

Company

7 July 2010 | 10 pages

Skilled Healthcare Group (SKH)

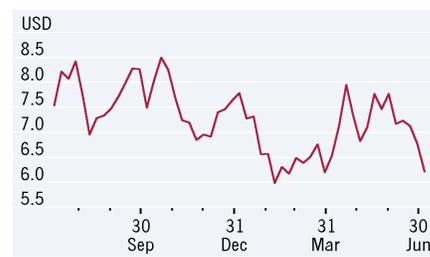
 Equity

SKH Faces Untenable Legal Judgment in California

- Conclusion(s)** — Last night SKH announced a CA jury has delivered a \$671m verdict against the company. Punitive damages have yet to be decided. If the verdict is upheld, it is difficult to foresee how SKH could continue as an ongoing entity. However, it is possible that the judge could reduce the unprecedented size of the verdict. SKH will likely want to appeal, but would be unable to post the required 150% bond unless the verdict is first reduced. We believe SKH has contested excess insurance coverage of up to \$126m. We have not yet talked to management.
- Details** — A class action case filed 5/06 has been the subject of an ongoing trial since 11/09. The suit represents a class of 32,000 patients and alleges that SKH entities violated California's 2000 minimum staffing ratio law over the period 2003-2009. Apparently the jury awarded the maximum penalty of \$500/patient day (\$613m statutory damages) + another \$58m of restitutionary damages. SKH has exhausted its primary professional liability insurance coverages related to the years in question. The company does maintain an excess liability policy with \$18m annual aggregate limit (so presumably 7 years in question x \$18m = \$126m total). However, the excess coverage carrier has asserted non-coverage for this case due to the lack of any allegation of harm to the plaintiffs. We're not sure how "lack of allegation of harm to plaintiffs" reconciles with a supportable \$671m verdict against the company, so it seems likely one position (or both) is likely to change.
- Range of Outcomes Will Pressure Stock** — To us, the magnitude of this verdict is unprecedented. The verdict thus far represents 6.1x trailing EBITDA and far exceeds SKH's current \$2.1m cash balance, \$94m borrowing capacity, \$284m net equity and our calculation of up to \$126m of excess insurance coverage. We would expect the stock to trade materially lower today as the market handicaps the probability of the judge reducing the verdict. At this point we'd logically guess some reduction is likely but concede we don't yet have legal experience or facts to support our guess. We do note that a \$48m jury verdict against a NM Res-Care (RSCR) group home was reduced by a judge to \$9.6m in February 2010.

Hold/Speculative	2S
Price (06 Jul 10)	US\$6.22
Target price	US\$8.00
Expected share price return	28.6%
Expected dividend yield	0.0%
Expected total return	28.6%
Market Cap	US\$235M

Price Performance (RIC: SKH.N, BB: SKH US)



Gary Taylor

 +1-212-816-0975
 gary.p.taylor@citi.com

 Patrick Feeley, CPA, CFA
 patrick.feeley@citi.com

 Ryan M Langston
 ryan.m.langston@citi.com

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Figure 1. SKH Earnings Model

