flow hedge accounting treatment at June 30, 2015. However, an amendment to the Prior Term Loan Facility completed in May 2013 reduced the LIBOR floor from 1.5% to 1.0%, therefore some partial ineffectiveness will result through the expiration of the interest rate swap agreements.

In March 2014, the Company entered into an additional interest rate swap agreement to hedge its floating interest rate on an aggregate of $400 million of debt outstanding under the Term Loan Facility (as defined in Note 10). On April 8, 2014, the Company completed a novation of a portion of its $400 million swap agreement to two new counterparties, each in the amount of $125 million. The original swap contract was not amended, terminated or otherwise modified. The interest rate swap had an effective date of April 9, 2014 and will expire on April 9, 2018 and continues to apply to the Term Loan Facility. The Company is required to make payments based upon a fixed interest rate of 1.867% calculated on the notional amount of $400 million. In exchange, the Company will receive interest on $400 million at a variable interest rate that is based upon the three-month LIBOR, subject to a minimum rate of 1.0%. The Company determined this interest rate swap continues to qualify for cash flow hedge accounting treatment at June 30, 2015.

The Company records the effective portion of the gain or loss on these derivative financial instruments in accumulated other comprehensive income (loss) as a component of stockholders' equity and records the ineffective portion of the gain or loss on these derivative financial instruments as interest expense. For the three months and six months ended June 30, 2015 and 2014, the ineffectiveness related to the interest rate swaps was immaterial.

The aggregate fair value of the interest rate swaps recorded in other accrued liabilities was $4.9 million and $3.7 million at June 30, 2015 and December 31, 2014, respectively. See Note 13.

Variable interest entities

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

In January 2015, the Company completed the acquisition of Centerre Healthcare Corporation ("Centerre"), which operated 11 IRFs. Each entity operating one of the IRFs is subject to a partnership and a management services agreement with the Company. Under GAAP, the Company determined that all of the entities acquired qualify as VIEs and that the Company is the primary beneficiary in all but one arrangement. The Company holds an equity interest and acts as manager in each of the entities. Through the management services agreement, the Company is delegated necessary responsibilities to provide management services, administrative services and direction of the day-to-day operations. Based on the Company’s assessment of the most significant activities of the IRFs, the manager has the ability to direct the majority of those activities in ten of the entities.

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

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 1 – BASIS OF PRESENTATION (Continued)

Variable interest entities (Continued)

The carrying amounts and classifications of the assets and liabilities of the consolidated VIEs as of June 30, 2015 are as follows (in thousands):

Assets:	
Current assets:	
Cash and cash equivalents	$31,972
Accounts receivable, net	31,303
Inventories	1,459
Other	3,938
	68,672
Property and equipment, net	13,989
Goodwill	261,278
Intangible assets, net	23,093
Other	49
Total assets	$367,081
Liabilities:	
Current liabilities:	
Accounts payable	$17,111
Salaries, wages and other compensation	2,512
Other accrued liabilities	3,738
Long-term debt due within one year	2,851
	26,212
Long-term debt	1,798
Deferred credits and other liabilities	3,972
Total liabilities	$31,982

Other information

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q of Regulation S-X and do not include all of the disclosures normally required by GAAP or those normally required in annual reports on Form 10-K. Accordingly, these financial statements should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2014 filed with the Securities and Exchange Commission (the "SEC") on Form 10-K. The accompanying condensed consolidated balance sheet at December 31, 2014 was derived from audited consolidated financial statements, but does not include all disclosures required by GAAP.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the Company’s customary accounting practices. Management believes that financial information included herein reflects all adjustments necessary for a fair statement of interim results and, except as otherwise disclosed, all such adjustments are of a normal and recurring nature.

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

Reclassifications

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

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 – GENTIVA MERGER

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

At the effective time of the Gentiva Merger, each share of common stock, par value $0.10 per share, of Gentiva ("Gentiva Common Stock") issued and outstanding immediately prior to the effective time of the Gentiva Merger (other than shares held by Kindred, Gentiva and any wholly owned subsidiaries (which were cancelled) and shares owned by stockholders who properly exercised and perfected a demand for appraisal rights under Delaware law), including each deferred share unit, were converted into the right to receive (i) $14.50 in cash (the "Cash Consideration"), without interest, and (ii) 0.257 of a validly issued, fully paid and nonassessable share of Kindred common stock, par value $0.25 per share (the "Stock Consideration"). Kindred issued 9.7 million shares of common stock as the Stock Consideration. The purchase price totaled $722.3 million and was comprised of $544.8 million of Cash Consideration and $177.5 million of Stock Consideration. The Company also assumed $1.2 billion of long-term debt, which was paid off upon consummation of the Gentiva Merger.

The Company used the net proceeds from the Financing Transactions (as defined in Note 10), to fund the Cash Consideration for the Gentiva Merger, repay Gentiva's existing debt and pay related transaction fees and expenses.

Operating results in the second quarter of 2015 included transaction and integration costs totaling $2.0 million, retention and severance costs totaling $2.4 million and a lease termination charge of $0.2 million related to the Gentiva Merger. Operating results for the six months ended June 30, 2015 included transaction and integration costs totaling $34.1 million, retention and severance costs totaling $56.9 million, a lease termination charge of $0.8 million and financing costs totaling $23.4 million related to the Gentiva Merger. Operating results in both the second quarter of 2014 and for the six months ended June 30, 2014 included transaction costs totaling $2.1 million related to the Gentiva Merger. Transaction, integration, retention and severance costs were recorded as general and administrative expenses, the lease termination charge was recorded as rent expense and financing costs were recorded as general and administrative expenses ($6.0 million) and as interest expense ($17.4 million).

As of December 31, 2014, Gentiva provided home health services, hospice services and community care services serving patients through approximately 491 locations in 40 states.

Purchase price allocation

The Gentiva Merger purchase price of $722.3 million was allocated on a preliminary basis to the estimated fair value of the tangible and intangible assets, and goodwill. During the second quarter of 2015, Kindred received approximately $10 million in cash related to a settlement of an escrow account from a prior Gentiva acquisition, which resulted in an increase to other current assets.

The following is the preliminary Gentiva Merger purchase price allocation (in thousands):

Cash and cash equivalents	$64,695
Accounts receivable	258,438
Deferred tax assets	28,483
Other current assets	64,195
Property and equipment	46,860
Identifiable intangible assets:	
Certificates of need (indefinite life)	255,660
Medicare certifications (indefinite life)	103,080
Trade names (indefinite life)	22,200
Trade name	15,600
Non-compete agreements	1,820
Leasehold interests	1,439
Total identifiable intangible assets	399,799
Other assets	133,240
Current portion of long-term debt	(53,075)
Accounts payable and other current liabilities	(289,002)
Long-term debt, less current portion	(1,124,288)
Deferred tax liabilities	(47,748)
Other liabilities	(130,739)
Noncontrolling interests	(3,992)
Total identifiable net assets	(653,134)
Goodwill	1,375,400
Net assets	$722,266

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 2 – GENTIVA MERGER (Continued)

Purchase price allocation (Continued)

The preliminary fair value allocation was measured primarily using a discounted cash flows methodology, which is considered a Level 3 input (as described in Note 13).

The value of gross contractual accounts receivable before determining uncollectable amounts totaled $272.3 million. Accounts estimated to be uncollectable totaled $13.9 million.

The weighted average life of the definite lived intangible assets consisting primarily of a trade name is three years.

The aggregate goodwill arising from the Gentiva Merger is based upon the expected future cash flows of the Gentiva operations, which reflect both growth expectations and cost savings from combining the operations of the Company and Gentiva. Goodwill is not amortized and is not deductible for income tax purposes. Goodwill was preliminarily assigned to the Company's home health reporting unit ($603.8 million), hospice reporting unit ($606.8 million) and community care reporting unit ($164.8 million).

