

KINDRED HEALTHCARE, INC
Form 10-Q
November 07, 2008
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

**□ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2008

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
(State or other jurisdiction of
incorporation or organization)

680 South Fourth Street

Louisville, KY
(Address of principal executive offices)

(502) 596-7300

(Registrant's telephone number, including area code)

61-1323993
(I.R.S. Employer
Identification No.)

40202-2412
(Zip 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

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to such filing requirements for the past 90 days. Yes 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 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

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 October 31, 2008 |
|--------------------------------|--|
| Common stock, \$0.25 par value | 38,915,056 shares |

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Table of Contents**KINDRED HEALTHCARE, INC.****CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS****(Unaudited)****(In thousands, except per share amounts)**

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|------------|------------------------------------|--------------|
| | 2008 | 2007 | 2008 | 2007 |
| Revenues | \$ 1,010,680 | \$ 999,418 | \$ 3,101,114 | \$ 3,183,244 |
| Salaries, wages and benefits | 606,468 | 592,234 | 1,803,880 | 1,784,669 |
| Supplies | 78,586 | 108,648 | 238,785 | 468,921 |
| Rent | 86,444 | 87,152 | 259,048 | 258,149 |
| Other operating expenses | 211,584 | 191,208 | 656,274 | 546,439 |
| Other income | (4,313) | (3,201) | (14,197) | (3,201) |
| Depreciation and amortization | 29,432 | 30,578 | 91,417 | 88,509 |
| Interest expense | 3,710 | 5,014 | 11,538 | 11,301 |
| Investment income | (672) | (3,770) | (6,257) | (11,209) |
| | 1,011,239 | 1,007,863 | 3,040,488 | 3,143,578 |
| Income (loss) from continuing operations before income taxes | (559) | (8,445) | 60,626 | 39,666 |
| Provision (benefit) for income taxes | (1,345) | (692) | 23,526 | 19,636 |
| Income (loss) from continuing operations | 786 | (7,753) | 37,100 | 20,030 |
| Discontinued operations, net of income taxes: | | | | |
| Income (loss) from operations | 12 | (1,309) | (2,663) | (6,224) |
| Loss on divestiture of operations | (22,058) | | (19,346) | (76,968) |
| Net income (loss) | \$ (21,260) | \$ (9,062) | \$ 15,091 | \$ (63,162) |
| Earnings (loss) per common share: | | | | |
| Basic: | | | | |
| Income (loss) from continuing operations | \$ 0.02 | \$ (0.20) | \$ 0.98 | \$ 0.51 |
| Discontinued operations: | | | | |
| Income (loss) from operations | | (0.03) | (0.07) | (0.16) |
| Loss on divestiture of operations | (0.58) | | (0.51) | (1.96) |
| Net income (loss) | \$ (0.56) | \$ (0.23) | \$ 0.40 | \$ (1.61) |
| Diluted: | | | | |
| Income (loss) from continuing operations | \$ 0.02 | \$ (0.20) | \$ 0.95 | \$ 0.49 |
| Discontinued operations: | | | | |
| Income (loss) from operations | | (0.03) | (0.07) | (0.15) |
| Loss on divestiture of operations | (0.56) | | (0.49) | (1.90) |
| Net income (loss) | \$ (0.54) | \$ (0.23) | \$ 0.39 | \$ (1.56) |
| Shares used in computing earnings (loss) per common share: | | | | |
| Basic | 38,034 | 39,013 | 37,732 | 39,271 |

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| | | | | |
|---------|--------|--------|--------|--------|
| Diluted | 39,369 | 39,013 | 38,994 | 40,522 |
|---------|--------|--------|--------|--------|

See accompanying notes.

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KINDRED HEALTHCARE, INC.
CONDENSED CONSOLIDATED BALANCE SHEET

(Unaudited)

(In thousands, except per share amounts)

| | September 30, 2008 | December 31, 2007 |
|---|-----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 19,295 | \$ 32,877 |
| Cash restricted | 4,935 | 5,360 |
| Insurance subsidiary investments | 193,911 | 231,693 |
| Accounts receivable less allowance for loss of \$30,558 September 30, 2008 and \$33,305 December 31, 2007 | 700,372 | 598,108 |
| Inventories | 22,675 | 22,035 |
| Deferred tax assets | 59,087 | 59,936 |
| Income taxes | 29,040 | 43,128 |
| Other | 22,046 | 20,510 |
| | 1,051,361 | 1,013,647 |
| Property and equipment | 1,347,223 | 1,226,111 |
| Accumulated depreciation | (627,559) | (542,773) |
| | 719,664 | 683,338 |
| Goodwill | 71,244 | 69,100 |
| Intangible assets less accumulated amortization of \$1,599 September 30, 2008 and \$1,095 December 31, 2007 | 64,584 | 79,956 |
| Assets held for sale | 11,122 | 15,837 |
| Insurance subsidiary investments | 47,409 | 49,166 |
| Deferred tax assets | 127,199 | 113,854 |
| Other | 45,822 | 54,654 |
| | \$ 2,138,405 | \$ 2,079,552 |

LIABILITIES AND STOCKHOLDERS EQUITY

| | | |
|---|------------|------------|
| Current liabilities: | | |
| Accounts payable | \$ 155,982 | \$ 180,367 |
| Salaries, wages and other compensation | 275,594 | 261,608 |
| Due to third party payors | 42,171 | 41,980 |
| Professional liability risks | 59,218 | 64,740 |
| Other accrued liabilities | 81,964 | 80,663 |
| Long-term debt and capital lease obligation due within one year | 79 | 584 |
| | 615,008 | 629,942 |
| Long-term debt | 329,054 | 275,814 |
| Capital lease obligation | | 15,760 |
| Professional liability risks | 195,533 | 186,652 |
| Deferred credits and other liabilities | 106,135 | 109,260 |
| Commitments and contingencies | | |

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Stockholders' equity:

| | | |
|--|--------------|--------------|
| Common stock, \$0.25 par value; authorized 175,000 shares; issued 38,915 shares - September 30, 2008 | 9,729 | 9,585 |
| and 38,339 shares - December 31, 2007 | | |
| Capital in excess of par value | 809,201 | 790,367 |
| Accumulated other comprehensive income (loss) | (1,787) | 1,250 |
| Retained earnings | 75,532 | 60,922 |
| | 892,675 | 862,124 |
| | \$ 2,138,405 | \$ 2,079,552 |

See accompanying notes.

Table of Contents**KINDRED HEALTHCARE, INC.****CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS****(Unaudited)****(In thousands)**

| | Three months ended | | Nine months ended | |
|--|-----------------------|-----------------|-----------------------|------------------|
| | September 30, 2008 | 2007 | September 30, 2008 | 2007 |
| Cash flows from operating activities: | | | | |
| Net income (loss) | \$ (21,260) | \$ (9,062) | \$ 15,091 | \$ (63,162) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | | |
| Depreciation and amortization | 29,595 | 30,916 | 92,269 | 92,019 |
| Amortization of stock-based compensation costs | 2,411 | 19,547 | 9,806 | 27,699 |
| Provision for doubtful accounts | 6,877 | 6,612 | 22,037 | 23,494 |
| Deferred income taxes | 8,226 | (2,129) | (4,921) | (17,044) |
| Loss on divestiture of discontinued operations | 22,058 | | 19,346 | 76,968 |
| Other | (853) | (650) | (1,946) | (2,165) |
| Change in operating assets and liabilities: | | | | |
| Accounts receivable | (41,141) | (84,996) | (125,287) | (130,424) |
| Inventories and other assets | (422) | 16,413 | (4,880) | 13,503 |
| Accounts payable | (2,726) | 9,700 | (13,756) | (6,914) |
| Income taxes | (17,796) | (14,216) | 21,188 | 12,865 |
| Due to third party payors | 14,998 | 16,403 | 191 | 20,791 |
| Other accrued liabilities | 7,262 | 31,601 | 12,251 | 53,101 |
| Net cash provided by operating activities | 7,229 | 20,139 | 41,389 | 100,731 |
| Cash flows from investing activities: | | | | |
| Purchase of property and equipment | (47,293) | (54,256) | (112,153) | (133,012) |
| Acquisitions | (22,419) | (22,850) | (48,824) | (238,104) |
| Sale of assets | 745 | 1,786 | 27,984 | 81,692 |
| Purchase of insurance subsidiary investments | (25,908) | (22,484) | (94,976) | (114,363) |
| Sale of insurance subsidiary investments | 22,568 | 28,559 | 89,501 | 126,843 |
| Net change in insurance subsidiary cash and cash equivalents | 1,671 | (7,798) | 40,099 | (3,117) |
| Net change in other investments | 2 | 500 | 7,002 | 514 |
| Other | 1,340 | (3,851) | 2,628 | (7,274) |
| Net cash used in investing activities | (69,294) | (80,394) | (88,739) | (286,821) |
| Cash flows from financing activities: | | | | |
| Proceeds from borrowings under revolving credit | 391,700 | 413,500 | 1,119,800 | 1,289,300 |
| Repayment of borrowings under revolving credit | (328,800) | (430,500) | (1,066,500) | (1,184,300) |
| Repayment of long-term debt | (19) | (18) | (57) | (53) |
| Repayment of capital lease obligation | | | (16,268) | |
| Payment of deferred financing costs | (211) | (1,752) | (390) | (2,058) |
| Proceeds from borrowing related to spin-off transaction | | 125,000 | | 125,000 |
| Issuance of common stock | 3,087 | 302 | 8,865 | 10,050 |
| Repurchase of common stock | | (49,997) | | (49,997) |
| Other | (3,213) | 3,790 | (11,682) | (5,080) |

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| | | | | |
|--|-------------------------|-----------|-----------|-----------|
| Net cash provided by financing activities | 62,544 | 60,325 | 33,768 | 182,862 |
| Change in cash and cash equivalents | 479 | 70 | (13,582) | (3,228) |
| Cash and cash equivalents at beginning of period | 18,816 | 17,559 | 32,877 | 20,857 |
| Cash and cash equivalents at end of period | \$ 19,295 | \$ 17,629 | \$ 19,295 | \$ 17,629 |
| Supplemental information: | | | | |
| Interest payments | \$ 3,214 | \$ 4,548 | \$ 10,847 | \$ 10,777 |
| Income tax payments | 9,614 | 14,000 | 6,924 | 17,399 |
| | See accompanying notes. | | | |

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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 hospitals, nursing centers and a contract rehabilitation services business across the United States (collectively, the Company). At September 30, 2008, the Company's hospital division operated 82 long-term acute care (LTAC) hospitals in 24 states. The Company's health services division operated 228 nursing centers in 27 states. The Company also operated a contract rehabilitation services business which provides rehabilitative services primarily in long-term care settings.

On July 31, 2007, the Company completed the spin-off of its former institutional pharmacy business. See Note 2.

In recent years, the Company has completed several transactions related to the 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 have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at September 30, 2008 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 3 for a summary of discontinued operations.

Impact of recent accounting pronouncements

In June 2008, the Financial Accounting Standards Board (the FASB) issued FASB Staff Position EITF 03-6-1 (EITF 03-6-1), Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities, which clarifies that share-based payment awards that entitle the holder to receive nonforfeitable dividends before vesting would be considered participating securities. As participating securities, these instruments should be included in the calculation of basic earnings per common share. The provisions of EITF 03-6-1 will be effective for fiscal years beginning after December 15, 2008. The adoption of EITF 03-6-1 is not expected to have a material impact on the Company's earnings per common share calculation.

In December 2007, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 141 (revised 2007) (SFAS 141R), Business Combinations, which significantly changes the accounting for business combinations, including, among other changes, new accounting concepts in determining the fair value of assets and liabilities acquired, recording the fair value of contingent considerations and contingencies at the acquisition date and expensing acquisition and restructuring costs. SFAS 141R will be applied prospectively and is effective for business combinations which occur during fiscal years beginning after December 15, 2008. At this time, the Company cannot determine the impact that SFAS 141R will have on its financial position, results of operations or liquidity.

In December 2007, the FASB issued SFAS No. 160 (SFAS 160), Noncontrolling Interests in Consolidated Financial Statements, which will change the accounting and reporting for minority interests. SFAS 160 will recharacterize minority interests as noncontrolling interests and they will be classified as a component of stockholders' equity. The new consolidation method will significantly change the accounting for transactions with minority-interest holders. SFAS 160 is effective for fiscal years beginning after December 15, 2008. The adoption of SFAS 160 is not expected to have a material impact on the Company's financial position, results of operations or liquidity.

In September 2006, the FASB issued SFAS No. 157 (SFAS 157), 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 generally accepted accounting principles. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position SFAS No. 157-2 (SFAS 157-2), Effective Date of FASB Statement No. 157, which deferred the effective date of

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 1 BASIS OF PRESENTATION (Continued)***Impact of recent accounting pronouncements (Continued)*

SFAS 157 for one year for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. Accordingly, the Company will defer the adoption of SFAS 157-2 until January 2009. The provisions of SFAS 157 apply to assets and liabilities, including investments, loans and transfers (including sales and securitizations) of financial assets, derivatives, financial liabilities, and other various financial assets and liabilities. The adoption of SFAS 157 did not have a material impact on the Company's financial position, results of operations or liquidity. The adoption of SFAS 157-2 is not expected to have a material impact on the Company's financial position, results of operations or liquidity.