	2003A	2004A	2005A	2006A	2007A	2008A	2009A				FY	2010E				2011E	2012E	
	FY	FY	FY	FY	FY	FY	Mar Q1A	June Q2A	Sept Q3A	Dec Q4A		Mar Q1A	June Q2E	Sept Q3E	Dec Q4E	FYE	FYE	FYE
TOTAL REVENUE	\$359.3	\$373.0	\$462.8	\$531.7	\$634.6	\$733.3	\$189.5	\$193.4	\$188.4	\$189.0	\$760.2	\$189.3	\$200.1	\$206.6	\$206.2	\$802.2	\$830.0	\$871.0
Yr/Yr Change	na	3.8%	24.1%	14.9%	19.4%	15.6%	4.8%	7.2%	3.2%	(0.4%)	3.7%	(0.1%)	3.5%	9.7%	9.1%	5.5%	3.5%	4.9%
Sequential Change			na	na	na	na	(0.2%)	2.1%	(2.6%)	0.3%		0.2%	5.7%	3.3%	(0.2%)			
Cost of Services			347.2	394.9	473.5	579.0	148.8	154.3	152.5	152.3	607.8	151.7	160.1	167.3	164.8	643.9	667.0	700.0
% of Revenue			75.0%	74.3%	74.6%	79.0%	78.5%	79.8%	80.9%	80.6%	80.0%	80.1%	80.0%	81.0%	79.9%	80.3%	80.4%	80.4%
General & Administrative			30.5	39.9	47.9	24.5	6.2	5.9	6.3	5.7	24.2	6.4	6.8	7.2	7.0	27.3	27.7	28.6
% of Revenue			6.6%	7.5%	7.6%	3.3%	3.3%	3.1%	3.4%	3.0%	3.2%	3.4%	3.4%	3.5%	3.4%	3.4%	3.3%	3.3%
Equity In Earnings of JV (income)/loss			(1.8)	(1.9)	(1.6)	(2.5)	(0.7)	(0.8)	(0.7)	(0.5)	(2.8)	(0.8)	(0.8)	(0.8)	(0.6)	(3.0)	(3.2)	(3.4)
EBITDAR			\$86.9	\$98.8	\$114.8	\$132.3	\$35.1	\$34.0	\$30.3	\$31.5	\$130.9	\$32.1	\$34.0	\$32.9	\$35.0	\$134.0	\$138.4	\$145.8
Rent			9.8	10.0	12.9	18.2	4.5	4.6	4.5	4.6	18.2	4.6	4.7	4.9	5.0	19.2	19.9	20.9
% of Revenue			2.1%	1.9%	2.0%	2.5%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%
EBITDA	\$49.1	\$58.9	\$77.1	\$88.7	\$102.0	\$114.1	\$30.6	\$29.4	\$25.8	\$26.9	\$112.7	\$27.5	\$29.3	\$28.0	\$30.0	\$114.8	\$118.5	\$124.9
EBITDA Margin	13.7%	15.8%	16.7%	16.7%	16.1%	15.6%	16.2%	15.2%	13.7%	14.3%	14.8%	14.5%	14.7%	13.5%	14.5%	14.3%	14.3%	14.3%
EBITDA Yr/Yr			31.0%	15.1%	14.9%	11.9%	8.2%	2.2%	(1.1%)	(12.9%)	(1.2%)	(10.2%)	(0.3%)	8.4%	11.3%	1.8%	3.2%	5.4%
Depreciation & Amortization	9.8	9.7	10.0	13.9	17.7	21.0	5.5	5.9	6.0	6.0	23.3	5.9	6.3	6.5	6.7	25.5	27.4	29.3
% of Revenue	2.7%	2.6%	2.2%	2.6%	2.8%	2.9%	2.9%	3.0%	3.2%	3.1%	3.1%	3.1%	3.2%	3.2%	3.3%	3.2%	3.3%	3.4%