The unaudited pro forma net effect of the Gentiva Merger assuming the acquisition occurred as of January 1, 2014 is as follows (in thousands, except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2015	2014	2015	2014
Revenues	$1,833,475	$1,759,437	$3,671,141	$3,519,552
Income (loss) from continuing operations attributable to Kindred	25,011	14,369	(9,768)	(46,054)
Income (loss) attributable to Kindred	25,407	3,836	(12,767)	(66,965)
Earnings (loss) per common share:				
Basic:				
Income (loss) from continuing operations	0.29	0.16	(0.11)	(0.54)
Net income (loss)	0.29	0.04	(0.15)	(0.78)
Diluted:				
Income (loss) from continuing operations	0.29	0.16	(0.11)	(0.54)
Net income (loss)	0.29	0.04	(0.15)	(0.78)

The unaudited pro forma financial data has been derived by combining the historical financial results of the Company and the operations acquired in the Gentiva Merger for the periods presented. The unaudited pro forma financial data includes transaction, integration, retention and severance costs, a lease termination charge and financing costs totaling $132.2 million incurred by both the Company and Gentiva in connection with the Gentiva Merger. These costs have been eliminated from the results of operations for 2015 and have been reflected as expenses incurred as of January 1, 2014 for purposes of the pro forma financial presentation. Revenues and earnings before interest, income taxes, transaction, integration, retention and severance costs associated with Gentiva aggregated $520.1 million and $64.7 million, respectively, in the second quarter of 2015 and $855.0 million and $101.2 million, respectively, since the date of the Gentiva Merger.

NOTE 3 – OTHER ACQUISITIONS

The following is a summary of the Company's other acquisition activities. The operating results of the acquired businesses have been included in the accompanying unaudited condensed consolidated financial statements of the Company from the respective acquisition dates. The purchase price of acquired businesses and acquired leased facilities resulted from negotiations with each of the sellers that were based upon both the historical and expected future cash flows of the respective businesses and real estate values. Each of these acquisitions was financed through operating cash flows and borrowings under the Company's ABL Facility (as defined in Note 10). Unaudited pro forma financial data related to the acquired businesses have not been presented because the acquisitions are not material, either individually or in the aggregate, to the Company's consolidated financial statements.

During the second quarter of 2015, the Company acquired a home-based primary care practice for $8.0 million and another home-based primary care practice was acquired during the six months ended June 30, 2015 for $4.1 million.

On January 1, 2015, the Company completed the acquisition of Centerre for a purchase price of approximately $195 million in cash (the "Centerre Acquisition"). During the second quarter of 2015, the Company paid approximately $4 million in cash for a working capital settlement. Centerre operated 11 IRFs with 614 beds through partnerships.

During the six months ended June 30, 2014, the Company acquired the real estate of two previously leased nursing centers for $22.3 million. Annual rent associated with the nursing centers aggregated $2.0 million. The fair value of the assets acquired was measured using discounted cash flow methodologies which are considered Level 3 inputs (as described in Note 13).

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4 – DISCONTINUED OPERATIONS

In accordance with the authoritative guidance for the impairment or disposal of long-lived assets, the divestitures or planned divestiture of unprofitable businesses discussed in Note 1 has been accounted for as discontinued operations. Accordingly, the results of operations of these businesses for all periods presented and the gains, losses or impairments associated with these transactions have been classified as discontinued operations, net of income taxes, in the accompanying unaudited condensed consolidated statement of operations based upon the authoritative guidance which was in effect through December 31, 2014. Effective January 1, 2015, the authoritative guidance modified the requirements for reporting discontinued operations. A disposal is now required to be reported in discontinued operations only if the disposal represents a strategic shift that has (or will have) a major effect on the Company's operations and financial results. At June 30, 2015, the Company held for sale seven nursing centers reported as discontinued operations.

On December 27, 2014, the Company entered into an agreement with Ventas, Inc. ("Ventas") to transition the operations under the leases for nine non-strategic nursing centers (the "2014 Expiring Facilities"). Each lease will terminate when the operation of such nursing center is transferred to a new operator, which is expected to occur during 2015. The current lease term for eight of these nursing centers is scheduled to expire on April 30, 2018. The current lease term for the ninth of these nursing centers is scheduled to expire on April 30, 2020. The Company will continue to operate these facilities until operations are transferred. During the second quarter of 2015, the Company transferred the operations of two of the 2014 Expiring Facilities, resulting in a gain on divestiture of $1.6 million ($1.0 million net of income taxes). For accounting purposes, the 2014 Expiring Facilities qualified as assets held for sale and the Company reflected the operating results as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all historical periods. Under the terms of the agreement, the Company incurred a $40 million termination fee in exchange for the early termination of the leases, which was paid to Ventas in January 2015.

During the second quarter of 2014, the Company reclassified as discontinued for all periods presented the operations of three TC hospitals and two nursing centers that were either closed or divested through a planned sale of such facility or the expiration of a lease. The Company recorded a loss on divestiture of $2.9 million ($1.7 million net of income taxes) for the three months ended June 30, 2014 related to these divestitures.

The Company allowed the lease to expire on a TC hospital during the six months ended June 30, 2014 resulting in a loss on divestiture primarily related to a write-off of an indefinite-lived intangible asset of $3.4 million ($2.1 million net of income taxes) for the six months ended June 30, 2014. The Company reflected the operating results of this TC hospital as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all historical periods.

A summary of discontinued operations follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2015	2014	2015	2014
Revenues	$12,282	$96,499	$23,999	$253,178
Salaries, wages and benefits	5,979	40,724	12,571	104,382

Supplies	700	5,185	1,400	13,258
Rent	2,003	14,708	4,657	33,844
Other operating expenses	2,616	18,517	5,007	49,067
General and administrative expenses	1,734	30,316	6,619	75,181
Other expense	–	–	–	–
Impairment charges	–	220	–	664
Depreciation	224	1,750	366	3,962
Interest expense	1	5	1	15
Investment (income) expense	(3)	(469)	(5)	(468)
	13,254	110,956	30,616	279,905
Loss from operations before income taxes	(972)	(14,457)	(6,617)	(26,727)
Income tax benefit	(383)	(5,689)	(2,604)	(10,517)
Loss from operations	(589)	(8,768)	(4,013)	(16,210)
Gain (loss) on divestiture of operations	983	(2,018)	983	(5,024)
Income (loss) from discontinued operations	394	(10,786)	(3,030)	(21,234)
Loss attributable to noncontrolling interests	2	253	31	323
Income (loss) attributable to Kindred	$ 396	$ (10,533)	$ (2,999)	$ (20,911)

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 4 – DISCONTINUED OPERATIONS (Continued)

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

	Three months ended June 30, 2015	2014	Six months ended June 30, 2015	2014
Revenues:				
Hospital division	$ 1,081	$10,272	$1,589	$25,694
Nursing center division	11,201	86,227	22,410	227,484
	$12,282	$96,499	$23,999	$253,178
Operating income (loss):				
Hospital division	$500	$(592)	$422	$289
Nursing center division	753	2,129	(2,020)	10,337
	$1,253	$1,537	$(1,598)	$10,626
Rent:				
Hospital division	$474	$1,432	$1,037	$3,120
Nursing center division	1,529	13,276	3,620	30,724
	$2,003	$14,708	$4,657	$33,844
Depreciation:				
Hospital division	$–	$465	$–	$983
Nursing center division	224	1,285	366	2,979
	$224	$1,750	$366	$3,962

A summary of the net assets held for sale follows (in thousands):

	June 30, 2015	December 31, 2014
Long-term assets:		
Property and equipment, net	$1,713	$ 3,306
Other	671	169
	2,384	3,475
Current liabilities (included in other accrued liabilities)	–	–
	$2,384	$ 3,475

NOTE 5 – REVENUES

Revenues are recorded based upon estimated amounts due from patients and third party payors for healthcare services provided, including anticipated settlements under reimbursement agreements with Medicare, Medicaid, Medicare Advantage, Medicaid Managed and other third party payors. Revenues under third party agreements are subject to examination and retroactive adjustment. Provisions for estimated third party adjustments are provided in the period the related services are rendered. Differences between the amounts accrued and subsequent settlements are recorded in the periods the interim or final settlements are determined.