In October 2008, the FASB issued FASB Staff Position SFAS No. 157-3 (SFAS 157-3), Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active, which clarifies the application of SFAS 157 and provides key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. SFAS 157-3 is effective upon issuance and did not have a material impact on the Company's financial position, results of operations or liquidity.

SFAS 157 defines fair value 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. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard 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.

The Company's financial assets and liabilities measured at fair value on a recurring basis are summarized below (in thousands):

| | September 30, 2008 | | | Assets/liabilities at fair value |
|-------------------------------------|--------------------|------------|---------|-------------------------------------|
| | Level 1 | Level 2 | Level 3 | |
| Assets: | | | | |
| Available-for-sale securities | \$ 32,091 | \$ 108,178 | \$ | \$ 140,269 |
| Deposits held in money market funds | 3,604 | | | 3,604 |
| | \$ 35,695 | \$ 108,178 | \$ | \$ 143,873 |

| | | | | |
|-------------|----|----|----|----|
| Liabilities | \$ | \$ | \$ | \$ |
|-------------|----|----|----|----|

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 1 BASIS OF PRESENTATION (Continued)***Impact of recent accounting pronouncements (Continued)*

The Company's available-for-sale securities are held by its wholly owned limited purpose insurance subsidiary and are comprised of money market funds, asset backed securities, corporate bonds, commercial paper, equities and U.S. Treasury notes. These available-for-sale securities and the insurance subsidiary's cash and cash equivalents of \$101.0 million, classified as insurance subsidiary investments, are maintained for the payment of claims and expenses related to professional liability and workers compensation risks.

The fair value of actively traded debt and equity securities and money market funds are based upon quoted market prices and are generally classified as Level 1. The fair value of inactively traded debt securities are 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 are generally classified as Level 2.

Comprehensive income (loss)

The following table sets forth the computation of comprehensive income (loss) (in thousands):

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|------------|------------------------------------|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| Net income (loss) | \$ (21,260) | \$ (9,062) | \$ 15,091 | \$ (63,162) |
| Net unrealized investment gains (losses), net of income taxes | (1,269) | 716 | (3,037) | 1,177 |
| Comprehensive income (loss) | \$ (22,529) | \$ (8,346) | \$ 12,054 | \$ (61,985) |

Other information

The accompanying unaudited condensed consolidated financial statements are 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 generally accepted accounting principles 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, 2007 filed with the Securities and Exchange Commission (the "SEC") on Form 10-K. The accompanying condensed consolidated balance sheet at December 31, 2007 was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles.

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 presentation 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 generally accepted accounting principles 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. These changes did not have any impact on the Company's financial position, results of operations or liquidity.

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 2 SPIN-OFF TRANSACTION**

On July 31, 2007, the Company completed the spin-off of its former institutional pharmacy business, Kindred Pharmacy Services, Inc. (KPS), and the immediate subsequent combination of KPS with the former institutional pharmacy business of AmerisourceBergen Corporation to form a new, independent, publicly traded company named PharMerica Corporation (PharMerica) (the Spin-off Transaction).

For accounting purposes, the assets and liabilities of KPS were eliminated from the balance sheet of the Company effective at the close of business on July 31, 2007, and beginning August 1, 2007, the operating results of KPS are no longer included in the operating results of the Company. In accordance with SFAS No. 144 (SFAS 144), Accounting for the Impairment or Disposal of Long-Lived Assets, the historical operating results of KPS were not reported as a discontinued operation of the Company because of the significance of the expected continuing cash flows between PharMerica and the Company under pharmacy services contracts for services to be provided by PharMerica to the Company's hospitals and nursing centers. Accordingly, for periods prior to August 1, 2007, the historical operating results of KPS are included in the historical continuing operations of the Company.

In addition to the pharmacy services contracts noted above, the Company also entered into new agreements with PharMerica for information systems services, transition services and certain tax matters. The Company recorded \$4.3 million and \$3.2 million in other income in the third quarter of 2008 and 2007, respectively, and \$14.2 million and \$3.2 million for the nine months ended September 30, 2008 and 2007, respectively, related to the information systems and transition services agreements.

A summary of the net assets of KPS which were transferred to PharMerica in the Spin-off Transaction follows (in thousands):

| | | |
|-----------------------------|------------|------------|
| Assets: | | |
| Current assets | \$ 140,934 | |
| Property and equipment, net | 24,008 | |
| Goodwill | 45,819 | |
| Intangible assets, net | 35,655 | |
| Other long-term assets | 19,370 | \$ 265,786 |
| Liabilities: | | |
| Current liabilities | \$ 56,024 | |
| Long-term debt | 125,000 | |
| Other long-term liabilities | 4,542 | 185,566 |
| | | \$ 80,220 |

The net assets transferred by the Company were recorded as a reduction to retained earnings during the third quarter of 2007.

NOTE 3 DISCONTINUED OPERATIONS

In accordance with SFAS 144, the divestiture of unprofitable businesses discussed in Note 1 have been accounted for as discontinued operations. Accordingly, the results of operations of these businesses for all periods presented and the gains, losses or impairments related to these divestitures have been classified as discontinued operations, net of income taxes, in the accompanying unaudited condensed consolidated statement of operations.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 3 DISCONTINUED OPERATIONS (Continued)

In September 2008, the Company purchased for resale a LTAC hospital in Massachusetts for \$22.3 million that was previously leased. The Company recorded a pretax loss of \$35.9 million (\$22.1 million net of income taxes) in the third quarter resulting from the losses related to the purchase, closure and planned divestiture of the hospital, including the impairment of a certificate of need intangible asset (\$15.2 million), the impairment of property and equipment (\$16.3 million) and other costs (\$4.4 million). The impairments were a result of the Company's decision to acquire the real estate for resale, close the hospital and relinquish the licensed beds to the Commonwealth of Massachusetts.

In September 2008, the Company also announced it intends to dispose of a LTAC hospital in California and its related operations. The hospital operations have been closed but the Company continues to operate a co-located 64-bed skilled nursing unit. The Company recorded a pretax loss of \$5.1 million (\$3.1 million net of income taxes) in the second quarter of 2008 related to the impairment of the hospital's building and equipment. The impairment of the building and equipment was a result of the Company's voluntary termination of its participation in the Medicare program.

At September 30, 2008, the Company held for sale two LTAC hospitals. The Company expects to dispose of these two hospitals within one year and to generate approximately \$11 million in proceeds from the sales.

The Company also discontinued the operations of a hospital in the third quarter of 2008 after terminating the hospital operating lease and closing the operations.

In June 2007, the Company purchased for resale 21 nursing centers and one LTAC hospital (collectively, the Facilities) previously leased from Ventas, Inc. (Ventas) for \$171.5 million (the Facility Acquisitions). In addition, the Company paid Ventas a lease termination fee of \$3.5 million.

The Company recorded a pretax gain of \$9.5 million (\$5.9 million net of income taxes) during the nine months ended September 30, 2008 and a pretax loss of \$112.7 million (\$69.3 million net of income taxes) during the nine months ended September 30, 2007 related to the sale of the Facilities. As of September 30, 2008, the Company had sold all of the Facilities for approximately \$95 million.

In January 2007, the Company acquired from Health Care Property Investors, Inc. (HCP) the real estate related to 11 unprofitable leased nursing centers operated by the Company for resale in exchange for the real estate related to three hospitals previously owned by the Company (the HCP Transaction). As part of the HCP Transaction, the Company continues to operate the hospitals under a long-term lease arrangement with HCP. In addition, the Company paid HCP a one-time cash payment of approximately \$36 million. The Company also amended its existing master lease with HCP to (1) terminate the current annual rent of approximately \$9.9 million on the 11 nursing centers, (2) add the three hospitals to the master lease with current annual rent payments of approximately \$6.3 million and (3) extend the initial expiration date of the master lease until January 31, 2017 except for one hospital which has an expiration date of January 31, 2022. During the nine months ended September 30, 2007, the Company sold all of the nursing centers acquired in the HCP Transaction and received proceeds of \$77.9 million. In addition, the Company terminated a nursing center lease with another landlord during the nine months ended September 30, 2007. The Company recorded a pretax loss related to these divestitures of \$13.4 million (\$8.2 million net of income taxes) during the nine months ended September 30, 2007.

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 3 DISCONTINUED OPERATIONS (Continued)**

A summary of discontinued operations follows (in thousands):

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|------------|------------------------------------|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| Revenues | \$ 7,175 | \$ 49,852 | \$ 42,240 | \$ 163,702 |
| Salaries, wages and benefits | 4,364 | 29,368 | 26,965 | 92,892 |
| Supplies | 824 | 3,633 | 4,186 | 11,613 |
| Rent | 717 | 1,007 | 2,746 | 9,041 |
| Other operating expenses | 1,068 | 17,652 | 11,827 | 56,790 |
| Depreciation | 163 | 338 | 852 | 3,510 |
| Interest expense | | 1 | 2 | 5 |
| Investment expense (income) | 19 | (17) | (8) | (29) |
| | 7,155 | 51,982 | 46,570 | 173,822 |
| Income (loss) from operations before income taxes | 20 | (2,130) | (4,330) | (10,120) |
| Income tax provision (benefit) | 8 | (821) | (1,667) | (3,896) |
| Income (loss) from operations | 12 | (1,309) | (2,663) | (6,224) |
| Loss on divestiture of operations, net of income taxes | (22,058) | | (19,346) | (76,968) |
| | \$ (22,046) | \$ (1,309) | \$ (22,009) | \$ (83,192) |

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---------------------------------|-------------------------------------|-----------|------------------------------------|------------|
| | 2008 | 2007 | 2008 | 2007 |
| Revenues: | | | | |
| Hospital division | \$ 6,727 | \$ 14,609 | \$ 32,799 | \$ 46,607 |
| Health services division | 448 | 35,243 | 9,441 | 117,095 |
| | \$ 7,175 | \$ 49,852 | \$ 42,240 | \$ 163,702 |
| Operating income (loss): | | | | |
| Hospital division | \$ (672) | \$ (381) | \$ (3,775) | \$ 1,122 |
| Health services division | 1,591 | (420) | 3,037 | 1,285 |
| | \$ 919 | \$ (801) | \$ (738) | \$ 2,407 |

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Rent:

| | | | | |
|--------------------------|--------|----------|----------|----------|
| Hospital division | \$ 714 | \$ 940 | \$ 2,723 | \$ 3,404 |
| Health services division | 3 | 67 | 23 | 5,637 |
| | \$ 717 | \$ 1,007 | \$ 2,746 | \$ 9,041 |

Depreciation:

| | | | | |
|--------------------------|--------|--------|--------|----------|
| Hospital division | \$ 163 | \$ 338 | \$ 852 | \$ 1,195 |
| Health services division | | | | 2,315 |
| | \$ 163 | \$ 338 | \$ 852 | \$ 3,510 |

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 3 DISCONTINUED OPERATIONS (Continued)**

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

| | September 30, 2008 | December 31, 2007 |
|---|-----------------------|----------------------|
| Long-term assets: | | |
| Property and equipment, net | \$ 11,056 | \$ 15,595 |
| Other | 66 | 242 |
| | 11,122 | 15,837 |
| Current liabilities (included in other accrued liabilities) | (126) | (717) |
| | \$ 10,996 | \$ 15,120 |

NOTE 4 SIGNIFICANT QUARTERLY ADJUSTMENTS

Operating results for the third quarter of 2008 included a \$0.9 million pretax other-than-temporary impairment of an investment in a failed financial institution held in the Company's insurance subsidiary investment portfolio that reduced investment income in the accompanying unaudited condensed consolidated statement of operations. In addition, the provision for income taxes included a favorable adjustment of approximately \$1.8 million related to the resolution of certain income tax contingencies for prior years.

Operating results for the nine months ended September 30, 2008 also included pretax income of \$10.3 million related to the favorable settlement of a prior year nursing center Medicaid cost report dispute and a pretax charge of \$1.9 million related to a prior period rent escalator adjustment for ten leased facilities which the Company does not believe is material to the financial statements for the current or prior periods.

Operating results for the third quarter of 2007 included a non-cash pretax charge of \$17.7 million for compensation costs resulting from the Spin-off Transaction (primarily related to the revaluation of stock options adjusted in the Spin-off Transaction and the vesting of certain stock-based and other compensation), a pretax charge of \$3.9 million for professional fees and other costs incurred in connection with the Spin-off Transaction and a pretax charge of \$0.9 million for employee severance costs. In addition, the provision for income taxes included a net charge of \$2.2 million related to income tax items associated with the Spin-off Transaction and the favorable resolution of certain income tax contingencies for prior years.

Operating results for the nine months ended September 30, 2007 included a pretax charge of \$10.8 million for professional fees and other costs incurred in connection with the Spin-off Transaction and a pretax charge of \$4.3 million for employee severance costs. The Company also recorded a pretax charge of \$4.6 million related to an unfavorable judgment rendered in connection with a civil dispute with a hospital vendor. In addition, operating results for the nine months ended September 30, 2007 included pretax income of \$5.5 million related to a favorable settlement of a rehabilitation therapy contract dispute from prior years.

NOTE 5 ACQUISITION

In July 2007, the Company acquired a combined nursing center and assisted living facility for \$20.3 million. Goodwill and identifiable intangible assets recorded in connection with the acquisition aggregated \$0.9 million.

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 6 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 and other third party payors.