OPERATING INCOME	\$39.3	\$49.2	\$67.1	\$74.8	\$84.3	\$93.1	\$25.1	\$23.5	\$19.8	\$21.0	\$89.4	\$21.5	\$23.0	\$21.4	\$23.3	\$89.2	\$91.1	\$95.6
Operating Margin	10.9%	13.2%	14.5%	14.1%	13.3%	12.7%	13.3%	12.2%	10.5%	11.1%	11.8%	11.4%	11.5%	10.4%	11.3%	11.1%	11.0%	11.0%
Operating Income Yr/Yr			36.4%	11.5%	12.6%	10.5%	8.6%	(0.7%)	(4.8%)	(17.6%)	(3.9%)	(14.3%)	(2.3%)	8.4%	10.9%	(0.2%)	2.0%	5.0%
Interest Expense and Other Income, Net	25.8	20.4	26.8	45.3	42.5	36.3	8.0	7.8	8.1	7.9	31.7	7.1	9.6	9.9	9.9	36.5	39.5	35.7
PRE TAX INCOME (ex. non-recurring)	13.5	28.8	40.3	29.5	41.8	56.8	17.2	15.7	11.7	13.1	57.7	14.5	13.4	11.5	13.3	52.7	51.5	59.9
Pre-Tax Margin	3.8%	7.7%	8.7%	5.6%	6.6%	7.7%	9.1%	8.1%	6.2%	6.9%	7.6%	7.6%	6.7%	5.6%	6.5%	6.6%	6.2%	6.9%
Pre-Tax Income Yr/Yr			40.1%	(26.8%)	41.4%	36.1%	23.4%	6.5%	(0.3%)	(20.0%)	1.6%	(15.7%)	(14.7%)	(1.8%)	1.7%	(8.6%)	(2.3%)	16.1%
Provision (Benefit) for Taxes	5.3	11.4	15.9	11.8	17.0	22.1	6.3	6.1	4.6	5.1	22.1	5.6	5.2	4.5	5.2	20.5	20.1	23.4
Tax Rate	39.5%	39.5%	39.5%	40.0%	40.8%	38.8%	36.7%	39.0%	39.0%	39.0%	38.3%	38.6%	39.0%	39.0%	39.0%	38.9%	39.0%	39.0%
NET INCOME (ex. non-recurring)	8.2	17.4	24.4	17.7	24.7	34.8	10.9	9.6	7.1	8.0	35.6	8.9	8.2	7.0	8.1	32.2	31.4	36.5
Net Margin	2.3%	4.7%	5.3%	3.3%	3.9%	4.7%	5.7%	5.0%	3.8%	4.2%	4.7%	4.7%	4.1%	3.4%	3.9%	4.0%	3.8%	4.2%
Net Income Yr/Yr			(27.4%)	39.5%	40.5%	28.7%	7.4%	(0.3%)	(21.6%)		2.5%	(18.3%)	(14.7%)	(1.8%)	1.7%	(9.5%)	(2.4%)	16.1%
Diluted Shares Outstanding	29.1	29.1	29.1	29.1	33.8	36.9	36.9	36.9	37.0	36.9	36.9	37.0	37.0	37.0	37.0	37.0	37.0	37.0
EPS (ex. non-recurring charges)	\$0.28	\$0.60	\$0.84	\$0.61	\$0.73	\$0.94	\$0.29	\$0.26	\$0.19	\$0.22	\$0.96	\$0.24	\$0.22	\$0.19	\$0.22	\$0.87	\$0.85	\$0.99
EPS Yr/Yr Change			(27%)	20%	29%	29%	29%	7%	(0%)	(22%)	2%	(19%)	(15%)	(2%)	1%	(10%)	(2%)	16%
EPS Sequential Change							6%	(12%)	(25%)	12%		11%	(8%)	(14%)	16%			