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

	Three months ended June 30,		Six months ended June 30,	
	2015	2014	2015	2014
Medicare	$937,384	$524,935	$1,757,975	$1,066,498
Medicaid	212,809	150,488	400,223	302,061
Medicare Advantage	139,875	94,672	273,294	193,053
Medicaid Managed	50,764	28,366	94,401	52,014
Other	555,404	515,136	1,109,217	1,024,630
	1,896,236	1,313,597	3,635,110	2,638,256
Eliminations	(62,761)	(52,200)	(125,668)	(104,249)
	$1,833,475	$1,261,397	$3,509,442	$2,534,007

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 6 – EARNINGS (LOSS) PER SHARE

Earnings (loss) per common share are based upon the weighted average number of common shares outstanding during the respective periods. Because the Company is reporting a loss from continuing operations attributable to the Company for the three months ended June 30, 2014 and the six months ended June 30, 2015 and 2014, the diluted calculation of earnings per common share excludes the dilutive impact of stock options and tangible equity units. The Company follows the provisions of the authoritative guidance for determining whether instruments granted in share-based payment transactions are participating securities, which requires that unvested restricted stock that entitles the holder to receive nonforfeitable dividends before vesting be included as a participating security in the basic and diluted earnings per common share calculation pursuant to the two-class method.

A computation of earnings (loss) per common share follows (in thousands, except per share amounts):

	Three months ended June 30,				Six months ended June 30,			
	2015		2014		2015		2014	
	Basic	Diluted	Basic	Diluted	Basic	Diluted	Basic	Diluted
Earnings (loss):								
Amounts attributable to Kindred stockholders:								
Income (loss) from continuing operations:								
As reported in Statement of Operations	$21,975	$21,975	$(25,278)	$(25,278)	$(121,460)	$(121,460)	$(6,880)	$(6,880)
Allocation to participating unvested restricted stockholders	(385)	(383)	–	–	–	–	–	–
Available to common stockholders	$21,590	$21,592	$(25,278)	$(25,278)	$(121,460)	$(121,460)	$(6,880)	$(6,880)
Discontinued operations, net of income taxes:								
Loss from operations:								
As reported in Statement of Operations	$(587)	$(587)	$(8,515)	$(8,515)	$(3,982)	$(3,982)	$(15,887)	$(15,887)
Allocation to participating unvested restricted stockholders	10	10	–	–	–	–	–	–
Available to common stockholders	$(577)	$(577)	$(8,515)	$(8,515)	$(3,982)	$(3,982)	$(15,887)	$(15,887)

Gain (loss) on divestiture of operations:								
As reported in Statement of Operations	$983	$983	$(2,018)	$(2,018)	$983	$983	$(5,024)	$(5,024)
Allocation to participating unvested restricted stockholders	(17)	(17)	–	–	–	–	–	–
Available to common stockholders	$966	$966	$(2,018)	$(2,018)	$983	$983	$(5,024)	$(5,024)
Income (loss) from discontinued operations:								
As reported in Statement of Operations	$396	$396	$(10,533)	$(10,533)	$(2,999)	$(2,999)	$(20,911)	$(20,911)
Allocation to participating unvested restricted stockholders	(7)	(7)	–	–	–	–	–	–
Available to common stockholders	$389	$389	$(10,533)	$(10,533)	$(2,999)	$(2,999)	$(20,911)	$(20,911)
Net income (loss):								
As reported in Statement of Operations	$22,371	$22,371	$(35,811)	$(35,811)	$(124,459)	$(124,459)	$(27,791)	$(27,791)
Allocation to participating unvested restricted stockholders	(392)	(390)	–	–	–	–	–	–
Available to common stockholders	$21,979	$21,981	$(35,811)	$(35,811)	$(124,459)	$(124,459)	$(27,791)	$(27,791)
Shares used in the computation:								
Weighted average shares outstanding – basic computation	86,045	86,045	53,714	53,714	82,828	82,828	53,180	53,180
Dilutive effect of employee stock options		67		–		–		–
Dilutive effect of tangible equity units		290		–		–		–
Adjusted weighted average shares outstanding – diluted computation		86,402		53,714		82,828		53,180
Earnings (loss) per common share:								
Income (loss) from continuing operations	$0.25	$0.25	$(0.47)	$(0.47)	$(1.47)	$(1.47)	$(0.13)	$(0.13)
Discontinued operations:								
Loss from operations	(0.01)	(0.01)	(0.16)	(0.16)	(0.05)	(0.05)	(0.30)	(0.30)
Gain (loss) on divestiture of operations	0.01	0.01	(0.04)	(0.04)	0.01	0.01	(0.09)	(0.09)

Income (loss) from discontinued operations	–	–	(0.20)	(0.20)	(0.04)	(0.04)	(0.39)	(0.39)
Net income (loss)	$0.25	$0.25	$(0.67)	$(0.67)	$(1.51)	$(1.51)	$(0.52)	$(0.52)
Number of antidilutive stock options and tangible equity units excluded from shares used in the diluted earnings (loss) per common share computation		816		314		2,573		337

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7 – BUSINESS SEGMENT DATA

The Company is organized into four operating divisions: the hospital division, the Kindred at Home division (formerly the care management division), the rehabilitation division (now known as Kindred Rehabilitation Services) and the nursing center division. Based upon the authoritative guidance for business segments, the operating divisions represent six reportable operating segments, including (1) hospitals, (2) home health services, (3) hospice services, (4) hospital rehabilitation services (now known as Kindred Hospital Rehabilitation Services), (5) skilled nursing rehabilitation services (now known as RehabCare) and (6) nursing centers. These reportable operating segments are consistent with information used by the Company's President and Chief Executive Officer and its Chief Operating Officer to assess performance and allocate resources. The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies. Prior period segment information has been reclassified to conform with the current period presentation, including the transfer of five IRFs from the hospital division to the Kindred Hospital Rehabilitation Services business segment as of January 1, 2015. As a result, $51.0 million of goodwill was reallocated from the hospital division to the Kindred Hospital Rehabilitation Services business segment based upon the relative fair value of the five IRFs.