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---------------------|-------------------------------------|------------|------------------------------------|--------------|
| | 2008 | 2007 | 2008 | 2007 |
| Medicare | \$ 411,737 | \$ 426,754 | \$ 1,317,951 | \$ 1,435,191 |
| Medicaid | 280,526 | 273,020 | 822,249 | 818,738 |
| Other third parties | 385,044 | 370,968 | 1,162,155 | 1,189,076 |
| | 1,077,307 | 1,070,742 | 3,302,355 | 3,443,005 |
| Eliminations: | | | | |
| Rehabilitation | (66,627) | (59,011) | (201,241) | (175,478) |
| Pharmacy | | (12,313) | | (84,283) |
| | (66,627) | (71,324) | (201,241) | (259,761) |
| | \$ 1,010,680 | \$ 999,418 | \$ 3,101,114 | \$ 3,183,244 |

NOTE 7 EARNINGS (LOSS) PER SHARE

Earnings (loss) per common share are based upon the weighted average number of common shares outstanding during the respective periods. The diluted calculation of earnings (loss) per common share includes the dilutive effect of stock options and non-vested restricted stock.

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|------------|------------------------------------|-------------|
| | 2008 | 2007 | 2008 | 2007 |
| Earnings (loss): | | | | |
| Income (loss) from continuing operations | \$ 786 | \$ (7,753) | \$ 37,100 | \$ 20,030 |
| Discontinued operations, net of income taxes: | | | | |
| Income (loss) from operations | 12 | (1,309) | (2,663) | (6,224) |
| Loss on divestiture of operations | (22,058) | | (19,346) | (76,968) |
| Net income (loss) | \$ (21,260) | \$ (9,062) | \$ 15,091 | \$ (63,162) |
| Shares used in the computation: | | | | |
| Weighted average shares outstanding basic computation | 38,034 | 39,013 | 37,732 | 39,271 |

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| | | | | | |
|--|---------------------|--------|--------|--------|--------|
| Dilutive effect of certain securities: | | | | | |
| Employee stock options | | 860 | 753 | 844 | |
| Non-vested restricted stock | | 475 | 509 | 407 | |
| Adjusted weighted average shares outstanding | diluted computation | 39,369 | 39,013 | 38,994 | 40,522 |

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 7 EARNINGS (LOSS) PER SHARE (Continued)**

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|-----------|------------------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| Earnings (loss) per common share: | | | | |
| Basic: | | | | |
| Income (loss) from continuing operations | \$ 0.02 | \$ (0.20) | \$ 0.98 | \$ 0.51 |
| Discontinued operations: | | | | |
| Income (loss) from operations | | (0.03) | (0.07) | (0.16) |
| Loss on divestiture of operations | (0.58) | | (0.51) | (1.96) |
| Net income (loss) | \$ (0.56) | \$ (0.23) | \$ 0.40 | \$ (1.61) |
| Diluted: | | | | |
| Income (loss) from continuing operations | \$ 0.02 | \$ (0.20) | \$ 0.95 | \$ 0.49 |
| Discontinued operations: | | | | |
| Income (loss) from operations | | (0.03) | (0.07) | (0.15) |
| Loss on divestiture of operations | (0.56) | | (0.49) | (1.90) |
| Net income (loss) | \$ (0.54) | \$ (0.23) | \$ 0.39 | \$ (1.56) |

Number of antidilutive stock options and non-vested restricted stock excluded from shares used in the diluted earnings (loss) per share computation

| | | | | |
|--|-----|-------|-----|-----|
| | 317 | 2,611 | 403 | 128 |
|--|-----|-------|-----|-----|

As a result of the loss from continuing operations reported by the Company in the third quarter of 2007, approximately 880,000 incremental shares have been excluded from the calculation of diluted earnings (loss) per share because the inclusion of such shares would have been antidilutive.

NOTE 8 BUSINESS SEGMENT DATA

At September 30, 2008, the Company operated three business segments: the hospital division, the health services division and the rehabilitation division. The hospital division operates LTAC hospitals. The health services division operates nursing centers. The rehabilitation division provides rehabilitation services primarily in long-term care settings. For segment purposes, the Company defines operating income as earnings before interest, income taxes, depreciation, amortization and rent. Operating income reported for each of the Company's business segments excludes the allocation of corporate overhead.

Beginning January 1, 2008, certain incentive compensation costs were charged to the operating divisions that had previously been classified as corporate overhead. These charges approximated \$0.7 million for the hospital division, \$0.5 million for the health services division and \$0.2 million for the rehabilitation division in the third quarter of 2008 and approximated \$4.0 million for the hospital division, \$3.2 million for the health services division and \$0.9 million for the rehabilitation division for the nine months ended September 30, 2008. Segment operating results for prior periods were not restated to reflect this reclassification.

The Spin-off Transaction was completed on July 31, 2007. As a result, the Company's consolidated operating results for the third quarter of 2007 and for the nine months ended September 30, 2007 included the results of the Company's former pharmacy division. For accounting purposes, the pharmacy division was not treated as a discontinued operation in the Company's historical consolidated financial statements. See Note 2.

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 8 BUSINESS SEGMENT DATA (Continued)**

The Company identifies its segments in accordance with the aggregation provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. This information is consistent with information used by the Company in managing its businesses and aggregates businesses with similar economic characteristics.

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

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|------------|------------------------------------|--------------|
| | 2008 | 2007 | 2008 | 2007 |
| Revenues: | | | | |
| Hospital division | \$ 434,774 | \$ 416,267 | \$ 1,372,005 | \$ 1,289,341 |
| Health services division | 535,737 | 508,191 | 1,612,737 | 1,490,225 |
| Rehabilitation division | 106,796 | 88,284 | 317,613 | 257,328 |
| Pharmacy division | | 58,000 | | 406,111 |
| | 1,077,307 | 1,070,742 | 3,302,355 | 3,443,005 |
| Eliminations: | | | | |
| Rehabilitation | (66,627) | (59,011) | (201,241) | (175,478) |
| Pharmacy | | (12,313) | | (84,283) |
| | (66,627) | (71,324) | (201,241) | (259,761) |
| | \$ 1,010,680 | \$ 999,418 | \$ 3,101,114 | \$ 3,183,244 |
| Income (loss) from continuing operations: | | | | |
| Operating income (loss): | | | | |
| Hospital division | \$ 64,818 | \$ 83,433 | \$ 247,506 | \$ 268,906 |
| Health services division | 78,801 | 75,166 | 243,447 | 208,788 |
| Rehabilitation division | 7,448 | 8,309 | 29,112 | 27,450 |
| Pharmacy division | | 431 | | 17,557 |
| Corporate: | | | | |
| Overhead | (30,937) | (54,954) | (99,068) | (131,254) |
| Insurance subsidiary | (1,775) | (1,856) | (4,625) | (5,031) |
| | (32,712) | (56,810) | (103,693) | (136,285) |
| Operating income | 118,355 | 110,529 | 416,372 | 386,416 |
| Rent | (86,444) | (87,152) | (259,048) | (258,149) |
| Depreciation and amortization | (29,432) | (30,578) | (91,417) | (88,509) |
| Interest, net | (3,038) | (1,244) | (5,281) | (92) |
| Income (loss) from continuing operations before income taxes | (559) | (8,445) | 60,626 | 39,666 |

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| | | | | |
|--------------------------------------|---------|------------|-----------|-----------|
| Provision (benefit) for income taxes | (1,345) | (692) | 23,526 | 19,636 |
| | \$ 786 | \$ (7,753) | \$ 37,100 | \$ 20,030 |

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 8 BUSINESS SEGMENT DATA (Continued)**

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|--------------|------------------------------------|--------------|
| | 2008 | 2007 | 2008 | 2007 |
| Rent: | | | | |
| Hospital division | \$ 36,461 | \$ 35,068 | \$ 110,118 | \$ 103,897 |
| Health services division | 48,551 | 50,078 | 144,609 | 146,302 |
| Rehabilitation division | 1,405 | 1,180 | 4,156 | 3,382 |
| Pharmacy division | | 740 | | 4,325 |
| Corporate | 27 | 86 | 165 | 243 |
| | \$ 86,444 | \$ 87,152 | \$ 259,048 | \$ 258,149 |
| Depreciation and amortization: | | | | |
| Hospital division | \$ 11,719 | \$ 10,818 | \$ 34,477 | \$ 29,269 |
| Health services division | 11,794 | 13,284 | 39,860 | 36,090 |
| Rehabilitation division | 547 | 284 | 1,419 | 793 |
| Pharmacy division | | 934 | | 6,510 |
| Corporate | 5,372 | 5,258 | 15,661 | 15,847 |
| | \$ 29,432 | \$ 30,578 | \$ 91,417 | \$ 88,509 |
| Capital expenditures, excluding acquisitions (including discontinued operations): | | | | |
| Hospital division | \$ 19,736 | \$ 23,505 | \$ 53,314 | \$ 70,179 |
| Health services division | 19,746 | 13,908 | 37,625 | 31,064 |
| Rehabilitation division | 271 | 385 | 833 | 756 |
| Pharmacy division | | 790 | | 4,115 |
| Corporate: | | | | |
| Information systems | 7,051 | 4,668 | 19,499 | 14,890 |
| Other | 489 | 11,000 | 882 | 12,008 |
| | \$ 47,293 | \$ 54,256 | \$ 112,153 | \$ 133,012 |
| Assets at end of period: | | | | |
| Hospital division | | \$ 903,731 | | \$ 846,429 |
| Health services division | | 596,768 | | 550,525 |
| Rehabilitation division | | 42,842 | | 30,751 |
| Corporate | | 595,064 | | 651,847 |
| | | \$ 2,138,405 | | \$ 2,079,552 |
| Goodwill: | | | | |
| Hospital division | | \$ 68,577 | | \$ 67,598 |

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| | | |
|--------------------------|-----------|-----------|
| Health services division | 639 | 639 |
| Rehabilitation division | 2,028 | 863 |
| | \$ 71,244 | \$ 69,100 |

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 9 INSURANCE RISKS**

The Company insures a substantial portion of its professional liability risks and workers compensation risks through a wholly owned limited purpose insurance subsidiary. Provisions for loss for these risks are based upon management's best available information including actuarially determined estimates.

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 liabilities 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 subsequent 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 September 30, | | Nine months ended September 30, | |
|-------------------------|-------------------------------------|----------|------------------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| Professional liability: | | | | |
| Continuing operations | \$ 4,824 | \$ 7,519 | \$ 31,612 | \$ 38,173 |
| Discontinued operations | (1,378) | 3,798 | (3,633) | 10,429 |
| Workers compensation: | | | | |
| Continuing operations | \$ 7,408 | \$ 8,846 | \$ 24,237 | \$ 29,994 |
| Discontinued operations | 47 | 671 | 467 | 2,166 |

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

| | September 30, 2008 | | | December 31, 2007 | | |
|----------------------------------|------------------------|----------------------|------------|------------------------|----------------------|------------|
| | Professional liability | Workers compensation | Total | Professional liability | Workers compensation | Total |
| Assets: | | | | | | |
| Current: | | | | | | |
| Insurance subsidiary investments | \$ 108,901 | \$ 85,010 | \$ 193,911 | \$ 127,017 | \$ 104,676 | \$ 231,693 |
| Reinsurance recoverables | 2,160 | | 2,160 | 4,334 | | 4,334 |
| | 111,061 | 85,010 | 196,071 | 131,351 | 104,676 | 236,027 |
| Non-current: | | | | | | |
| Insurance subsidiary investments | 47,409 | | 47,409 | 49,166 | | 49,166 |
| Reinsurance recoverables | 12,075 | | 12,075 | 4,530 | | 4,530 |
| Deposits | 2,000 | 1,463 | 3,463 | 6,250 | 1,455 | 7,705 |
| Other | | 144 | 144 | | 261 | 261 |
| | 61,484 | 1,607 | 63,091 | 59,946 | 1,716 | 61,662 |

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\$ 172,545 \$ 86,617 \$ 259,162 \$ 191,297 \$ 106,392 \$ 297,689

Liabilities:

Allowance for insurance risks:

| | | | | | | |
|-------------|------------|-----------|------------|------------|-----------|------------|
| Current | \$ 59,218 | \$ 24,405 | \$ 83,623 | \$ 64,740 | \$ 26,144 | \$ 90,884 |
| Non-current | 195,533 | 62,182 | 257,715 | 186,652 | 63,132 | 249,784 |
| | \$ 254,751 | \$ 86,587 | \$ 341,338 | \$ 251,392 | \$ 89,276 | \$ 340,668 |

Table of Contents**KINDRED HEALTHCARE, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****NOTE 9 INSURANCE RISKS (Continued)**

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 5% in each period presented. 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 \$265.7 million at September 30, 2008 and \$263.8 million at December 31, 2007.

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 10 INSURANCE SUBSIDIARY INVESTMENTS

The Company maintains investments, consisting principally of cash and cash equivalents, asset backed securities, corporate bonds, commercial paper, equities and U.S. Treasury notes 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.