Source: Citi Investment Research and Analysis, Company Filings

Figure 2. HC Facilities Estimates

Ticker	Rating	7/7/10	CIR	Market	CIR or Consensus Est.			Consensus EPS			Current EV(\$m)	Consensus EBITDA			CY EBITDA (\$m)			CY Revenue (\$m)		
		Price	Target	Cap (\$m)	2010E	2011E	2012E	2010E	2011E	2012E		2010E	2011E	2012E	2010E	2011E	2012E	2010E	2011E	2012E
Acute Care																				
MDTH	2S	\$7.52	\$12.00	\$148	\$0.08	\$0.31	\$0.32	\$0.05	\$0.22	-	\$174	\$36	\$42	-	\$40	\$48	\$50	\$555	\$565	\$595
THC	2S	\$4.32	\$7.00	\$2,195	\$0.25	\$0.31	\$0.34	\$0.28	\$0.32	\$0.35	\$6,175	\$1,066	\$1,113	\$1,175	\$1,056	\$1,120	\$1,156	\$9,384	\$9,768	\$10,144
UHS	1M	\$36.43	\$47.00	\$3,550	\$2.64	\$2.97	\$3.34	\$2.62	\$2.82	\$3.03	\$4,436	\$720	\$757	\$794	\$732	\$791	\$861	\$5,448	\$5,768	\$6,113
			Total	\$5,893																
CYH	1H	\$32.21	\$55.00	\$2,990	\$3.05	\$3.34	\$3.66	\$2.98	\$3.31	\$3.66	\$11,412	\$1,742	\$1,837	\$1,932	\$1,760	\$1,860	\$1,945	\$13,046	\$13,824	\$14,652
HMA	1H	\$7.35	\$12.00	\$1,837	\$0.61	\$0.69	\$0.81	\$0.61	\$0.69	\$0.75	\$4,767	\$734	\$770	\$813	\$727	\$760	\$803	\$5,099	\$5,354	\$5,622
LPNT	2M	\$29.89	\$39.00	\$1,623	\$2.68	\$2.81	\$2.97	\$2.74	\$2.95	\$3.11	\$2,809	\$493	\$519	\$534	\$497	\$514	\$544	\$3,163	\$3,372	\$3,572
			Total	\$6,450																
Sub-Acute Care																				
BKD	nr	\$14.07	-	\$1,679	\$0.87	\$1.11	-	\$0.87	\$1.11	-	\$4,243	\$373	\$413	\$442	\$373	\$413	\$442	\$2,209	\$2,315	\$2,483
CHE	nr	\$51.98	-	\$1,197	\$3.76	\$4.03	\$3.85	\$3.76	\$4.03	\$3.85	\$1,238	\$178	\$190	\$190	\$178	\$190	\$190	\$1,253	\$1,307	\$1,338
ESC	nr	\$15.09	-	\$593	(\$1.18)	(\$0.69)	(\$0.59)	(\$1.18)	(\$0.69)	(\$0.59)	\$2,153	\$146	\$167	\$150	\$146	\$167	\$150	\$954	\$1,018	\$1,057
ENSG	nr	\$15.73	-	\$331	\$1.79	\$1.93	\$1.93	\$1.79	\$1.93	\$1.93	\$399	\$87	\$91	\$91	\$87	\$91	\$91	\$624	\$652	\$657
HLS	nr	\$17.83	-	\$1,926	\$1.75	\$1.98	\$2.20	\$1.75	\$1.98	\$2.20	\$3,854	\$415	\$443	\$463	\$415	\$443	\$463	\$2,004	\$2,107	\$2,147
KND	nr	\$11.77	-	\$457	\$1.30	\$1.41	-	\$1.30	\$1.41	-	\$3,215	\$220	\$232	\$260	\$520	\$562	\$260	\$4,402	\$4,573	\$4,751
NHC	nr	\$34.74	-	\$477	\$2.45	\$2.52	\$2.61	\$2.45	\$2.52	\$2.61	\$606	\$78	\$81	-	\$78	\$81	-	\$696	\$712	\$704
PSYS	2M	\$32.86	\$33.75	\$1,853	\$2.27	\$2.47	\$2.73	\$2.33	\$2.50	\$2.70	\$3,007	\$332	\$355	\$362	\$332	\$354	\$384	\$1,940	\$2,050	\$2,166
RHB	nr	\$20.80	-	\$513	\$2.66	\$2.98	-	\$2.66	\$2.98	-	\$939	\$170	\$185	\$173	\$170	\$185	\$173	\$1,355	\$1,419	\$1,449
SEM	nr	\$6.17	-	\$987	\$0.63	\$0.74	\$0.86	\$0.63	\$0.74	\$0.86	\$2,341	\$365	\$390	\$424	\$365	\$390	\$424	\$2,383	\$2,516	\$2,731
SKH	2S	\$6.22	\$8.00	\$230	\$0.87	\$0.85	\$0.99	\$0.89	\$0.95	\$1.02	\$824	\$114	\$121	\$124	\$134	\$138	\$146	\$802	\$830	\$871
SUNH	1H	\$7.78	\$12.00	\$344	\$0.94	\$1.00	\$1.20	\$0.95	\$1.00	\$1.11	\$1,508	\$169	\$176	\$182	\$244	\$254	\$277	\$1,925	\$2,000	\$2,112