For segment purposes, the Company defines segment operating income as earnings before interest, income taxes, depreciation, amortization and rent. Segment operating income reported for each of the Company's operating segments excludes litigation contingency expense, impairment charges, transaction costs and the allocation of corporate overhead.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7 – BUSINESS SEGMENT DATA (Continued)

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

	Three months ended June 30, 2015	Three months ended June 30, 2014	Six months ended June 30, 2015	Six months ended June 30, 2014
Revenues:				
Hospital division	$627,206	$612,517	$1,267,689	$1,239,762
Kindred at Home:				
Home health	427,820	75,502	728,687	150,293
Hospice	178,005	12,484	297,062	25,397
	605,825	87,986	1,025,749	175,690
Kindred Rehabilitation Services:				
Kindred Hospital Rehabilitation Services	152,544	94,963	304,108	188,140
RehabCare	236,791	253,694	489,386	507,637
	389,335	348,657	793,494	695,777
Nursing center division	273,870	264,437	548,178	527,027
	1,896,236	1,313,597	3,635,110	2,638,256
Eliminations:				
Kindred Hospital Rehabilitation Services	(23,201)	(22,855)	(47,203)	(46,088)
RehabCare	(38,262)	(28,485)	(76,051)	(56,639)
Nursing centers	(1,298)	(860)	(2,414)	(1,522)
	(62,761)	(52,200)	(125,668)	(104,249)
	$1,833,475	$1,261,397	$3,509,442	$2,534,007
Income (loss) from continuing operations:				
Operating income (loss):				
Hospital division	$130,967	$131,990	$265,078	$271,495
Kindred at Home:				
Home health	72,329	5,048	118,025	7,893
Hospice	26,238	2,017	42,717	3,869
	98,567	7,065	160,742	11,762
Kindred Rehabilitation Services:				
Kindred Hospital Rehabilitation Services	44,531	25,572	89,095	51,282
RehabCare	14,681	19,687	30,389	37,703
	59,212	45,259	119,484	88,985
Nursing center division	39,877	35,409	76,840	72,981
Support center	(70,209)	(48,808)	(136,774)	(93,264)
Litigation contingency expense	(3,925)	(4,600)	(98,925)	(4,600)
Impairment charges	–	–	(6,726)	–

Transaction costs	(5,216)	(4,496)	(99,918)	(5,179)
Operating income	249,273	161,819	279,801	342,180
Rent	(96,402)	(77,699)	(188,542)	(156,229)
Depreciation and amortization	(38,625)	(39,172)	(77,560)	(78,264)
Interest, net	(56,140)	(78,081)	(117,917)	(103,698)
Income (loss) from continuing operations before income taxes	58,106	(33,133)	(104,218)	3,989
Provision (benefit) for income taxes	24,396	(12,683)	(3,340)	1,512
	$33,710	$(20,450)	$(100,878)	$2,477

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7 – BUSINESS SEGMENT DATA (Continued)

	Three months ended June 30, 2015	2014	Six months ended June 30, 2015	2014
Rent:				
Hospital division	$51,404	$50,820	$102,858	$102,174
Kindred at Home:				
Home health	9,547	1,942	16,040	3,972
Hospice	4,726	235	7,865	461
	14,273	2,177	23,905	4,433
Kindred Rehabilitation Services:				
Kindred Hospital Rehabilitation Services	7,509	1,728	14,882	3,560
RehabCare	1,010	1,067	2,009	2,156
	8,519	2,795	16,891	5,716
Nursing center division	21,383	21,346	42,881	42,780
Support center	823	561	2,007	1,126
	$96,402	$77,699	$188,542	$156,229
Depreciation and amortization:				
Hospital division	$13,531	$16,482	$28,007	$32,939
Kindred at Home:				
Home health	4,273	1,976	7,866	3,942
Hospice	1,482	163	2,938	322
	5,755	2,139	10,804	4,264
Kindred Rehabilitation Services:				
Kindred Hospital Rehabilitation Services	3,314	3,014	6,732	6,106
RehabCare	1,924	2,885	3,835	5,580
	5,238	5,899	10,567	11,686
Nursing center division	6,962	7,416	14,456	14,713
Support center	7,139	7,236	13,726	14,662
	$38,625	$39,172	$77,560	$78,264

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7 – BUSINESS SEGMENT DATA (Continued)

	Three months ended June 30, 2015	2014	Six months ended June 30, 2015	2014
Capital expenditures, excluding acquisitions (including discontinued operations):				
Hospital division:				
Routine	$6,080	$8,225	$14,890	$16,627
Development	–	51	–	562
	6,080	8,276	14,890	17,189
Kindred at Home:				
Home health:				
Routine	859	158	1,111	438
Development	–	–	–	–
	859	158	1,111	438
Hospice:				
Routine	445	10	482	38
Development	–	–	–	–
	445	10	482	38
Kindred Rehabilitation Services:				
Kindred Hospital Rehabilitation Services:				
Routine	28	44	275	100
Development	40	–	61	–
	68	44	336	100
RehabCare:				
Routine	246	593	716	1,442
Development	–	–	–	–
	246	593	716	1,442
Nursing center division:				
Routine	4,342	5,163	9,408	10,218
Development	478	321	6,245	561
	4,820	5,484	15,653	10,779
Support center:				
Routine:				
Information systems	12,022	10,061	17,570	16,967
Other	478	231	817	332
	12,500	10,292	18,387	17,299
Totals:				
Routine	24,500	24,485	45,269	46,162
Development	518	372	6,306	1,123
	$25,018	$24,857	$51,575	$47,285

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 7 – BUSINESS SEGMENT DATA (Continued)

	June 30, 2015	December 31, 2014
Assets at end of period:		
Hospital division	$1,716,616	$ 1,751,695
Kindred at Home:		
Home health	1,426,826	203,154
Hospice	910,233	32,733
	2,337,059	235,887
Kindred Rehabilitation Services:		
Kindred Hospital Rehabilitation Services	806,422	366,153
RehabCare	357,326	360,860
	1,163,748	727,013
Nursing center division	504,513	513,603
Support center	883,991	2,424,766
	$6,605,927	$ 5,652,964
Goodwill:		
Hospital division	$628,519	$ 679,480
Kindred at Home:		
Home health	895,216	117,589
Hospice	633,736	26,910
	1,528,952	144,499
Kindred Rehabilitation Services:		
Kindred Hospital Rehabilitation Services	485,857	173,618
RehabCare	–	–
	485,857	173,618
	$2,643,328	$ 997,597

NOTE 8 – INSURANCE RISKS

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

The allowance for professional liability risks includes an estimate of the expected cost to settle reported claims and an amount, based upon past experiences, for losses incurred but not reported. These risks are necessarily based upon estimates and, while management believes that the provision for loss is adequate, the ultimate liability may be in excess of, or less than, the amounts recorded. To the extent that expected ultimate claims costs vary from historical provisions for loss, future earnings will be charged or credited.

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

	Three months ended June 30,		Six months ended June 30,	
	2015	2014	2015	2014
Professional liability:				
Continuing operations	$ 14,465	$ 15,595	$ 31,289	$ 29,172
Discontinued operations	(741)	3,387	(667)	9,006
Workers compensation:				
Continuing operations	$ 14,266	$ 9,197	$ 28,856	$ 17,455
Discontinued operations	(415)	596	(6)	1,445

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 8 – INSURANCE RISKS (Continued)

A summary of the assets and liabilities related to insurance risks included in the accompanying unaudited condensed consolidated balance sheet follows (in thousands):

	June 30, 2015			December 31, 2014		
	Professional liability	Workers compensation	Total	Professional liability	Workers compensation	Total
Assets:						
Current:						
Insurance subsidiary investments	$58,354	$ 46,180	$104,534	$63,183	$ 36,768	$99,951
Reinsurance recoverables	2,762	–	2,762	7,376	–	7,376
Other	–	100	100	–	100	100
	61,116	46,280	107,396	70,559	36,868	107,427
Non-current:						
Insurance subsidiary investments	94,562	103,848	198,410	84,210	81,835	166,045
Reinsurance and other recoverables	91,497	88,169	179,666	81,722	73,714	155,436
Deposits	4,080	4,345	8,425	3,879	1,428	5,307
Other	–	38	38	–	38	38
	190,139	196,400	386,539	169,811	157,015	326,826
	$251,255	$ 242,680	$493,935	$240,370	$ 193,883	$434,253
Liabilities:						
Allowance for insurance risks:						
Current	$61,550	$ 50,811	$112,361	$64,137	$ 39,802	$103,939
Non-current	267,503	215,192	482,695	243,614	149,457	393,071
	$329,053	$ 266,003	$595,056	$307,751	$ 189,259	$497,010

Provisions for loss for professional liability risks retained by the Company's limited purpose insurance subsidiary have been discounted based upon actuarial estimates of claim payment patterns using a discount rate of 1% to 5% depending upon the policy year. The discount rate was 1% for the 2015 and 2014 policy years. The discount rates are based upon the risk free interest rate for the respective year. Amounts equal to the discounted loss provision are funded annually. The Company does not fund the portion of professional liability risks related to estimated claims that have been incurred but not reported. Accordingly, these liabilities are not discounted. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated $331.5 million at June 30, 2015 and $310.3 million at December 31, 2014.