The amortized cost and estimated fair value of the Company's insurance subsidiary investments at September 30, 2008 and December 31, 2007 follow (in thousands):

| | September 30, 2008 | | | | December 31, 2007 | | | |
|-------------------------------|--------------------|------------------|-------------------|------------|-------------------|------------------|-------------------|------------|
| | Amortized cost | Unrealized gains | Unrealized losses | Fair value | Amortized cost | Unrealized gains | Unrealized losses | Fair value |
| Cash and cash equivalents (a) | \$ 109,113 | \$ | \$ | \$ 109,113 | \$ 149,212 | \$ | \$ | \$ 149,212 |
| Asset backed securities | 58,500 | 262 | (308) | 58,454 | 52,098 | 444 | (33) | 52,509 |
| Corporate bonds | 35,095 | 101 | (1,273) | 33,923 | 35,824 | 126 | (215) | 35,735 |
| Commercial paper | 15,828 | | (27) | 15,801 | 20,912 | 15 | | 20,927 |
| Equities | 14,468 | 1,005 | (2,289) | 13,184 | 14,498 | 2,278 | (886) | 15,890 |
| U.S. Treasury notes | 10,813 | 38 | (6) | 10,845 | 6,141 | 445 | | 6,586 |
| | \$ 243,817 | \$ 1,406 | \$ (3,903) | \$ 241,320 | \$ 278,685 | \$ 3,308 | \$ (1,134) | \$ 280,859 |

(a) Includes \$8.1 million and \$9.3 million of money market funds at September 30, 2008 and December 31, 2007, respectively. 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 September 30, 2008 and recognized a \$0.9 million pretax other-than-temporary impairment of an investment in a failed financial institution held in the Company's insurance subsidiary investment portfolio. Because the Company considers the remaining unrealized losses at September 30, 2008 to be temporary, the Company has not

recorded any additional impairment losses related to these securities.

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 11 INCOME TAXES

During the third quarter of 2008, the Company reduced its unrecognized tax benefits and related accrued interest by \$2.8 million. The deferred tax asset associated with unrecognized tax benefits also was reduced by \$1.0 million. As of September 30, 2008, the Company's unrecognized tax benefits totaled \$7.0 million and accrued interest related to uncertain tax positions totaled \$0.8 million.

The federal statute of limitations remains open for tax years 2005 through 2007.

State jurisdictions generally have statutes of limitations ranging from three to five years. The state impact of federal income tax changes remains subject to examination by various states for a period up to one year after formal notification to the states. Currently, the Company has various state income tax returns under examination.

Within the next 12 months, the statutes of limitations associated with certain state tax filing positions will expire and may decrease the amount of unrecognized income tax benefits. A reduction of the Company's income tax liability of up to approximately \$2.0 million for unrecognized income tax benefits and up to \$0.8 million of accrued interest is reasonably possible and would favorably impact the Company's financial position and results of operations.

NOTE 12 CONTINGENCIES

Management continually evaluates contingencies based upon the best available information. In addition, allowances for loss are provided currently for disputed items that have continuing significance, such as certain third party reimbursements and deductions that continue to be claims 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.

Professional liability risks The Company has provided for loss 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 9.

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. In addition, the Company is a party to a tax matters agreement with PharMerica which sets forth the Company's rights and obligations related to taxes for periods before and after the Spin-off Transaction.

Litigation The Company is a party to various legal actions (some of which are not insured), and regulatory and other government investigations and sanctions in the ordinary course of business. The Company is unable to predict the ultimate outcome of pending litigation and regulatory and other government 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 which may, either individually or in the aggregate, have a material adverse effect on the Company's financial position, results of operations and liquidity.

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

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KINDRED HEALTHCARE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 12 CONTINGENCIES (Continued)

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.

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

Cautionary Statement

This Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). All statements regarding the Company's expected future financial position, results of operations, cash flows, financing plans, business strategy, budgets, capital expenditures, competitive positions, growth opportunities, plans and objectives of management and statements containing the words such as anticipate, approximate, believe, plan, estimate, expect, project, could, should, will, intend, may and other similar expressions, are forward-looking statements.

Such forward-looking statements are inherently uncertain, and stockholders and other potential investors must recognize that actual results may differ materially from the Company's expectations as a result of a variety of factors, including, without limitation, those discussed below. Such forward-looking statements are based upon management's current expectations and include known and unknown risks, uncertainties and other factors, many of which the Company is unable to predict or control, that may cause the Company's actual results or performance to differ materially from any future results or performance expressed or implied by such forward-looking statements. These statements involve risks, uncertainties and other factors discussed below and detailed from time to time in the Company's filings with the SEC. Factors that may affect the Company's plans or results include, without limitation:

changes in the reimbursement rates or the methods or timing of payment from third party payors, including the Medicare and Medicaid programs, changes arising from and related to the Medicare prospective payment system for LTAC hospitals (LTAC PPS), including potential changes in the Medicare payment rules, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, and changes in Medicare and Medicaid reimbursements for the Company's nursing centers,

the impact of the Medicare, Medicaid and SCHIP Extension Act of 2007 (the SCHIP Extension Act), including the ability of the Company's hospitals to adjust to potential LTAC certification and the three-year moratorium on future hospital development,

the Company's ability to operate pursuant to the terms of its debt obligations and its master leases with Ventas,

the Company's ability to meet its rental and debt service obligations,

the Company's ability to attract and retain key executives and other healthcare personnel,

increased operating costs due to shortages in qualified nurses, therapists and other healthcare personnel,

the effects of healthcare reform and government regulations, interpretation of regulations and changes in the nature and enforcement of regulations governing the healthcare industry,

failure of the Company's facilities to meet applicable licensure and certification requirements,

national and regional economic, financial, business and political conditions, including their effect on the availability and cost of labor, credit, materials and other services,

the Company's ability to control costs, particularly labor and employee benefit costs,

the Company's ability to successfully pursue its development activities and successfully integrate new operations, including the realization of anticipated revenues, economies of scale, cost savings and productivity gains associated with such operations,

the increase in the costs of defending and insuring against alleged professional liability claims and the Company's ability to predict the estimated costs related to such claims, including the impact of differences in actuarial assumptions and estimates compared to eventual outcomes,

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

Cautionary Statement (Continued)

the Company's ability to successfully reduce (by divestiture of operations or otherwise) its exposure to professional liability claims,

the further consolidation of managed care organizations and other third party payors,

the Company's ability to successfully dispose of unprofitable facilities,

events or circumstances which could result in impairment of an asset or other charges,

changes in generally accepted accounting principles or practices,

the condition of the financial markets, including volatility and deterioration in the capital and credit markets, which would limit the availability and terms of debt and equity financing sources to fund the requirements of the Company's businesses, or which could negatively impact the Company's investment portfolio, and

the Company's ability to maintain an effective system of internal controls over financial reporting.

Many of these factors are beyond the Company's control. The Company cautions investors that any forward-looking statements made by the Company are not guarantees of future performance. The Company disclaims any obligation to update any such factors or to announce publicly the results of any revisions to any of the forward-looking statements to reflect future events or developments.

General

The accompanying unaudited condensed consolidated financial statements, including the notes thereto, should be read in conjunction with the following discussion and analysis.

The Company is a healthcare services company that through its subsidiaries operates hospitals, nursing centers and a contract rehabilitation services business across the United States. At September 30, 2008, the Company's hospital division operated 82 LTAC hospitals (6,428 licensed beds) in 24 states. The Company's health services division operated 228 nursing centers (28,695 licensed beds) in 27 states. The Company also operated a contract rehabilitation services business which provides rehabilitative services primarily in long-term care settings.

On July 31, 2007, the Company completed the Spin-off Transaction. See Note 2 of the accompanying Notes to Condensed Consolidated Financial Statements.

In recent years, the Company has completed several strategic divestitures 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 have been classified as discontinued operations in the accompanying unaudited condensed consolidated statement of operations for all periods presented. Assets not sold at September 30, 2008 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.

Critical Accounting Policies

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Management's discussion and analysis of financial condition and results of operations are based upon the Company's consolidated financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that affect the reported amounts and related disclosures of commitments and contingencies. The Company relies on historical experience and on various other assumptions that management

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

Critical Accounting Policies (Continued)

believes to be reasonable under the circumstances to make judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates.

The Company believes the following critical accounting policies, among others, affect the more significant judgments and estimates used in the preparation of its consolidated financial statements.

Revenue recognition

The Company has agreements with third party payors that provide for payments to each of its operating divisions. These payment arrangements may be based upon prospective rates, reimbursable costs, established charges, discounted charges or per diem payments. Net patient service revenue is recorded at the estimated net realizable amounts from Medicare, Medicaid, other third party payors and individual patients for services rendered. Retroactive adjustments that are likely to result from future examinations by third party payors are accrued on an estimated basis in the period the related services are rendered and adjusted as necessary in future periods based upon new information or final settlements.

Operating results for the nine months ended September 30, 2008 included pretax income of approximately \$10 million related to the favorable settlement of a prior year nursing center Medicaid cost report dispute.

Collectibility of accounts receivable

Accounts receivable consist primarily of amounts due from the Medicare and Medicaid programs, other government programs, managed care health plans, commercial insurance companies and individual patients and customers. Estimated provisions for doubtful accounts are recorded to the extent it is probable that a portion or all of a particular account will not be collected.

In evaluating the collectibility of accounts receivable, the Company considers a number of factors, including the age of the accounts, changes in collection patterns, the composition of patient accounts by payor type, the status of ongoing disputes with third party payors and general industry conditions. Actual collections of accounts receivable in subsequent periods may require changes in the estimated provision for loss. Changes in these estimates are charged or credited to the results of operations in the period of the change.

The provision for doubtful accounts totaled \$7 million and \$6 million for the third quarter of 2008 and 2007, respectively, and \$21 million for each of the nine months ended September 30, 2008 and 2007.

Allowances for insurance risks

The Company insures a substantial portion of its professional liability risks and workers compensation risks through a wholly owned limited purpose insurance subsidiary. Provisions for loss for these risks are based upon management's best available information including actuarially determined estimates.

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 liabilities 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 subsequent expected ultimate claims costs vary from historical provisions for loss, future earnings will be charged or credited.

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

Critical Accounting Policies (Continued)

Allowances for insurance risks (Continued)

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 5% in each period presented. 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. The allowance for professional liability risks aggregated \$255 million at September 30, 2008 and \$251 million at December 31, 2007. If the Company did not discount any of the allowances for professional liability risks, these balances would have approximated \$266 million at September 30, 2008 and \$264 million at December 31, 2007.

As a result of improved professional liability underwriting results of the Company's limited purpose insurance subsidiary, the Company received distributions of approximately \$39 million and \$37 million during the nine months ended September 30, 2008 and 2007, respectively, from its limited purpose insurance subsidiary. These proceeds were used to repay borrowings under the Company's revolving credit facility.

Changes in the number of professional liability claims and the cost to settle these claims significantly impact the allowance for professional liability risks. A relatively small variance between the Company's estimated and actual number of claims or average cost per claim could have a material impact, either favorable or unfavorable, on the adequacy of the allowance for professional liability risks. For example, a 1% variance in the allowance for professional liability risks at September 30, 2008 would impact the Company's operating income by approximately \$3 million.

The provision for professional liability risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated \$5 million and \$7 million for the third quarter of 2008 and 2007, respectively, and \$32 million and \$38 million for the nine months ended September 30, 2008 and 2007, respectively.

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. The allowance for workers compensation risks aggregated \$87 million at September 30, 2008 and \$89 million at December 31, 2007. The provision for workers compensation risks (continuing operations), including the cost of coverage maintained with unaffiliated commercial insurance carriers, aggregated \$7 million and \$9 million for the third quarter of 2008 and 2007, respectively, and \$24 million and \$30 million for the nine months ended September 30, 2008 and 2007, respectively.

Accounting for income taxes

The provision for income taxes is based upon the Company's estimate of annual taxable income or loss for each respective accounting period. The Company recognizes an asset or liability for the deferred tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements. These temporary differences will result in taxable or deductible amounts in future years when the reported amounts of the assets are recovered or liabilities are settled. The Company also recognizes as deferred tax assets the future tax benefits from net operating and capital loss carryforwards. A valuation allowance is provided for these deferred tax assets if it is more likely than not that some portion or all of the net deferred tax assets will not be realized.

The Company's effective income tax rate for the third quarter and nine months ended September 30, 2008 was favorably impacted by \$2 million related to the resolution of certain income tax contingencies for prior years.

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

Critical Accounting Policies (Continued)

Accounting for income taxes (Continued)

The effective income tax rate for the third quarter and nine months ended September 30, 2007 was negatively impacted by certain non-deductible expenses associated with the Spin-off Transaction. In addition, during the same periods in 2007, the effective income tax rate was favorably impacted by \$2 million related to the favorable resolution of certain income tax contingencies for prior years.

There are significant uncertainties with respect to capital loss and net operating loss carryforwards that could affect materially the realization of certain deferred tax assets. Accordingly, the Company has recognized deferred tax assets to the extent it is more likely than not they will be realized and a valuation allowance is provided for deferred tax assets to the extent that it is uncertain that the deferred tax asset will be realized. The Company recognized deferred tax assets totaling \$186 million at September 30, 2008 and \$174 million at December 31, 2007.

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. While the Company believes its tax positions are appropriate, there can be no assurance that the various authorities engaged in the examination of its income tax returns will not challenge the Company's positions.

Valuation of long-lived assets and goodwill

The Company regularly reviews the carrying value of certain long-lived assets and identifiable intangible assets with respect to any events or circumstances that indicate an impairment or an adjustment to the amortization period is necessary. If circumstances suggest the recorded amounts cannot be recovered based upon estimated future cash flows, the carrying values of such assets are reduced to fair value. The Company determines fair value based upon widely accepted valuation techniques, including discounted cash flows and market multiple analyses. These types of analyses require the Company to make assumptions and estimates regarding future cash flows, industry economic factors and the profitability of future business strategies.