SRZ	nr	\$2.54	-	\$141	-	-	-	-	-	-	\$919	-	-	-	-	-	-	-	-	-
			Total	\$11,624																
Outpatient																				
AMSG	1M	\$16.95	\$25.00	\$521	\$1.71	\$1.88	\$2.10	\$1.71	\$1.83	\$2.10	\$793	\$260	\$285	\$313	\$254	\$281	\$312	\$725	\$794	\$877
DVA	1M	\$60.39	\$72.00	\$6,327	\$4.37	\$4.86	\$5.81	\$4.40	\$4.63	\$5.70	\$9,179	\$1,214	\$1,255	\$1,401	\$1,164	\$1,263	\$1,462	\$6,494	\$6,833	\$7,314
FMS	**1L	\$53.94	-	\$16,028	\$3.26	\$3.65	-	\$3.26	\$3.65	-	\$21,074	\$2,366	\$2,528	-	\$2,366	\$2,528	-	\$12,147	\$12,791	-
GTIV	nr	\$23.01	-	\$696	\$2.71	\$2.50	\$2.98	\$2.71	\$2.50	\$2.98	\$760	\$153	\$148	\$144	\$153	\$148	\$144	\$1,242	\$1,323	\$1,488
LNCR	1M	\$26.43	\$37.33	\$2,572	\$1.90	\$2.34	\$2.90	\$1.88	\$2.14	\$2.46	\$2,984	\$457	\$500	\$533	\$461	\$530	\$617	\$1,719	\$1,874	\$2,061
			Total	\$26,144																
Outsourced Services																				
AHCI	nr	\$2.25	-	\$102	\$0.28	-	-	\$0.28	-	-	\$61	-	-	-	-	-	-	\$284	-	-
AHS	2H	\$6.71	\$9.50	\$225	\$0.08	\$0.19	\$0.47	\$0.13	\$0.31	\$0.39	\$271	\$33	\$41	\$39	\$32	\$37	\$56	\$582	\$623	\$721
AIQ	nr	\$3.64	-	\$192	(\$0.02)	\$0.05	-	(\$0.02)	\$0.05	-	\$738	\$160	\$168	-	\$160	\$168	-	\$481	\$497	-
AIRM	nr	\$27.62	-	\$346	\$2.19	\$2.63	-	\$2.19	\$2.63	-	\$413	\$72	\$83	-	\$72	\$83	-	\$526	\$563	-
ASGN	nr	\$4.83	-	\$176	\$0.12	\$0.31	-	\$0.12	\$0.31	-	\$223	\$25	\$35	-	\$25	\$35	-	\$420	\$461	-
BRLI	nr	\$20.69	-	\$581	\$0.96	\$1.18	\$1.56	\$0.96	\$1.18	\$1.56	\$604	\$61	-	-	\$61	-	-	\$457	-	-
CCRN	2H	\$8.34	\$10.00	\$260	\$0.18	\$0.25	\$0.31	\$0.19	\$0.31	\$0.30	\$304	\$27	\$33	\$31	\$26	\$31	\$32	\$476	\$488	\$526
DGX	1L	\$48.91	\$71.00	\$8,920	\$4.28	\$4.81	\$5.33	\$4.19	\$4.59	\$5.09	\$11,573	\$1,657	\$1,746	\$1,851	\$1,673	\$1,791	\$1,870	\$7,558	\$7,805	\$8,116
EMS	1L	\$47.00	\$61.00	\$2,093	\$3.12	\$3.60	\$4.03	\$3.18	\$3.64	\$3.97	\$2,166	\$321	\$356	\$387	\$315	\$347	\$376	\$2,801	\$3,024	\$3,235
GDX	nr	\$17.07	-	\$310	\$1.26	\$1.44	\$1.45	\$1.26	\$1.44	\$1.45	\$178	\$50	\$50	-	\$50	\$50	-	\$212	\$232	\$252
IPCM	nr	\$24.89	-	\$413	\$1.40	\$1.68	\$2.02	\$1.40	\$1.68	\$2.02	\$373	\$41	\$49	\$60	\$41	\$49	\$60	\$360	\$418	\$484
LH	1L	\$74.20	\$90.00	\$7,902	\$5.33	\$5.87	\$6.45	\$5.45	\$6.04	\$6.58	\$9,058	\$1,217	\$1,297	\$1,408	\$1,196	\$1,268	\$1,336	\$4,861	\$5,069	\$5,326
NHWK	nr	\$2.31	-	\$54	\$0.27	\$0.34	-	\$0.27	\$0.34	-	\$99	\$20	\$23	-	\$20	\$23	-	\$151	\$155	-
MD	1M	\$52.28	\$66.00	\$2,471	\$4.08	\$4.48	\$5.27	\$4.03	\$4.41	\$5.27	\$2,577	\$333	\$367	-	\$339	\$380	\$430	\$1,402	\$1,537	\$1,697
RURL	nr	\$7.96	-	\$200	\$0.61	-	-	\$0.61	-	-	\$440	\$70	-	-	\$70	-	-	\$543	-	-
			Total	\$25,021																
Benchmarks																				
SP500		\$1,028	--	--	\$79.40	\$92.69	\$109.63													
SP400		\$700	--	--	\$47.20	\$57.67	\$68.34													
SP600		\$318	--	--	\$19.42	\$24.89	\$29.65													