Provisions for loss for workers compensation risks retained by the Company's limited purpose insurance subsidiary are not discounted and amounts equal to the loss provision are funded annually.

NOTE 9 – INSURANCE SUBSIDIARY INVESTMENTS

The Company maintains investments, consisting principally of cash and cash equivalents, debt securities, equities and certificates of deposit for the payment of claims and expenses related to professional liability and workers compensation risks. These investments have been categorized as available-for-sale and are reported at fair value.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 9 – INSURANCE SUBSIDIARY INVESTMENTS (Continued)

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

	June 30, 2015				December 31, 2014			
	Cost	Unrealized gains	Unrealized losses	Fair value	Cost	Unrealized gains	Unrealized losses	Fair value
Cash and cash equivalents (a)	$179,527	$ –	$ –	$179,527	$150,556	$ –	$ –	$150,556
Debt securities:								
Corporate bonds	45,719	29	(49)	45,699	49,077	19	(60)	49,036
Debt securities issued by U.S. government agencies	25,985	51	(6)	26,030	25,313	19	(19)	25,313
U.S. Treasury notes	28,994	28	(1)	29,021	25,813	3	(7)	25,809
	100,698	108	(56)	100,750	100,203	41	(86)	100,158
Equities by industry:								
Consumer	2,771	287	(37)	3,021	1,539	107	(13)	1,633
Financial services	2,146	115	(66)	2,195	975	56	(6)	1,025
Technology	1,968	107	(100)	1,975	989	41	(34)	996
Healthcare	1,514	162	(24)	1,652	962	60	(8)	1,014
Industrials	938	32	(14)	956	649	14	(22)	641
Other	4,768	5	(459)	4,314	3,145	40	(265)	2,920
	14,105	708	(700)	14,113	8,259	318	(348)	8,229
Certificates of deposit	8,550	4	–	8,554	7,051	2	–	7,053
	$302,880	$ 820	$ (756)	$302,944	$266,069	$ 361	$ (434)	$265,996

(a) Includes $31.1 million and $15.6 million of money market funds at June 30, 2015 and December 31, 2014, respectively.

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

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

The Company considered the severity and duration of its unrealized losses at June 30, 2015 and 2014 for various investments held in its insurance subsidiary investment portfolio and determined that these unrealized losses were temporary and did not record any impairment losses related to these investments.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 10 – LONG-TERM DEBT

Capitalization

A summary of long-term debt follows (in thousands):

	June 30, 2015	December 31, 2014
Term Loan Facility, net of unamortized original issue discount (“OID”) of $6.8 million at June 30, 2015 and $6.4 million at December 31, 2014	$1,182,203	$988,645
8.00% Notes due 2020	750,000	750,000
8.75% Notes due 2023	600,000	600,000
6.375% Notes due 2022	500,000	500,000
ABL Facility	185,000	–
Mandatory Redeemable Preferred Stock (See Note 11)	29,341	34,773
Capital lease obligations	990	–
Other	7,263	3,720
Total debt, average life of 6 years (weighted average rate 6.3% for 2015 and 6.7% for 2014)	3,254,797	2,877,138
Amounts due within one year	(32,354)	(24,607)
Long-term debt	$3,222,443	$2,852,531

2015 Term Loan Amendment

On March 10, 2015, the Company entered into an incremental amendment agreement, which provided for an incremental term loan in an aggregate principal amount of $200 million under its Term Loan Facility (as defined below). The Company used the net proceeds of the incremental term loan to repay outstanding borrowings under its $900 million ABL Facility (as defined below). The incremental term loan was issued with 50 basis points of OID and has the same terms as, and is fungible with, the outstanding $995 million of term loans under the Company’s Term Loan Facility.

Gentiva Merger – Financing Transactions

The following transactions (collectively, the “Financing Transactions”) occurred in connection with the Gentiva Merger:

• the Company issued $1.35 billion aggregate principal amount of senior notes;

• the Company issued approximately 15 million shares of its common stock through two common stock offerings (see Note 11) and issued 9.7 million shares of its common stock through the Stock Consideration (see Note 2);

• the Company issued 172,500 tangible equity units (the “Units”) (see Note 11); and

• the Company amended its credit facilities.

Notes Offering

On December 18, 2014, Kindred Escrow Corp. II (the “Escrow Issuer”), one of the Company’s subsidiaries, completed a private placement of $750 million aggregate principal amount of 8.00% Senior Notes due 2020 (the “Notes due 2020”) and $600 million aggregate principal amount of 8.75% Senior Notes due 2023 (the “Notes due 2023”) (the Notes due 2020 and the Notes due 2023 are collectively referred to as the “Notes”). The Notes due 2020 were issued pursuant to the indenture, dated as of December 18, 2014 (the “2020 Indenture”), between the Escrow Issuer and Wells Fargo Bank, National Association, as trustee. The Notes due 2023 were issued pursuant to the indenture, dated as of December 18, 2014 (the “2023 Indenture” and, together with the 2020 Indenture, the “Indentures”), between the Escrow Issuer and Wells Fargo Bank, National Association.

Prior to the consummation of the Gentiva Merger, the Notes were senior secured obligations of the Escrow Issuer. Upon consummation of the Gentiva Merger, the Escrow Issuer was merged with and into the Company, as a result of which the Notes were assumed by the Company and fully and unconditionally guaranteed on a senior unsecured basis by substantially all of the Company’s domestic 100% owned subsidiaries, including substantially all of the Company’s and Gentiva’s domestic 100% owned subsidiaries (the “Guarantors”), ranking pari passu with all of the Company’s respective existing and future senior unsubordinated indebtedness.

The Indentures contain certain restrictive covenants that limit the Company and its restricted subsidiaries’ ability to, among other things, incur, assume or guarantee additional indebtedness; pay dividends, make distributions or redeem or repurchase capital stock; effect dividends, loans or asset transfers from its subsidiaries; sell or otherwise dispose of assets; and enter into transactions with affiliates. These covenants are subject to a number of limitations and exceptions. The Indentures also contain customary events of default.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 10 – LONG-TERM DEBT (Continued)

Notes Offering (Continued)

Under the terms of the Indentures, the Company may pay dividends pursuant to specified exceptions or, if its consolidated coverage ratio (as defined therein) is at least 2.0 to 1.0, it may also pay dividends in an amount equal to 50% of its consolidated net income (as defined therein) and 100% of the net cash proceeds from the issuance of capital stock, in each case since January 1, 2014. The making of certain other restricted payments or investments by the Company or its restricted subsidiaries would reduce the amount available for the payment of dividends pursuant to the foregoing exception.

Registration Rights Agreements – Notes due 2020 and Notes due 2023

On December 18, 2014, the Escrow Issuer entered into a registration rights agreement related to each of the Notes (the "Registration Rights Agreements"), each with Citigroup Global Markets Inc., as representative of the initial purchasers of the Notes. After the consummation of the Gentiva Merger, the Company and each of the Guarantors executed a joinder agreement to become parties to the Registration Rights Agreements.