In assessing the carrying values of long-lived assets, the Company estimates future cash flows at the lowest level for which there are independent, identifiable cash flows. For this purpose, these cash flows are aggregated based upon the contractual agreements underlying the operation of the facility or group of facilities. Generally, an individual facility is considered the lowest level for which there are independent, identifiable cash flows. However, to the extent that groups of facilities are leased under a master lease agreement in which the operations of a facility and compliance with the lease terms are interdependent upon other facilities in the agreement (including the Company's ability to renew the lease or divest a particular property), the Company defines the group of facilities under a master lease agreement as the lowest level for which there are independent, identifiable cash flows. Accordingly, the estimated cash flows of all facilities within a master lease agreement are aggregated for purposes of evaluating the carrying values of long-lived assets.

In accordance with SFAS No. 142 (SFAS 142), Goodwill and Other Intangible Assets, the Company is required to perform an impairment test for goodwill and indefinite lived intangible assets at least annually or more frequently if adverse events or changes in circumstances indicate that the asset may be impaired. The Company performs its annual impairment test at the end of each year. No impairment charge was recorded at December 31, 2007 in connection with the Company's annual impairment test.

The Company's other intangible assets with finite lives are amortized under SFAS 142 using the straight-line method over their estimated useful lives ranging from one to five years.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(Continued)****Recently Issued Accounting Pronouncements**

In June 2008, the FASB issued EITF 03-6-1, which clarifies that share-based payment awards that entitle the holder to receive nonforfeitable dividends before vesting would be considered participating securities. As participating securities, these instruments should be included in the calculation of basic earnings per common share. The provisions of EITF 03-6-1 will be effective for fiscal years beginning after December 15, 2008. The adoption of EITF 03-6-1 is not expected to have a material impact on the Company's earnings per common share calculation.

In December 2007, the FASB issued SFAS 141R, which significantly changes the accounting for business combinations, including, among other changes, new accounting concepts in determining the fair value of assets and liabilities acquired, recording the fair value of contingent considerations and contingencies at the acquisition date and expensing acquisition and restructuring costs. SFAS 141R will be applied prospectively and is effective for business combinations which occur during fiscal years beginning after December 15, 2008. At this time, the Company cannot determine the impact that SFAS 141R will have on its financial position, results of operations or liquidity.

In December 2007, the FASB issued SFAS 160, which will change the accounting and reporting for minority interests. SFAS 160 will recharacterize minority interests as noncontrolling interests and they will be classified as a component of stockholders' equity. The new consolidation method will significantly change the accounting for transactions with minority-interest holders. SFAS 160 is effective for fiscal years beginning after December 15, 2008. The adoption of SFAS 160 is not expected to have a material impact on the Company's financial position, results of operations or liquidity.

In September 2006, the FASB issued SFAS 157, which addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued SFAS 157-2, which deferred the effective date of SFAS 157 for one year for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. Accordingly, the Company will defer the adoption of SFAS 157-2 until January 2009. The provisions of SFAS 157 apply to assets and liabilities, including investments, loans and transfers (including sales and securitizations) of financial assets, derivatives, financial liabilities, and other various financial assets and liabilities. The adoption of SFAS 157 did not have a material impact on the Company's financial position, results of operations or liquidity. The adoption of SFAS 157-2 is not expected to have a material impact on the Company's financial position, results of operations or liquidity.

In October 2008, the FASB issued SFAS 157-3, which clarifies the application of SFAS 157 and provides key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. SFAS 157-3 is effective upon issuance and did not have a material impact on the Company's financial position, results of operations or liquidity.

Results of Operations – Continuing Operations***Hospital Division***

Revenues increased 4% in the third quarter of 2008 to \$435 million compared to \$416 million in the third quarter of 2007 and increased 6% to \$1.4 billion for the nine months ended September 30, 2008 from \$1.3 billion in the same period in 2007. Revenue growth in both periods was primarily a result of increased same-store admissions, expansion of services and new hospitals recently opened. On a same-store basis, aggregate admissions rose 4% in the third quarter of 2008 and 5% for the nine months ended September 30, 2008 compared to the same periods in 2007, while non-government same-store admissions increased 12% in the third quarter of 2008 and 16% for the nine months ended September 30, 2008 compared to the same periods in 2007.

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

Results of Operations – Continuing Operations (Continued)

Hospital Division (Continued)

Despite growth in admissions and revenues, hospital operating margins declined in the third quarter of 2008 primarily due to declines in length of stay (particularly related to commercial insurance patients), operating cost inefficiencies associated with lower patient days and the negative impact of the Gulf hurricanes. Hospital wage and benefit costs increased 11% to \$210 million in the third quarter of 2008 from \$189 million in the same period in 2007 and increased 10% to \$635 million for the nine months ended September 30, 2008 from \$578 million in the same period in 2007. Average hourly wage rates grew 5% in the third quarter of 2008 and 4% for the nine months ended September 30, 2008 compared to the respective prior year periods, while employee benefit costs increased 9% in the third quarter of 2008 and 8% for the nine months ended September 30, 2008 compared to the respective periods in 2007.

Operating results for the third quarter of 2008 included approximately \$6 million related to direct costs and operating declines compared to the same period in 2007 in the Company's Louisiana and southern Texas hospital operations resulting from the Gulf hurricanes.

Professional liability costs were \$2 million in the third quarter of both 2008 and 2007, and \$11 million and \$12 million for the nine months ended September 30, 2008 and 2007, respectively.

Health Services Division

Revenues increased 5% in the third quarter of 2008 to \$536 million compared to \$508 million in the third quarter of 2007 and increased 8% to \$1.6 billion for the nine months ended September 30, 2008 from \$1.5 billion in the same period in 2007. Revenue growth in both periods was primarily attributable to reimbursement rate increases, growth in managed care volumes, acquired nursing centers and, for the nine months ended September 30, 2008, growth in Medicare volumes. On a same-store basis, aggregate patient days were relatively unchanged in both the third quarter of 2008 and the nine months ended September 30, 2008 compared to the same periods in 2007. For the first nine months of 2008, revenues have been favorably impacted by growth in Medicare, Medicare Advantage and private and other patient volumes.

Operating results for the nine months ended September 30, 2008 also included pretax income of approximately \$10 million related to the favorable settlement of a prior year nursing center Medicaid cost report dispute.

Nursing center operating margins declined slightly in the third quarter of 2008 as a result of lower Medicare volumes. Nursing center operating margins improved for the nine months ended September 30, 2008 primarily due to same-store growth in Medicare, Medicare Advantage and private and other patient volumes, the favorable impact of acquired nursing centers and reductions in professional liability and workers compensation costs. Nursing center wage and benefit costs increased 5% to \$280 million in the third quarter of 2008 compared to \$267 million in the same period in 2007 and increased 6% to \$825 million for the nine months ended September 30, 2008 from \$781 million in the same period in 2007. Average hourly wage rates grew 4% in the third quarter of 2008 and for the nine months ended September 30, 2008 compared to the respective prior year periods, while employee benefit costs increased 5% in the third quarter of 2008 and for the nine months ended September 30, 2008 compared to the respective prior year periods.

Professional liability costs were \$3 million and \$5 million in the third quarter of 2008 and 2007, respectively, and \$20 million and \$25 million for the nine months ended September 30, 2008 and 2007, respectively.

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

Results of Operations – Continuing Operations (Continued)

Rehabilitation Division

Revenues increased 21% in the third quarter of 2008 to \$106 million compared to \$88 million in the third quarter of 2007 and increased 23% to \$317 million for the nine months ended September 30, 2008 from \$257 million in the same period in 2007. The increase in revenues in both periods was primarily attributable to growth in new contracts and the volume of services provided to existing customers. Revenues generated from unaffiliated customers aggregated \$40 million and \$29 million in the third quarter of 2008 and 2007, respectively, and \$116 million and \$82 million for the nine months ended September 30, 2008 and 2007, respectively.

Despite growth in volumes and revenues, operating margins in both the third quarter of 2008 and for the nine months ended September 30, 2008 declined primarily due to wage rate pressures resulting from an increasingly competitive marketplace for therapists and start-up costs associated with unaffiliated customer contract growth.

Pharmacy Division

The Spin-off Transaction was completed on July 31, 2007. As a result, the Company's consolidated operating results for the third quarter of 2008 and for the nine months ended September 30, 2008 did not include any results of the Company's former pharmacy division.

For accounting purposes, the pharmacy division was not treated as a discontinued operation in the Company's historical condensed consolidated financial statements.

Corporate Overhead

Operating income for the Company's operating divisions excludes allocations of corporate overhead. These costs aggregated \$31 million and \$55 million in the third quarter of 2008 and 2007, respectively, and \$99 million and \$131 million for the nine months ended September 30, 2008 and 2007, respectively. As described in Note 4 of the accompanying Notes to Condensed Consolidated Financial Statements, corporate overhead for the third quarter of 2007 and for the nine months ended September 30, 2007 included certain items related primarily to the Spin-off Transaction. As a percentage of consolidated revenues, corporate overhead totaled 3.1% and 5.5% in the third quarter of 2008 and 2007, respectively, and totaled 3.2% and 4.1% for the nine months ended September 30, 2008 and 2007, respectively.

Beginning January 1, 2008, certain incentive compensation costs were charged to the operating divisions that had previously been classified as corporate overhead. These charges approximated \$0.7 million for the hospital division, \$0.5 million for the health services division and \$0.2 million for the rehabilitation division in the third quarter of 2008 and approximated \$4 million for the hospital division, \$3 million for the health services division and \$1 million for the rehabilitation division for the nine months ended September 30, 2008.

The Company recorded approximately \$4 million and \$3 million in other income in the third quarter of 2008 and 2007, respectively, and approximately \$14 million and \$3 million in other income for the nine months ended September 30, 2008, and 2007, respectively, related to the information systems and transition services agreements with PharMerica.

Corporate expenses included the operating losses from the Company's limited purpose insurance subsidiary of \$2 million in the third quarter of both 2008 and 2007, and \$5 million for both the nine months ended September 30, 2008 and 2007.

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

Results of Operations – Continuing Operations (Continued)

Capital Costs

Rent expense declined 1% to \$86 million in the third quarter of 2008 compared to \$87 million in the third quarter of 2007 and was relatively flat at \$259 million for the nine months ended September 30, 2008 compared to \$258 million in the same period in 2007. Rent expense for the nine months ended September 30, 2008 included a charge of approximately \$2 million related to a prior period rent escalator adjustment for ten leased facilities which the Company does not believe is material to the financial statements for the current or prior periods.

Depreciation and amortization expense decreased 4% in the third quarter of 2008 to \$29 million compared to the third quarter of 2007 and increased 3% to \$91 million for the nine months ended September 30, 2008 from \$88 million in the same period in 2007. The decrease in depreciation expense in the third quarter of 2008 was primarily attributable to assets which became fully depreciated during the quarter. The increase for the nine months ended September 30, 2008 was primarily a result of the Company's ongoing capital expenditure program and its acquisition and development activities.

Interest expense aggregated \$4 million and \$5 million in the third quarter of 2008 and 2007, respectively, and aggregated \$11 million for each of the nine months ended September 30, 2008 and 2007. The decrease in interest expense in the third quarter of 2008 was primarily attributable to lower interest rates under the Company's revolving credit facility compared to the same period a year ago.

Investment income related primarily to the Company's insurance subsidiary investments totaled \$1 million and \$4 million in the third quarter of 2008 and 2007, respectively, and aggregated \$6 million and \$11 million for the nine months ended September 30, 2008 and 2007, respectively. Investment income was negatively impacted in the third quarter of 2008 by a \$1 million pretax other-than-temporary impairment of an investment in a failed financial institution held in the Company's insurance subsidiary investment portfolio.

Consolidated Results

Loss from continuing operations before income taxes aggregated \$0.5 million in the third quarter of 2008 compared to a loss from continuing operations before income taxes of \$8 million in the third quarter of 2007. Income from continuing operations before income taxes increased 53% to \$61 million for the nine months ended September 30, 2008 from \$40 million in the same period in 2007. Income from continuing operations aggregated \$1 million in the third quarter of 2008 compared to a loss from continuing operations of \$8 million in the third quarter of 2007. Income from continuing operations increased 85% to \$37 million for the nine months ended September 30, 2008 from \$20 million in the same period in 2007.

Results of Operations – Discontinued Operations

Income from discontinued operations was break-even in the third quarter of 2008 compared to a loss of \$1 million in the third quarter of 2007, while loss from discontinued operations aggregated \$3 million for the nine months ended September 30, 2008 compared to a loss from discontinued operations of \$6 million in the same period in 2007.

The Company recorded a pretax loss on divestiture of operations of \$36 million (\$22 million net of income taxes) during the third quarter of 2008 related to the planned divestiture of a LTAC hospital.

The Company recorded a pretax loss on divestiture of operations of \$31 million (\$19 million net of income taxes) during the nine months ended September 30, 2008. The Company recorded a pretax loss on divestiture of

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(Continued)****Results of Operations – Discontinued Operations (Continued)**

operations of \$113 million (\$69 million net of income taxes) during the nine months ended September 30, 2007 related to the Facility Acquisitions and related planned divestitures. The Company also recorded a pretax loss on divestiture of operations related to the HCP Transaction of \$13 million (\$8 million net of income taxes) during the nine months ended September 30, 2007.