** FMS Covered by CIR analyst Cora McCallum

Source: Citi Investment Research and Analysis, Company Filings

Figure 3. HC Facilities Valuations

Ticker	Rating	07/07/10		P/E				LTM FCF Yield	Current EV	Adj. EV/EBITDA ²				EV/Revenue				Debt / EBITDA
		Price	Market Cap	2009A	2010E	2011E	2012E			2009A	2010E	2011E	2012E	2009A	2010E	2011E	2012E	
Acute Care																		
MDTH	2S	\$7.52	\$148.1	11.6x	94.0x	24.3x	23.5x	-11%	\$174	4.7x	5.9x	4.9x	4.7x	0.3x	0.3x	0.3x	0.3x	0.5x
THC	2S	\$4.32	\$2,194.6	33.2x	17.3x	13.9x	12.7x	-1%	\$6,175	6.5x	5.9x	5.6x	5.4x	0.7x	0.7x	0.6x	0.6x	4.0x
UHS	1M	\$36.43	\$3,550.1	14.8x	13.8x	12.3x	10.9x	9%	\$4,436	7.3x	7.0x	6.5x	5.9x	0.9x	0.8x	0.8x	0.7x	1.3x
Sub-Acute Care																		
CYH	1H	\$32.21	\$2,990.2	12.1x	10.6x	9.6x	8.8x	14%	\$11,412	7.4x	7.1x	6.7x	6.4x	0.9x	0.9x	0.8x	0.8x	5.0x
HMA	1H	\$7.35	\$1,836.5	14.7x	12.0x	10.7x	9.1x	12%	\$4,767	7.7x	7.2x	6.9x	6.5x	1.0x	0.9x	0.9x	0.8x	4.2x
LPNT	2M	\$29.89	\$1,623.0	12.0x	11.2x	10.6x	10.1x	11%	\$2,809	6.1x	5.7x	5.5x	5.2x	0.9x	0.9x	0.8x	0.8x	2.5x
				13.4x	12.9x	11.5x	10.5x	12%	\$29,773	6.9x	6.5x	6.0x	5.7x	0.9x	0.8x	0.8x	0.8x	3.3x
BKD	nr	\$14.07	\$1,678.8	20.1x	16.1x	12.7x	--	--	\$4,243	13.6x	11.4x	10.3x	9.6x	2.1x	1.9x	1.8x	1.7x	7.8x
CHE	nr	\$51.98	\$1,196.6	16.0x	13.8x	12.9x	--	--	\$1,238	--	--	--	--	1.0x	1.0x	0.9x	0.9x	0.3x
ESC	nr	\$15.09	\$592.7	--	--	--	--	--	\$2,153	17.1x	14.7x	12.9x	14.3x	2.4x	2.3x	2.1x	2.0x	11.5x
ENSG	nr	\$15.73	\$331.5	10.0x	8.8x	8.2x	--	--	\$399	--	4.6x	4.3x	4.3x	0.7x	0.6x	0.6x	0.6x	0.9x
HLS	nr	\$17.83	\$1,925.6	11.7x	10.2x	9.0x	--	--	\$3,854	9.9x	9.3x	8.7x	8.3x	2.0x	1.9x	1.8x	1.8x	4.1x
KND	nr	\$11.77	\$457.4	7.4x	9.1x	8.4x	--	--	\$3,215	3.6x	3.8x	3.6x	5.4x	0.8x	0.7x	0.7x	0.7x	12.5x