Pursuant to the Registration Rights Agreements, the Company and the Guarantors will (among other obligations) use commercially reasonable efforts to file with the SEC a registration statement relating to an offer to exchange each of the Notes due 2020 and the Notes due 2023 for registered notes with substantially identical terms and consummate such offer within 365 days after the issuance of the Notes. A "Registration Default" will occur if, among other things, the Company and the Guarantors fail to comply with this requirement. If a Registration Default occurs with respect to the Notes due 2020 or the Notes due 2023, the annual interest rate of the Notes due 2020 or the Notes due 2023, as applicable, will be increased by 0.25% per annum and will increase by 0.25% per annum at the end of each subsequent 90-day period, but in no event will such increase exceed 1.00% per annum.

Escrow Agreements

On December 18, 2014, the Company and the Escrow Issuer entered into an escrow agreement related to each of the Notes (the "Escrow Agreements"), each with Wells Fargo Bank, National Association, as trustee under the Indentures, and as escrow agent. Pursuant to the Escrow Agreements, the Escrow Issuer deposited the gross proceeds of $1.35 billion from the sale of the Notes into the separate escrow accounts (the "Escrow Accounts") and the Company deposited an additional amount sufficient (together with the gross proceeds deposited by the Escrow Issuer) to fund the redemption of the Notes and to pay all regularly scheduled interest on the Notes to, but not including, the special mandatory redemption date into the respective Escrow Accounts. The amount of interest deposited on December 18, 2014 totaled $23.4 million. The amounts in the Escrow Accounts were released upon consummation of the Gentiva Merger. The release of the escrowed funds was conditioned on the consummation of the Gentiva Merger, the merger of the Escrow Issuer with and into the Company, as a result of which the Company assumed the Escrow Issuer's obligations under the Notes, and other conditions set forth in the Escrow Agreements.

Credit Facilities Amendments

On November 25, 2014, the Company entered into a fourth amendment and restatement agreement (the "Term Loan Amendment Agreement") among the Company, the consenting lenders party thereto and JPMorgan Chase Bank, N.A., as administrative agent. The Term Loan Amendment Agreement amended and restated the Term Loan Credit Agreement dated as of June 1, 2011, as amended by that certain Incremental Amendment No. 1 to the Term Loan Credit Agreement dated as of October 4, 2012 and as further amended and restated by that certain Amendment and Restatement Agreement dated as of May 30, 2013, that certain Second Amendment and Restatement Agreement dated as of August 21, 2013 and that certain Third Amendment and Restatement Agreement dated as of April 9, 2014, among the Company, the lenders party thereto and JPMorgan Chase Bank, N.A., as administrative agent and collateral agent (the "Term Loan Facility").

The Term Loan Amendment Agreement amended and restated the Term Loan Facility to, among other items, (i) modify certain provisions related to the issuance of Notes into the Escrow Accounts, (ii) increase the applicable interest rate margins for LIBOR borrowings from 3.00% to 3.25% and for base rate borrowings from 2.00% to 2.25%, (iii) temporarily increase the maximum total leverage ratio permitted under the financial maintenance covenants, (iv) include soft-call protection at a prepayment premium of 1.00% for twelve months starting from November 25, 2014 and (v) modify certain provisions related to the incurrence of debt and the making of acquisitions, investments and restricted payments. The Term Loan Amendment Agreement did not modify the maturity date of the loans made thereunder.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 10 – LONG-TERM DEBT (Continued)

Credit Facilities Amendments (Continued)

On October 31, 2014, the Company entered into a third amendment and restatement agreement (the “ABL Amendment Agreement”) among the Company, the consenting lenders party thereto and JPMorgan Chase Bank, N.A., as administrative agent. The ABL Amendment Agreement amended and restated the ABL Credit Agreement dated as of June 1, 2011, as amended by that certain Amendment No. 1 to the ABL Credit Agreement dated as of October 4, 2012 and as further amended and restated by that certain Amendment and Restatement Agreement dated as of August 21, 2013 and that certain Second Amendment and Restatement Agreement dated as of April 9, 2014 (the “ABL Facility”), among the Company, the lenders from time to time party thereto and JPMorgan Chase Bank, N.A., as administrative agent and collateral agent.

The ABL Amendment Agreement, among other items, modified certain provisions related to the issuance of Notes into the Escrow Accounts. Upon the consummation of the Gentiva Merger and the satisfaction of certain other conditions, the ABL Amendment Agreement further amended and restated the ABL Facility to, among other items, modify certain provisions related to the incurrence of debt and the making of acquisitions, investments and restricted payments. The ABL Amendment Agreement did not modify the maturity date of the revolving commitments thereunder or the applicable interest rate margins applicable to any borrowings thereunder.

In addition, on December 12, 2014, the Company entered into an incremental joinder agreement (the “Incremental ABL Joinder”) among the Company, JPMorgan Chase Bank, N.A., as administrative agent and collateral agent, the incremental lenders party thereto and the other credit parties party thereto. Upon the consummation of the Gentiva Merger and the satisfaction of certain other conditions, the Incremental ABL Joinder provided for additional revolving commitments in an aggregate principal amount of $150 million under the ABL Facility.

All obligations under the ABL Facility and the Term Loan Facility are fully and unconditionally guaranteed, subject to certain customary release provisions, by substantially all of the Company’s existing and future direct and indirect domestic 100% owned subsidiaries, as well as certain non-100% owned domestic subsidiaries as the Company may determine from time to time in its sole discretion. The Notes due 2022 (as defined below), the Notes due 2020 and the Notes due 2023 are fully and unconditionally guaranteed, subject to certain customary release provisions, by substantially all of the Company’s domestic 100% owned subsidiaries.

Amendment to Notes due 2022

On April 9, 2014, the Company completed a private placement of $500 million aggregate principal amount of 6.375% senior notes due 2022 (the “Notes due 2022”). The Notes due 2022 were issued pursuant to the indenture dated April 9, 2014 (the “2022 Indenture”) among the Company, the guarantors party thereto (the “2022 Guarantors”) and Wells Fargo Bank, National Association, as trustee.

On January 30, 2015, following the receipt of sufficient consents to approve the proposed amendments (the “Amendments”), the Company, the 2022 Guarantors and Wells Fargo Bank, National Association, as trustee, entered into the first supplemental indenture (the “2022 Notes Supplemental Indenture”) to the 2022 Indenture. The 2022 Notes

Supplemental Indenture conforms certain covenants, definitions and other terms in the 2022 Indenture to the covenants, definitions and terms contained in the Indentures governing the Notes. The Amendments became operative following the consummation of the Gentiva Merger.

April 2014 Debt Refinancing

On April 9, 2014, the Company completed the refinancing of substantially all of its then existing debt and incurred the following costs in the second quarter of 2014:

- Unamortized deferred financing costs related to the Company's prior ABL facility totaling $0.6 million ($0.4 million net of income taxes) were written-off and recorded as interest expense.
- Unamortized deferred financing costs and original issue discount related to the Company's Prior Term Loan Facility totaling $5.0 million ($3.1 million net of income taxes) were written-off and recorded as interest expense.
- Unamortized deferred financing costs totaling $10.7 million ($6.6 million net of income taxes), the applicable premium totaling $36.4 million ($22.5 million net of income taxes) and interest expense for the period from April 9, 2014 to May 9, 2014 totaling $3.9 million ($2.4 million net of income taxes), all related to the Company's prior $550 million, 8.25% senior notes due 2019, were written-off and recorded as interest expense.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 11 – CAPITAL STOCK

Gentiva Merger

In connection with the Gentiva Merger, Kindred issued 9.7 million shares of common stock as part of the Stock Consideration (see Note 2).

Common Stock Offerings

On November 25, 2014, in an offering registered with the SEC, the Company completed the sale of 5,000,000 shares of its common stock for cash and granted the underwriters a 30-day over-allotment option to purchase up to an additional 750,000 shares of common stock. On December 1, 2014, the underwriters exercised their over-allotment option to purchase 395,759 additional shares of common stock, which the Company closed on December 3, 2014. The Company refers to this offering and sale of its common stock herein as the “November Common Stock Offering.” The net proceeds of the November Common Stock Offering, after deducting the underwriting discount and offering expenses, were $101.0 million.