Liquidity*Operating cash flows, capital spending and financing activities*

Cash flows provided by operations (including discontinued operations) aggregated \$41 million for the nine months ended September 30, 2008 compared to \$101 million for the same period in 2007. Operating cash flows for the nine months ended September 30, 2008 were negatively impacted by the growth in accounts receivable. During both the nine months ended September 30, 2008 and 2007, the Company maintained sufficient liquidity to fund its ongoing capital expenditure program and finance ongoing hospital development expenditures, as well as its acquisition and strategic divestiture activities. The Company expects the settlement of approximately \$65 million of Medicare receivables during the fourth quarter of 2008.

Cash and cash equivalents totaled \$19 million at September 30, 2008 compared to \$33 million at December 31, 2007. The Company's long-term debt at September 30, 2008 aggregated \$329 million (substantially all of which related to borrowings under the Company's revolving credit facility). Assuming no further acquisitions or repurchases of common stock in the fourth quarter of 2008, the Company expects to end the year with approximately \$60 million to \$70 million in cash and cash equivalents and \$330 million to \$340 million in revolving credit facility borrowings.

Under the terms of the Company's \$500 million revolving credit facility, the aggregate amount of the credit may be increased to \$600 million at the Company's option if certain conditions are met. The term of the revolving credit facility expires in July 2012.

Interest rates under the revolving credit facility are based, at the Company's option, upon (a) the London Interbank Offered Rate (LIBOR) plus the applicable margin or (b) the applicable margin plus the higher of the prime rate or 0.5% over the federal funds rate. The revolving credit facility is collateralized by substantially all of the Company's assets including certain owned real property and is guaranteed by substantially all of the Company's subsidiaries. The terms of the revolving credit facility include one financial covenant and certain other provisions which limit acquisitions and annual capital expenditures. The Company was in compliance with the terms of the revolving credit facility at September 30, 2008.

Despite the recent turmoil within the financial markets nationally and globally, the Company is not aware of any individual lender limitations to extend credit under the revolving credit facility. However, the obligations of each of the lending institutions in the revolving credit facility are separate and there is no assurance that the availability of future borrowings under the revolving credit facility will not be impacted by the ongoing volatility and disruptions in the financial credit markets.

Based upon the Company's existing cash levels, expected operating cash flows and capital spending (including planned acquisition and development activities), and the availability of borrowings under the Company's revolving credit facility, management believes that the Company has the necessary financial resources to satisfy its liquidity needs on a short-term and long-term basis.

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

Liquidity (Continued)

Operating cash flows, capital spending and financing activities (Continued)

In May 2008, the Company received a cash distribution of \$7 million related to a partnership land sale. The Company has a noncontrolling ownership interest in the partnership which is accounted for under the equity method of accounting. No gain or loss was recognized on the land sale.

In April 2008, the Company repaid a capital lease obligation of approximately \$16 million in connection with a purchase option under a hospital lease agreement.

As a result of improved professional liability underwriting results of the Company's limited purpose insurance subsidiary, the Company received distributions of approximately \$39 million and \$37 million during the nine months ended September 30, 2008 and 2007, respectively, from its limited purpose insurance subsidiary. These proceeds were used to repay borrowings under the Company's revolving credit facility.

Immediately prior to the Spin-off Transaction, KPS incurred \$125 million of bank debt, the proceeds of which remained with the Company. The Company used the proceeds to reduce outstanding borrowings under its revolving credit facility.

In August 2007, the Company's Board of Directors authorized up to \$100 million in common stock repurchases. The authorization allowed for repurchases of up to \$50 million of common stock during 2007 and the remainder in 2008. During the third quarter of 2007, the Company expended \$50 million to purchase approximately 2.6 million shares of its common stock. The Company has not purchased any common stock during 2008.

Strategic divestitures

In September 2008, the Company purchased for resale a LTAC hospital in Massachusetts for \$22 million that was previously leased and announced its intention to dispose of a LTAC hospital in California and its related operations. The Company expects to dispose of these two hospitals within one year and to generate approximately \$11 million in proceeds from the sales.

In June 2007, the Company paid approximately \$176 million to complete the Facility Acquisitions with borrowings under the Company's revolving credit facility. As of September 30, 2008, the Company had sold all of the Facilities for approximately \$95 million.

In January 2007, the Company paid \$37 million to complete the HCP Transaction. The Company divested the 11 nursing centers acquired in the HCP Transaction during the first nine months of 2007 for approximately \$78 million.

Capital Resources

Excluding acquisitions, capital expenditures totaled \$112 million for the nine months ended September 30, 2008 compared to \$133 million for the same period in 2007. Excluding acquisitions and development of new facilities, the Company expects that capital spending in 2008 should approximate \$120 million to \$125 million. Hospital development capital spending should approximate \$50 million to \$55 million in 2008. The Company expects that most of these expenditures will be financed through internal resources. Management believes that its capital expenditure program is adequate to improve and equip existing facilities. At September 30, 2008, the estimated cost to complete and equip construction in progress approximated \$73 million.

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

Capital Resources (Continued)

At September 30, 2008, the Company's remaining amount for permitted acquisitions under its revolving credit facility aggregated \$299 million.

During the nine months ended September 30, 2008, the Company acquired four nursing centers that were previously leased for approximately \$24 million. Annual rents associated with the four nursing centers approximated \$3 million. These transactions were financed through borrowings under the Company's revolving credit facility.

In the third quarter of 2007, the Company acquired a combined nursing center and assisted living facility for approximately \$20 million and a hospital for \$3 million which was previously leased. These acquisitions were financed through borrowings under the Company's revolving credit facility.

Other Information

Effects of Inflation and Changing Prices

The Company derives a substantial portion of its revenues from the Medicare and Medicaid programs. Congress and certain state legislatures have enacted or may enact additional significant cost containment measures limiting the Company's ability to recover its cost increases through increased pricing of its healthcare services. Medicare revenues in LTAC hospitals and nursing centers are subject to fixed payments under the Medicare prospective payment systems. Medicaid reimbursement rates in many states in which the Company operates nursing centers also are based upon fixed payment systems. Generally, these rates are adjusted annually for inflation. However, these adjustments may not reflect the actual increase in the costs of providing healthcare services.

LTAC PPS maintains LTAC hospitals as a distinct provider type, separate from short-term acute care hospitals. Only providers certified as LTAC hospitals may be paid under this system. To maintain certification under LTAC PPS, the average length of stay of Medicare patients must be at least 25 days.

CMS is currently evaluating various certification criteria for designating a hospital as a LTAC hospital. If such certification criteria were developed and enacted into legislation, the Company's hospitals may not be able to maintain their status as LTAC hospitals or may need to adjust their operations.

The SCHIP Extension Act became effective for cost reporting periods after December 29, 2007. This legislation provides for, among other things:

- (1) a mandated study by the Secretary of Health and Human Services on the establishment of LTAC hospital certification criteria;
- (2) enhanced medical necessity review of LTAC hospital cases;
- (3) a three-year moratorium on the establishment of a LTAC hospital or satellite facility, subject to exceptions for facilities under development;
- (4) a three-year moratorium on an increase in the number of beds at a LTAC hospital or satellite facility, subject to exceptions for states where there is only one other LTAC hospital and upon request following the closure or decrease in the number of beds at a LTAC hospital within the state;

- (5) a three-year moratorium on the application of a one-time budget neutrality adjustment to payment rates to LTAC hospitals under LTAC PPS;

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

Other Information (Continued)

Effects of Inflation and Changing Prices (Continued)

- (6) a three-year moratorium on very short-stay outlier payment reductions to LTAC hospitals initially implemented on May 1, 2007;
- (7) a three-year moratorium on the application of the so-called 25 Percent Rule to freestanding LTAC hospitals;
- (8) a three-year period during which LTAC hospitals that are co-located within another hospital may admit up to 50% of their patients from their host hospitals and still be paid according to LTAC PPS;
- (9) a three-year period during which LTAC hospitals that are co-located with an urban single hospital or a hospital that generates more than 25% of the Medicare discharges in a metropolitan statistical area (MSA Dominant hospital) may admit up to 75% of their patients from such urban single hospital or MSA Dominant hospital and still be paid according to LTAC PPS; and
- (10) the elimination of the July 1, 2007 market basket increase in the standard federal payment rate of 0.71%, effective for discharges occurring on or after April 1, 2008.

On May 1, 2007, CMS issued regulatory changes regarding Medicare reimbursement for LTAC hospitals (the 2007 Final Rule) that became effective for discharges occurring on or after July 1, 2007. The 2007 Final Rule was amended on June 29, 2007 by revising the high cost outlier threshold. The 2007 Final Rule projected an overall decrease in payments to all Medicare certified LTAC hospitals of approximately 1.2%. Included in the 2007 Final Rule were (1) an increase to the standard federal payment rate of 0.71% (which was eliminated for discharges occurring on or after April 1, 2008 by the SCHIP Extension Act); (2) revisions to payment methodologies impacting short-stay outliers, which reduce payments by 0.9% (currently subject to a three-year moratorium pursuant to the SCHIP Extension Act); (3) adjustments to the wage index component of the federal payment resulting in projected reductions in payments of 0.5%; (4) an increase in the high cost outlier threshold per discharge to \$20,707, resulting in projected reductions of 0.4%; and (5) an extension of the policy known as the 25 Percent Rule to all LTAC hospitals, with a three-year phase-in, which CMS projects will not result in payment reductions for the first year of implementation (also currently subject to a three-year moratorium pursuant to the SCHIP Extension Act).

The 2007 Final Rule expanded the so-called 25 Percent Rule to all LTAC hospitals, regardless of whether they are co-located within another hospital. Under the 2007 Final Rule, all LTAC hospitals were to be paid the LTAC PPS rates for admissions from a single referral source up to 25% of aggregate Medicare admissions. Patients reaching high cost outlier status in the short-term hospital were not to be counted when computing the 25% limit. Admissions beyond the 25% threshold were to be paid at a lower amount based upon short-term acute care hospital rates. However, as set forth above, the SCHIP Extension Act has placed a three-year moratorium on the expansion of the 25 Percent Rule to freestanding hospitals. In addition, the SCHIP Extension Act provides for a three-year period during which (1) LTAC hospitals that are co-located within another hospital may admit up to 50% of their patients from their host hospitals and still be paid according to LTAC PPS, and (2) LTAC hospitals that are co-located with an urban single hospital or a MSA Dominant hospital may admit up to 75% of their patients from such urban single or MSA Dominant hospital and still be paid according to LTAC PPS.

On May 2, 2008, CMS issued regulatory changes regarding Medicare reimbursement for LTAC hospitals (the 2008 Final Rule) that became effective for discharges occurring on or after July 1, 2008. The 2008 Final Rule projected an overall increase in payments to all Medicare certified LTAC hospitals of approximately 2.5%. Included in the 2008 Final Rule were (1) an increase to the standard federal payment rate of 2.7% (as compared to the adjusted federal rate for discharges occurring on or after April 1, 2008 by the SCHIP Extension Act);

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

Other Information (Continued)

Effects of Inflation and Changing Prices (Continued)

(2) adjustments to the wage index component of the federal payment resulting in projected reductions in payments of 0.1%; (3) an increase in the high cost outlier threshold per discharge to \$22,960; and (4) an extension of the rate year cycle for one year to September 30, 2009, in order to be consistent thereafter with the federal fiscal year that begins October 1 of each year.

CMS has regulations governing payments to LTAC hospitals that are co-located within another hospital, such as a hospital-in-hospital (HIH). The rules generally limit Medicare payments to the HIH if the Medicare admissions to the HIH from the host hospital exceed 25% of the total Medicare discharges for the HIH's cost reporting period. There are limited exceptions for admissions from rural, urban single and MSA Dominant hospitals. Admissions that exceed this 25 Percent Rule are paid using the short-term acute care inpatient payment system (IPPS). Patients transferred after they have reached the short-term acute care outlier payment status are not counted toward the admission threshold. Patients admitted prior to meeting the admission threshold, as well as Medicare patients admitted from a non-host hospital, are eligible for the full payment under LTAC PPS. If the HIH's admissions from the host hospital exceed the limit in a cost reporting period, Medicare will pay the lesser of (1) the amount payable under LTAC PPS or (2) the amount payable under IPPS. At September 30, 2008, the Company operated 16 HIHs with 692 licensed beds.

On August 1, 2007, CMS issued final regulations regarding Medicare hospital inpatient payments to short-term acute care hospitals as well as certain provisions affecting LTAC hospitals. These regulations adopt a new system for classifying patients into diagnostic categories called Medicare Severity Diagnosis Related Groups or more specifically, for LTAC hospitals, MS-LTC-DRGs. This new MS-LTC-DRG system replaces the previous diagnostic related group system for LTAC hospitals and became effective for discharges occurring on or after October 1, 2007. The MS-LTC-DRG system creates additional severity-adjusted categories for most diagnoses, resulting in an expansion of the aggregate number of diagnostic groups from 538 to 745. CMS states that MS-LTC-DRG weights were developed in a budget neutral manner and as such, the estimated aggregate payments under LTAC PPS would be unaffected by the annual recalibration of MS-LTC-DRG payment weights.

On July 31, 2008, CMS issued final regulations regarding the re-weighting of MS-LTC-DRGs for discharges occurring on or after October 1, 2008. CMS announced that this update was made in a budget neutral manner, and that estimated aggregate LTAC Medicare payments would be unaffected by these regulations. Based upon the Company's historical Medicare patient volumes and relatively higher level of patient acuity, the Company believes that the re-weighting may improve the Company's Medicare payment rates.

The Company cannot predict the ultimate long-term impact of LTAC PPS. This payment system is subject to significant change. Slight variations in patient acuity could significantly change Medicare revenues generated under LTAC PPS. In addition, the Company's hospitals may not be able to appropriately adjust their operating costs as patient acuity levels change or to changes in reimbursement rates. In addition, there can be no assurance that LTAC PPS will not have a material adverse effect on revenues from non-government third party payors. Various factors, including a reduction in average length of stay, have negatively impacted revenues from non-government third party payors.

On July 31, 2008, CMS issued final regulations regarding Medicare reimbursement for nursing centers for the fiscal year beginning October 1, 2008. These regulations included, among other things, a market basket increase to the federal payment rates of 3.4% and updates to the wage indexes which adjust the federal payment. CMS estimates that the overall impact of these proposed changes will be a net increase in payments of 3.4%.

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

Other Information (Continued)

Effects of Inflation and Changing Prices (Continued)

On February 1, 2006, Congress passed the Deficit Reduction Act of 2005. This legislation allowed, among other things, an annual \$1,740 Medicare Part B outpatient therapy cap that was effective on January 1, 2006. CMS subsequently increased the therapy cap to \$1,780 on January 1, 2007 and to \$1,810 on January 1, 2008. The legislation also required CMS to implement a broad process for reviewing medically necessary therapy claims, creating an exception to the cap. The exception process, which was set to expire on January 1, 2007, was included in the Tax Relief and Health Care Act of 2006 and continued to function as an exception to the Medicare Part B outpatient therapy cap until January 1, 2008. The SCHIP Extension Act further extended the Medicare Part B outpatient therapy cap exception process until June 30, 2008. The Medicare Improvements for Patients and Providers Act of 2008, enacted on July 15, 2008, extended the therapy cap exception process from July 1, 2008 to December 31, 2009.

The Company believes that its operating margins may continue to be under pressure as the growth in operating expenses, particularly labor and employee benefits costs and professional liability costs, exceed payment increases from third party payors. In addition, as a result of competitive pressures, the Company's ability to maintain operating margins through price increases to private patients is limited.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(Continued)****Condensed Consolidated Statement of Operations****(Unaudited)****(In thousands, except per share amounts)**

| | 2007 Quarters | | | | 2008 Quarters | | |
|--|---------------|--------------|------------|------------|---------------|--------------|--------------|
| | First | Second | Third | Fourth | First | Second | Third |
| Revenues | \$ 1,098,087 | \$ 1,085,739 | \$ 999,418 | \$ 996,647 | \$ 1,048,523 | \$ 1,041,911 | \$ 1,010,680 |
| Salaries, wages and benefits | 596,329 | 596,106 | 592,234 | 574,245 | 601,251 | 596,161 | 606,468 |
| Supplies | 180,411 | 179,862 | 108,648 | 77,154 | 78,632 | 81,567 | 78,586 |
| Rent | 83,738 | 87,259 | 87,152 | 85,568 | 85,180 | 87,424 | 86,444 |
| Other operating expenses | 180,193 | 175,038 | 191,208 | 197,058 | 227,303 | 217,387 | 211,584 |
| Other income | | | (3,201) | (4,500) | (4,717) | (5,167) | (4,313) |
| Depreciation and amortization | 27,877 | 30,054 | 30,578 | 31,912 | 31,055 | 30,930 | 29,432 |
| Interest expense | 3,595 | 2,692 | 5,014 | 5,743 | 4,921 | 2,907 | 3,710 |
| Investment income | (3,829) | (3,610) | (3,770) | (4,900) | (3,248) | (2,337) | (672) |
| | 1,068,314 | 1,067,401 | 1,007,863 | 962,280 | 1,020,377 | 1,008,872 | 1,011,239 |
| Income (loss) from continuing operations before income taxes | 29,773 | 18,338 | (8,445) | 34,367 | 28,146 | 33,039 | (559) |
| Provision (benefit) for income taxes | 12,607 | 7,721 | (692) | 14,749 | 11,639 | 13,232 | (1,345) |
| Income (loss) from continuing operations | 17,166 | 10,617 | (7,753) | 19,618 | 16,507 | 19,807 | 786 |
| Discontinued operations, net of income taxes: | | | | | | | |
| Income (loss) from operations | (2,067) | (2,848) | (1,309) | (3,273) | (1,817) | (858) | 12 |
| Gain (loss) on divestiture of operations | (7,266) | (69,702) | | (53) | | 2,712 | (22,058) |
| Net income (loss) | \$ 7,833 | \$ (61,933) | \$ (9,062) | \$ 16,292 | \$ 14,690 | \$ 21,661 | \$ (21,260) |
| Earnings (loss) per common share: | | | | | | | |
| Basic: | | | | | | | |
| Income (loss) from continuing operations | \$ 0.44 | \$ 0.26 | \$ (0.20) | \$ 0.53 | \$ 0.44 | \$ 0.52 | \$ 0.02 |
| Discontinued operations: | | | | | | | |
| Income (loss) from operations | (0.05) | (0.07) | (0.03) | (0.09) | (0.05) | (0.02) | |
| Gain (loss) on divestiture of operations | (0.19) | (1.76) | | | | 0.07 | (0.58) |
| Net income (loss) | \$ 0.20 | \$ (1.57) | \$ (0.23) | \$ 0.44 | \$ 0.39 | \$ 0.57 | \$ (0.56) |
| Diluted: | | | | | | | |
| Income (loss) from continuing operations | \$ 0.43 | \$ 0.26 | \$ (0.20) | \$ 0.51 | \$ 0.43 | \$ 0.51 | \$ 0.02 |
| Discontinued operations: | | | | | | | |

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| | | | | | | | | |
|--|---------|-----------|-----------|---------|---------|---------|-----------|--|
| Income (loss) from operations | (0.05) | (0.07) | (0.03) | (0.08) | (0.05) | (0.02) | | |
| Gain (loss) on divestiture of operations | (0.18) | (1.71) | | | | 0.07 | (0.56) | |
| Net income (loss) | \$ 0.20 | \$ (1.52) | \$ (0.23) | \$ 0.43 | \$ 0.38 | \$ 0.56 | \$ (0.54) | |
| Shares used in computing earnings (loss) | | | | | | | | |
| per common share: | | | | | | | | |
| Basic | 39,212 | 39,591 | 39,013 | 37,365 | 37,444 | 37,714 | 38,034 | |
| Diluted | 39,997 | 40,645 | 39,013 | 38,366 | 38,618 | 38,943 | 39,369 | |

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**
(Continued)**Operating Data**

(Unaudited)

(In thousands)

| | 2007 Quarters | | | | 2008 Quarters | | |
|--|---------------|--------------|------------|------------|---------------|--------------|-----------------|
| | First | Second | Third | Fourth | First | Second | Third |
| Revenues: | | | | | | | |
| Hospital division | \$ 447,457 | \$ 425,617 | \$ 416,267 | \$ 438,078 | \$ 476,167 | \$ 461,064 | \$ 434,774 |
| Health services division | 485,635 | 496,399 | 508,191 | 524,561 | 534,793 | 542,207 | 535,737 |
| Rehabilitation division | 83,756 | 85,288 | 88,284 | 95,069 | 104,499 | 106,318 | 106,796 |
| Pharmacy division | 174,704 | 173,407 | 58,000 | | | | |
| | 1,191,552 | 1,180,711 | 1,070,742 | 1,057,708 | 1,115,459 | 1,109,589 | 1,077,307 |
| Eliminations: | | | | | | | |
| Rehabilitation | (58,017) | (58,450) | (59,011) | (61,061) | (66,936) | (67,678) | (66,627) |
| Pharmacy | (35,448) | (36,522) | (12,313) | | | | |
| | (93,465) | (94,972) | (71,324) | (61,061) | (66,936) | (67,678) | (66,627) |
| | \$ 1,098,087 | \$ 1,085,739 | \$ 999,418 | \$ 996,647 | \$ 1,048,523 | \$ 1,041,911 | \$ 1,010,680 |
| Income (loss) from continuing operations: | | | | | | | |
| Operating income (loss): | | | | | | | |
| Hospital division | \$ 99,534 | \$ 85,939 | \$ 83,433 | \$ 96,162 | \$ 96,802 | \$ 85,886 | \$ 64,818 (a,b) |
| Health services division | 61,669 | 71,953 | 75,166 | 87,961 | 74,200 | 90,446 | 78,801 (b) |
| Rehabilitation division | 10,044 | 9,097 | 8,309 | 7,076 | 11,486 | 10,178 | 7,448 (b) |
| Pharmacy division | 9,243 | 7,883 | 431 | | | | |
| Corporate: | | | | | | | |
| Overhead | (37,794) | (38,506) | (54,954) | (36,463) | (34,931) | (33,200) | (30,937)(b) |
| Insurance subsidiary | (1,542) | (1,633) | (1,856) | (2,046) | (1,503) | (1,347) | (1,775) |
| | (39,336) | (40,139) | (56,810) | (38,509) | (36,434) | (34,547) | (32,712) |
| Operating income | 141,154 | 134,733 | 110,529 | 152,690 | 146,054 | 151,963 | 118,355 |
| Rent | (83,738) | (87,259) | (87,152) | (85,568) | (85,180) | (87,424) | (86,444) |
| Depreciation and amortization | (27,877) | (30,054) | (30,578) | (31,912) | (31,055) | (30,930) | (29,432) |
| Interest, net | 234 | 918 | (1,244) | (843) | (1,673) | (570) | (3,038)(c) |
| Income (loss) from continuing operations before income taxes | 29,773 | 18,338 | (8,445) | 34,367 | 28,146 | 33,039 | (559) |
| Provision (benefit) for income taxes | 12,607 | 7,721 | (692) | 14,749 | 11,639 | 13,232 | (1,345)(d) |
| | \$ 17,166 | \$ 10,617 | \$ (7,753) | \$ 19,618 | \$ 16,507 | \$ 19,807 | \$ 786 |

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- (a) Includes \$5.8 million of direct costs and operating declines in the third quarter of 2008 compared to the same period last year in the Company's Louisiana and southern Texas hospital operations resulting from the Gulf hurricanes.
- (b) Beginning January 1, 2008, certain incentive compensation costs were charged to the operating divisions that had previously been classified as corporate overhead. These charges approximated \$0.7 million for the hospital division, \$0.5 million for the health services division and \$0.2 million for the rehabilitation division in the third quarter of 2008. Segment operating results for prior periods were not restated to reflect this reclassification.
- (c) Includes a \$0.9 million other-than-temporary impairment of an investment in a failed financial institution held in the Company's insurance subsidiary investment portfolio.
- (d) Includes a \$1.8 million favorable income tax adjustment related to the resolution of certain income tax contingencies for prior years.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(Continued)****Operating Data (Continued)****(Unaudited)****(In thousands)**

| | 2007 Quarters | | | | 2008 Quarters | | |
|--|---------------|-----------|-----------|-----------|---------------|-----------|-----------|
| | First | Second | Third | Fourth | First | Second | Third |
| Rent: | | | | | | | |
| Hospital division | \$ 33,714 | \$ 35,115 | \$ 35,068 | \$ 35,978 | \$ 35,907 | \$ 37,750 | \$ 36,461 |
| Health services division | 47,239 | 48,985 | 50,078 | 48,245 | 47,883 | 48,175 | 48,551 |
| Rehabilitation division | 1,069 | 1,133 | 1,180 | 1,259 | 1,358 | 1,393 | 1,405 |
| Pharmacy division | 1,642 | 1,943 | 740 | | | | |
| Corporate | 74 | 83 | 86 | 86 | 32 | 106 | 27 |
| | \$ 83,738 | \$ 87,259 | \$ 87,152 | \$ 85,568 | \$ 85,180 | \$ 87,424 | \$ 86,444 |
| Depreciation and amortization: | | | | | | | |
| Hospital division | \$ 8,758 | \$ 9,693 | \$ 10,818 | \$ 11,689 | \$ 11,303 | \$ 11,455 | \$ 11,719 |
| Health services division | 10,981 | 11,825 | 13,284 | 14,572 | 14,389 | 13,677 | 11,794 |
| Rehabilitation division | 236 | 273 | 284 | 383 | 387 | 485 | 547 |
| Pharmacy division | 2,816 | 2,760 | 934 | | | | |
| Corporate | 5,086 | 5,503 | 5,258 | 5,268 | 4,976 | 5,313 | 5,372 |
| | \$ 27,877 | \$ 30,054 | \$ 30,578 | \$ 31,912 | \$ 31,055 | \$ 30,930 | \$ 29,432 |
| Capital expenditures, excluding acquisitions (including discontinued operations): | | | | | | | |
| Hospital division | \$ 20,765 | \$ 25,909 | \$ 23,505 | \$ 24,905 | \$ 13,556 | \$ 20,022 | \$ 19,736 |
| Health services division | 6,696 | 10,460 | 13,908 | 15,876 | 7,135 | 10,744 | 19,746 |
| Rehabilitation division | 118 | 253 | 385 | 1,281 | 282 | 280 | 271 |
| Pharmacy division | 1,712 | 1,613 | 790 | | | | |
| Corporate: | | | | | | | |
| Information systems | 4,457 | 5,765 | 4,668 | 9,541 | 3,832 | 8,616 | 7,051 |
| Other | 274 | 734 | 11,000 | 1,873 | 135 | 258 | 489 |
| | \$ 34,022 | \$ 44,734 | \$ 54,256 | \$ 53,476 | \$ 24,940 | \$ 39,920 | \$ 47,293 |