On June 25, 2014, in an offering registered with the SEC, the Company completed the sale of 9,000,000 shares of its common stock for cash and granted the underwriters a 30-day option to purchase up to an additional 1,350,000 shares of common stock, of which 723,468 shares were purchased on July 14, 2014. The Company refers to this offering and the sale of its common stock herein as the “June Common Stock Offering.” The net proceeds of the June Common Stock Offering, after deducting the underwriting discount and offering expenses, were $220.4 million.

Units Offering

On November 25, 2014, in an offering registered with the SEC, the Company completed the sale of 150,000 Units for cash and granted the underwriters a 13-day over-allotment option to purchase up to an additional 22,500 Units. On December 1, 2014, the underwriters exercised in full their over-allotment option to purchase 22,500 additional Units, which the Company closed on December 3, 2014. Each Unit is composed of a prepaid stock purchase contract (a “Purchase Contract”) and one share of 7.25% Mandatory Redeemable Preferred Stock, Series A (the “Mandatory Redeemable Preferred Stock”), having a final preferred stock installment payment date of December 1, 2017 and an initial liquidation preference of $201.58 per share of Mandatory Redeemable Preferred Stock. The net proceeds from the offering of the Units, after deducting the underwriting discount and offering expenses, were $166.3 million. The Purchase Contracts were recorded as capital in excess of par value, net of issue costs, and the Mandatory Redeemable Preferred Stock has been recorded as long-term debt.

As of June 30, 2015, holders of 80,621 Purchase Contracts elected early settlement. As a result, holders thereof received 43.0918 shares of common stock per Purchase Contract, resulting in approximately 3.5 million shares of common stock being issued by the Company.

Dividends and Other Payments

During the first half of 2015, the Company paid a quarterly cash dividend of $0.12 per common share on June 10, 2015 to shareholders of record as of the close of business on May 20, 2015 and also paid a quarterly cash dividend of $0.12 per common share on April 1, 2015 to shareholders.

During the first half of 2014, the Company paid a quarterly cash dividend of $0.12 per common share on June 11, 2014 to shareholders of record as of the close of business on May 21, 2014 and also paid a quarterly cash dividend of $0.12 per common share on March 27, 2014 to shareholders.

The Company made an installment payment on the Company's Units on June 1, 2015 to holders of record on May 15, 2015, which consisted of a quarterly installment payment of $18.75 per Unit. The Company also made an installment payment on the Company's Units on March 2, 2015, which consisted of a quarterly installment payment of $18.75 per Unit, plus a one-time incremental payment of $1.25 per Unit for the period between November 25, 2014 and December 1, 2014, for a total payment of $20.00 per Unit. To the extent that any Unit has been separated into its constituent Purchase Contract and its constituent share of Mandatory Redeemable Preferred Stock, the installment payment is payable only on the constituent share of Mandatory Redeemable Preferred Stock.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 12 – CONTINGENCIES

Management continually evaluates contingencies based upon the best available information. In addition, allowances for losses are provided currently for disputed items that have continuing significance, such as certain third party reimbursements and deductions that continue to be claimed in current cost reports and tax returns.

Management believes that allowances for losses have been provided to the extent necessary and that its assessment of contingencies is reasonable.

Principal contingencies are described below.

Revenues – Certain third party payments are subject to examination by agencies administering the various reimbursement programs. The Company is contesting certain issues raised in audits of prior year cost reports and the denial of payment by third parties to the Company's customers.

Professional liability risks – The Company has provided for losses for professional liability risks based upon management's best available information including actuarially determined estimates. Ultimate claims costs may differ from the provisions for loss. See Note 8.

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

Legal and regulatory proceedings – The Company is a party to various legal actions and regulatory and other governmental and internal audits and investigations in the ordinary course of business (including investigations resulting from the Company's obligation to self-report suspected violations of law by the Company). The Company cannot predict the ultimate outcome of pending litigation and regulatory and other governmental and internal audits and investigations. The U.S. Department of Justice (the "DOJ"), the Centers for Medicare and 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. These matters could potentially subject the Company to sanctions, damages, recoupments, fines and other penalties (some of which may not be covered by insurance), which may, either individually or in the aggregate, have a material adverse effect on the Company's business, financial position, results of operations and liquidity. See Note 15.

Other indemnifications – In the ordinary course of business, the Company enters into contracts containing standard indemnification provisions and indemnifications specific to a transaction, such as a disposal of an operating facility. These indemnifications may cover claims related to employment-related matters, governmental regulations, environmental issues and tax matters, as well as patient, third party payor, supplier and contractual relationships. Obligations under these indemnities generally are initiated by a breach of the terms of a contract or by a third party claim or event.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 13 – FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS

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

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

Level 1 Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury, other U.S. Government and agency asset backed debt securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 13 – FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

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

	Fair value measurements			Assets/liabilities	Total
	Level 1	Level 2	Level 3	at fair value	losses
June 30, 2015:					
Recurring:					
Assets:					
Available-for-sale debt securities:					
Corporate bonds	$–	$45,699	$–	$ 45,699	$–
Debt securities issued by U.S. government agencies	–	26,030	–	26,030	–
U.S. Treasury notes	29,021	–	–	29,021	–
	29,021	71,729	–	100,750	–
Available-for-sale equity securities	14,113	–	–	14,113	–
Money market funds	33,100	–	–	33,100	–
Certificates of deposit	–	8,554	–	8,554	–
Total available-for-sale investments	76,234	80,283	–	156,517	–
Deposits held in money market funds	16,950	3,884	–	20,834	–
	$93,184	$84,167	$–	$ 177,351	$–
Liabilities:					
Contingent consideration liability	$–	$–	$(6,594)	$ (6,594)	$–
Interest rate swaps	–	(4,937)	–	(4,937)	–
	$–	$(4,937)	$(6,594)	$ (11,531)	$–
Non-recurring:					
Assets:					
Intangible assets – trade name	$–	$–	$1,405	$ 1,405	$(6,726)
Liabilities	$–	$–	$–	$ –	$–
December 31, 2014:					
Recurring:					
Assets:					
Available-for-sale debt securities:					
Corporate bonds	$–	$49,036	$–	$ 49,036	$–
Debt securities issued by U.S. government agencies	–	25,313	–	25,313	–
U.S. Treasury notes	25,809	–	–	25,809	–
	25,809	74,349	–	100,158	–
Available-for-sale equity securities	8,229	–	–	8,229	–
Money market funds	17,787	–	–	17,787	–
Certificates of deposit	–	7,053	–	7,053	–
Total available-for-sale investments	51,825	81,402	–	133,227	–

Deposits held in money market funds	105,140	3,883	–	109,023	–
	$156,965	$85,285	$–	$ 242,250	$–
Liabilities:					
Interest rate swaps	$–	$(3,673)	$–	$ (3,673)	$–
Non-recurring:					
Assets:					
Property and equipment	$–	$–	$19	$ 19	$(673)
Liabilities	$–	$–	$–	$ –	$–

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 13 – FINANCIAL INSTRUMENTS AND FAIR VALUE MEASUREMENTS (Continued)

Recurring measurements

The Company's available-for-sale investments held by its limited purpose insurance subsidiary consist of debt securities, equities, money market funds and certificates of deposit. These available-for-sale investments and the insurance subsidiary's cash and cash equivalents of $148.4 million as of June 30, 2015 and $135.0 million as of December 31, 2014, classified as insurance subsidiary investments, are maintained for the payment of claims and expenses related to professional liability and workers compensation risks.