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(Continued)****Operating Data (Continued)****(Unaudited)**

| | 2007 Quarters | | | | 2008 Quarters | | |
|--------------------------------|---------------|-----------|-----------|-----------|---------------|-----------|-----------|
| | First | Second | Third | Fourth | First | Second | Third |
| Hospital data: | | | | | | | |
| End of period data: | | | | | | | |
| Number of hospitals | 78 | 78 | 80 | 81 | 81 | 81 | 82 |
| Number of licensed beds | 6,110 | 6,169 | 6,286 | 6,358 | 6,358 | 6,358 | 6,428 |
| Revenue mix %: | | | | | | | |
| Medicare | 60 | 58 | 56 | 57 | 57 | 56 | 54 |
| Medicaid | 10 | 10 | 11 | 11 | 9 | 9 | 11 |
| Medicare Advantage | n/a | 5 | 6 | 7 | 8 | 9 | 9 |
| Commercial insurance and other | 30 | 27 | 27 | 25 | 26 | 26 | 26 |
| Admissions: | | | | | | | |
| Medicare | 7,435 | 6,903 | 6,628 | 7,174 | 7,920 | 7,268 | 6,786 |
| Medicaid | 1,053 | 1,007 | 1,094 | 1,050 | 1,034 | 1,008 | 1,148 |
| Medicare Advantage | n/a | 387 | 598 | 696 | 901 | 849 | 869 |
| Commercial insurance and other | 2,189 | 1,781 | 1,648 | 1,687 | 1,814 | 1,799 | 1,748 |
| | 10,677 | 10,078 | 9,968 | 10,607 | 11,669 | 10,924 | 10,551 |
| Admissions mix %: | | | | | | | |
| Medicare | 70 | 68 | 66 | 68 | 68 | 67 | 64 |
| Medicaid | 10 | 10 | 11 | 10 | 9 | 9 | 11 |
| Medicare Advantage | n/a | 4 | 6 | 6 | 8 | 8 | 8 |
| Commercial insurance and other | 20 | 18 | 17 | 16 | 15 | 16 | 17 |
| Patient days: | | | | | | | |
| Medicare | 205,757 | 198,117 | 189,968 | 199,655 | 216,737 | 210,064 | 188,832 |
| Medicaid | 50,852 | 49,837 | 49,955 | 52,548 | 50,335 | 50,676 | 54,108 |
| Medicare Advantage | n/a | 13,901 | 18,530 | 22,602 | 28,453 | 29,219 | 28,529 |
| Commercial insurance and other | 79,465 | 68,428 | 63,580 | 64,855 | 66,270 | 67,847 | 64,449 |
| | 336,074 | 330,283 | 322,033 | 339,660 | 361,795 | 357,806 | 335,918 |
| Average length of stay: | | | | | | | |
| Medicare | 27.7 | 28.7 | 28.7 | 27.8 | 27.4 | 28.9 | 27.8 |
| Medicaid | 48.3 | 49.5 | 45.7 | 50.0 | 48.7 | 50.3 | 47.1 |
| Medicare Advantage | n/a | 35.9 | 31.0 | 32.5 | 31.6 | 34.4 | 32.8 |
| Commercial insurance and other | 36.3 | 38.4 | 38.6 | 38.4 | 36.5 | 37.7 | 36.9 |
| Weighted average | 31.5 | 32.8 | 32.3 | 32.0 | 31.0 | 32.8 | 31.8 |
| Revenues per admission: | | | | | | | |
| Medicare | \$ 36,031 | \$ 35,731 | \$ 35,176 | \$ 34,985 | \$ 34,128 | \$ 35,717 | \$ 34,721 |
| Medicaid | 42,028 | 43,216 | 40,145 | 44,498 | 41,853 | 42,271 | 40,798 |
| Medicare Advantage | n/a | 49,250 | 41,079 | 41,556 | 42,167 | 46,448 | 45,679 |
| Commercial insurance and other | 61,813 | 65,351 | 69,562 | 66,065 | 68,691 | 66,385 | 64,431 |
| Weighted average | 41,908 | 42,232 | 41,760 | 41,301 | 40,806 | 42,206 | 41,207 |
| Revenues per patient day: | | | | | | | |

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| | | | | | | | |
|--|----------|----------|----------|----------|----------|----------|----------|
| Medicare | \$ 1,302 | \$ 1,245 | \$ 1,227 | \$ 1,257 | \$ 1,247 | \$ 1,236 | \$ 1,248 |
| Medicaid | 870 | 873 | 879 | 889 | 860 | 841 | 866 |
| Medicare Advantage | n/a | 1,371 | 1,326 | 1,280 | 1,335 | 1,350 | 1,391 |
| Commercial insurance and other | 1,703 | 1,701 | 1,803 | 1,718 | 1,880 | 1,760 | 1,748 |
| Weighted average | 1,331 | 1,289 | 1,293 | 1,290 | 1,316 | 1,289 | 1,294 |
| Medicare case mix index (discharged patients only) | 1.11 | 1.11 | 1.09 | 1.11 | 1.12 | 1.16 | 1.14 |
| Average daily census | 3,734 | 3,629 | 3,500 | 3,692 | 3,976 | 3,932 | 3,651 |
| Occupancy % | 68.2 | 65.4 | 61.4 | 63.8 | 67.9 | 67.1 | 62.2 |

n/a not available

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
(Continued)****Operating Data (Continued)****(Unaudited)**

| | 2007 Quarters | | | | 2008 Quarters | | |
|---|---------------|-----------|-----------|-----------|---------------|-----------|-----------|
| | First | Second | Third | Fourth | First | Second | Third |
| Nursing center data: | | | | | | | |
| End of period data: | | | | | | | |
| Number of nursing centers: | | | | | | | |
| Owned or leased | 223 | 223 | 224 | 224 | 224 | 224 | 224 |
| Managed | 4 | 4 | 4 | 4 | 4 | 4 | 4 |
| | 227 | 227 | 228 | 228 | 228 | 228 | 228 |
| Number of licensed beds: | | | | | | | |
| Owned or leased | 28,481 | 28,477 | 28,719 | 28,621 | 28,371 | 28,251 | 28,210 |
| Managed | 485 | 485 | 485 | 485 | 485 | 485 | 485 |
| | 28,966 | 28,962 | 29,204 | 29,106 | 28,856 | 28,736 | 28,695 |
| Revenue mix %: | | | | | | | |
| Medicare | 35 | 35 | 34 | 34 | 35 | 35 | 33 |
| Medicaid | 44 | 44 | 44 | 44 | 42 | 43 | 44 |
| Medicare Advantage | n/a | n/a | n/a | n/a | 5 | 5 | 5 |
| Private and other | 21 | 21 | 22 | 22 | 18 | 17 | 18 |
| Patient days (excludes managed facilities): | | | | | | | |
| Medicare | 389,354 | 390,142 | 382,527 | 390,907 | 409,902 | 402,269 | 370,782 |
| Medicaid | 1,405,392 | 1,417,578 | 1,441,273 | 1,429,155 | 1,394,925 | 1,387,374 | 1,430,461 |
| Medicare Advantage | n/a | n/a | n/a | n/a | 79,221 | 82,886 | 84,977 |
| Private and other | 432,145 | 448,605 | 478,831 | 489,190 | 415,290 | 407,141 | 417,695 |
| | 2,226,891 | 2,256,325 | 2,302,631 | 2,309,252 | 2,299,338 | 2,279,670 | 2,303,915 |
| Patient day mix %: | | | | | | | |
| Medicare | 18 | 17 | 17 | 17 | 18 | 18 | 16 |
| Medicaid | 63 | 63 | 62 | 62 | 61 | 61 | 62 |
| Medicare Advantage | n/a | n/a | n/a | n/a | 3 | 3 | 4 |
| Private and other | 19 | 20 | 21 | 21 | 18 | 18 | 18 |
| Revenues per patient day: | | | | | | | |
| Medicare Part A | \$ 406 | \$ 408 | \$ 408 | \$ 422 | \$ 429 | \$ 431 | \$ 434 |
| Total Medicare (including Part B) | 442 | 444 | 445 | 458 | 461 | 466 | 475 |
| Medicaid | 152 | 153 | 156 | 160 | 160 | 168 | 163 |
| Medicare Advantage | n/a | n/a | n/a | n/a | 348 | 351 | 347 |
| Private and other | 231 | 237 | 237 | 238 | 229 | 228 | 231 |
| Weighted average | 218 | 220 | 221 | 227 | 232 | 238 | 232 |
| Average daily census | 24,743 | 24,795 | 25,029 | 25,101 | 25,267 | 25,051 | 25,043 |
| Occupancy % | 88.2 | 87.4 | 87.8 | 87.8 | 89.2 | 89.0 | 89.1 |

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Rehabilitation data:

| Revenue mix %: | | | | | | | |
|--------------------------|------|------|------|------|------|------|------|
| Company-operated | 74 | 69 | 68 | 65 | 65 | 64 | 62 |
| Non-affiliated | 26 | 31 | 32 | 35 | 35 | 36 | 38 |
| Therapist productivity % | 79.6 | 80.2 | 79.0 | 78.9 | 81.9 | 81.3 | 80.1 |

n/a not available

Table of Contents**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The following discussion of the Company's exposure to market risk contains forward-looking statements that involve risks and uncertainties. Given the unpredictability of interest rates as well as other factors, actual results could differ materially from those projected in such forward-looking information.

The Company's exposure to market risk relates to changes in the prime rate, federal funds rate and LIBOR, which affect the interest paid on certain borrowings.

The following table provides information about the Company's financial instruments that are sensitive to changes in interest rates. The table presents principal cash flows and related weighted average interest rates by expected maturity date.

Interest Rate Sensitivity**Principal (Notional) Amount by Expected Maturity****Average Interest Rate****(Dollars in thousands)**

| | Expected maturities | | | | | | Total | Fair value 9/30/08 |
|--|---------------------|-------|-------|-------|------------|------------|------------|-----------------------|
| | 2008 | 2009 | 2010 | 2011 | 2012 | Thereafter | | |
| Liabilities: | | | | | | | | |
| Long-term debt, including amounts due within one year: | | | | | | | | |
| Fixed rate | \$ 19 | \$ 81 | \$ 86 | \$ 91 | \$ 96 | \$ 460 | \$ 833 | \$ 788(a) |
| Average interest rate | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% | | |
| Variable rate (b) | \$ | \$ | \$ | \$ | \$ 328,300 | \$ | \$ 328,300 | \$ 328,300 |

- (a) Calculated based upon the net present value of future principal and interest payments using a discount rate of 6%.
- (b) Interest on borrowings under the Company's revolving credit facility is payable, at the Company's option, at (1) LIBOR plus an applicable margin ranging from 1.25% to 2.00% or (2) the applicable margin ranging from 0.25% to 1.00% plus the higher of the prime rate or 0.5% over the federal funds rate. The applicable margin is based upon the Company's average daily excess availability as defined in the Company's revolving credit facility.

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures and Changes in Internal Control Over Financial Reporting

The Company has carried out an evaluation under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of September 30, 2008, the Company's disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed in the reports that the Company files and submits under the Exchange Act is recorded, processed, summarized and reported as and when required.

There has been no change in the Company's internal control over financial reporting during the Company's quarter ended September 30, 2008, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is a party to various legal actions (some of which are not insured), and regulatory and other government investigations and sanctions in the ordinary course of business. The Company is unable to predict the ultimate outcome of pending litigation and regulatory and other government investigations. The DOJ, CMS or other federal and state enforcement and regulatory agencies may conduct additional investigations related to the Company's businesses in the future which may, either individually or in the aggregate, have a material adverse effect on the Company's financial position, results of operations and liquidity.

Item 6. Exhibits

- 10.1 Third Amendment to Master Lease Agreement dated as of September 26, 2008 by and between HCRI Massachusetts Properties Trust and HCRI Massachusetts Properties Trust II, as Lessor and Kindred Hospitals East, L.L.C., as Tenant.
- 10.2 Amended and Restated Kindred Healthcare, Inc. Long-Term Incentive Plan.
- 10.3 Amended and Restated Kindred Healthcare, Inc. Short-Term Incentive Plan.
- 10.4 Kindred Deferred Compensation Plan, Third Amendment and Restatement effective as of January 1, 2009.
- 10.5 Amendment No. 6 to Supplemental Executive Retirement Plan.
- 10.6 Kindred Healthcare, Inc. 2001 Equity Plan for Non-Employee Directors (Amended and Restated).
- 31 Rule 13a-14(a)/15d-14(a) Certifications.
- 32 Section 1350 Certifications.

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SIGNATURES

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

KINDRED HEALTHCARE, INC.

Date: November 7, 2008

/s/ PAUL J. DIAZ
Paul J. Diaz
President and
Chief Executive Officer

Date: November 7, 2008

/s/ RICHARD A. LECHLEITER
Richard A. Lechleiter
Executive Vice President and
Chief Financial Officer