The Company also has available-for-sale investments totaling $2.0 million as of June 30, 2015 and $2.2 million as of December 31, 2014 related to a deferred compensation plan that is maintained for certain of the Company's current and former employees.

The fair value of actively traded debt and equity securities and money market funds is based upon quoted market prices and is generally classified as Level 1. The fair value of inactively traded debt securities and certificates of deposit is based upon either quoted market prices of similar securities or observable inputs such as interest rates using either a market or income valuation approach and is generally classified as Level 2. The Company's investment advisors obtain and review pricing for each security. The Company is responsible for the determination of fair value and as such the Company reviews the pricing information from its advisors in determining reasonable estimates of fair value. Based upon the Company's internal review procedures, there were no adjustments to the prices during the three months or six months ended June 30, 2015 or June 30, 2014.

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

The Company acquired a contingent consideration liability in the Gentiva Merger from a prior acquisition by Gentiva with an initial estimated fair value of $8.3 million. The fair value is determined using a discounted cash flow approach utilizing Level 2 and Level 3 inputs which includes observable market discount rates, fixed payment schedules, and assumptions based on achieving certain predefined performance criteria. As of June 30, 2015, the fair value of the Level 3 contingent consideration liability was $6.6 million. The change in fair value in the second quarter of 2015 consists of $1.8 million in fixed payments and $0.1 million in accrued interest included in interest expense in the accompanying unaudited condensed consolidated statement of operations. A one percent change in the discount rate used to calculate the accretion of the present value of the contingent consideration liability would have an impact on the fair value of approximately $0.1 million.

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

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

(In thousands)	June 30, 2015 Carrying value	Fair value	December 31, 2014 Carrying value	Fair value
Cash and cash equivalents	$119,536	$119,536	$164,188	$164,188
Insurance subsidiary investments	302,944	302,944	265,996	265,996
Note receivable	25,000	25,000	–	–
Long-term debt, including amounts due within one year (excluding capital lease obligations totaling $1.0 million at June 30, 2015)	3,253,807	3,366,704	2,877,138	2,930,815

Non-recurring measurements

During the six months ended June 30, 2015, the Company recorded an asset impairment charge of $6.7 million related to previously acquired home health and hospice trade names after the decision in the first quarter of 2015 to rebrand to the Kindred at Home trade name. These charges reflect the amount by which the carrying value exceeded its estimated fair value. The fair value of the trade names was measured using Level 3 unobservable inputs, primarily economic obsolescence.

KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 14 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION

The accompanying condensed consolidating financial information has been prepared and presented pursuant to SEC Regulation S-X, Rule 3-10, “Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered.” The Company’s $550 million aggregate principal amount of 8.25% Senior Notes due 2019, which were redeemed during 2014, were fully and unconditionally guaranteed by substantially all of the Company’s domestic 100% owned subsidiaries. The Company’s Notes due 2020, Notes due 2022 and Notes due 2023 are all fully and unconditionally guaranteed by the same subsidiaries. The Company’s Notes due 2020 and the Notes due 2023, which were issued during 2014, were senior unsecured obligations of the Escrow Issuer, which, prior to the Gentiva Merger, was a non-guarantor subsidiary of the Company. In conjunction with the Gentiva Merger, the Escrow Issuer was merged with and into the Company with the Company assuming the Notes due 2020 and Notes due 2023. See Note 10. The equity method has been used with respect to the parent company’s investment in subsidiaries.

The following unaudited condensed consolidating financial data present the financial position of the parent company/issuer, the guarantor subsidiaries and the non-guarantor subsidiaries as of June 30, 2015 and December 31, 2014, and the respective results of operations and cash flows for the three months and six months ended June 30, 2015 and June 30, 2014.

Condensed Consolidating Statement of Operations and Comprehensive Income (Loss)

	Three months ended June 30, 2015				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Revenues	$–	$ 1,615,664	$ 243,893	$ (26,082)	$ 1,833,475
Salaries, wages and benefits	–	876,994	58,693	–	935,687
Supplies	–	85,711	12,526	–	98,237
Rent	–	77,736	18,666	–	96,402
Other operating expenses	–	184,998	27,119	–	212,117
General and administrative expenses	–	262,124	98,763	(26,082)	334,805
Other (income) expense	–	214	(783)	–	(569)
Litigation contingency expense	–	3,925	–	–	3,925
Depreciation and amortization	–	36,216	2,409	–	38,625
Management fees	–	(4,262)	4,262	–	–
Intercompany interest (income) expense from affiliates	(52,529)	40,919	11,610	–	–
Interest expense	57,097	13	60	–	57,170
Investment income	–	(798)	(232)	–	(1,030)
Equity in net income of consolidating affiliates	(25,142)	–	–	25,142	–
	(20,574)	1,563,790	233,093	(940)	1,775,369

Income from continuing operations before income taxes	20,574	51,874	10,800	(25,142)	58,106
Provision (benefit) for income taxes	(1,797)	26,059	134	–	24,396
Income from continuing operations	22,371	25,815	10,666	(25,142)	33,710
Discontinued operations, net of income taxes:					
Loss from operations	–	(418)	(171)	–	(589)
Gain on divestiture of operations	–	983	–	–	983
Income (loss) from discontinued operations	–	565	(171)	–	394
Net income	22,371	26,380	10,495	(25,142)	34,104
(Earnings) loss attributable to noncontrolling interests:					
Continuing operations	–	–	(11,735)	–	(11,735)
Discontinued operations	–	–	2	–	2
	–	–	(11,733)	–	(11,733)
Income (loss) attributable to Kindred	$22,371	$26,380	$ (1,238)	$ (25,142)	$ 22,371
Comprehensive income	$22,767	$26,380	$ 10,405	$ (25,052)	$ 34,500
Comprehensive income (loss) attributable to Kindred	$22,767	$26,380	$ (1,328)	$ (25,052)	$ 22,767

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 14 – CONDENSED CONSOLIDATING FINANCIAL INFORMATION (Continued)

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

	Three months ended June 30, 2014				
(In thousands)	Parent company/ issuer	Guarantor subsidiaries	Non-guarantor subsidiaries	Consolidating and eliminating adjustments	Consolidated
Revenues	$–	$ 1,119,049	$ 168,158	$ (25,810)	$ 1,261,397
Salaries, wages and benefits	–	573,111	32,984	–	606,095
Supplies	–	63,550	8,035	–	71,585
Rent	–	65,684	12,015	–	77,699
Other operating expenses	–	177,650	20,834	(25,810)	172,674
General and administrative expenses	–	166,602	78,144	–	244,746
Other (income) expense	–	164	(286)	–	(122)
Litigation contingency expense	–	4,600	–	–	4,600
Depreciation and amortization	–	37,088	2,084	–	39,172
Management fees	–	(3,437)	3,437	–	–
Intercompany interest (income) expense from affiliates	(28,572)	19,398	9,174	–	–
Interest expense	80,479	6	45	–	80,530
Investment income	–	(236)	(2,213)	–	(2,449)
Equity in net loss of consolidating affiliates	4,330	–	–	(4,330)	–
	56,237	1,104,180	164,253	(30,140)	1,294,530
Income (loss) from continuing operations before income taxes	(56,237)	14,869	3,905	4,330	(33,133)
Provision (benefit) for income taxes	(20,426)	6,920	823	–	(12,683)
Income (loss) from continuing operations	(35,811)	7,949	3,082	4,330	(20,450)
Discontinued operations, net of income taxes:					
Loss from operations	–	(6,341)	(2,427)	–	(8,768)
Loss on divestiture of operations	–	(343)	(1,675)	–	(2,018)
Loss from discontinued operations	–	(6,684)	(4,102)	–	(10,786)
Net income (loss)	(35,811)	1,265			