NHC	nr	\$34.74	\$476.8	14.6x	14.2x	13.8x	--	--	\$606	7.3x	7.8x	7.4x	--	0.9x	0.9x	0.9x	0.9x	
PSYS	2M	\$32.86	\$1,852.8	15.3x	14.5x	13.3x	12.0x	2%	\$3,007	9.6x	9.1x	8.5x	7.8x	1.6x	1.6x	1.5x	1.4x	3.6x
RHB	nr	\$20.80	\$512.8	12.1x	7.8x	7.0x	--	--	\$939	13.4x	5.5x	5.1x	5.4x	1.1x	0.7x	0.7x	0.6x	5.2x
SEM	nr	\$6.17	\$987.3	10.1x	9.8x	8.4x	--	--	\$2,341	7.6x	6.4x	6.0x	5.5x	1.0x	1.0x	0.9x	0.9x	4.4x
SKH	2S	\$6.22	\$230.4	6.5x	7.1x	7.3x	6.3x	19%	\$824	6.3x	6.1x	6.0x	5.7x	1.1x	1.0x	1.0x	0.9x	4.6x
SUNH	1H	\$7.78	\$343.7	7.1x	8.3x	7.8x	6.5x	15%	\$1,508	6.0x	6.2x	5.9x	5.5x	0.8x	0.8x	0.8x	0.7x	4.7x
SRZ	nr	\$2.54	\$141.3	--	--	--	--	--	\$919	--	--	--	--	--	--	--	--	51.2x
				11.9x	10.0x	8.7x	6.5x	15%	\$26,113	9.6x	7.1x	6.7x	5.7x	1.1x	1.0x	0.9x	0.9x	
Outpatient																		
AMSG	1M	\$16.95	\$520.6	9.9x	9.9x	9.0x	8.1x	15%	\$793	7.4x	7.3x	6.6x	5.9x	1.2x	1.1x	1.0x	0.9x	1.1x
DVA	1M	\$60.39	\$6,326.8	14.9x	13.8x	12.4x	10.4x	11%	\$9,179	9.3x	8.9x	8.2x	7.1x	1.5x	1.4x	1.3x	1.3x	2.5x
FMS	**1L	\$53.94	\$16,028.3	18.0x	16.5x	14.8x	--	--	\$21,074	9.5x	8.9x	8.3x	--	1.9x	1.7x	1.6x	--	2.2x
GTIV	nr	\$23.01	\$696.4	10.5x	8.5x	9.2x	--	--	\$760	6.1x	5.0x	5.1x	5.3x	0.7x	0.6x	0.6x	0.5x	0.5x
LNCR	1M	\$26.43	\$2,571.8	19.6x	13.9x	11.3x	9.1x	15%	\$2,984	7.8x	6.5x	5.6x	4.8x	1.9x	1.7x	1.6x	1.4x	1.0x
				14.9x	13.8x	11.3x	9.1x	15%	\$34,791	7.8x	7.3x	6.6x	5.6x	1.5x	1.4x	1.3x	1.1x	1.1x
Outsourced Services																		
AHCI	nr	\$2.25	\$102.2	9.4x	8.0x	--	--	--	\$61	--	--	--	--	0.2x	0.2x	--	--	
AHS	2H	\$6.71	\$224.6	30.5x	83.9x	35.3x	14.3x	32%	\$271	6.8x	8.4x	7.3x	4.8x	0.4x	0.5x	0.4x	0.4x	1.3x
AIQ	nr	\$3.64	\$192.0	19.2x	--	75.3x	--	--	\$738	--	4.6x	4.4x	--	1.5x	1.5x	1.5x	--	3.4x
AIRM	nr	\$27.62	\$346.1	11.9x	12.6x	10.5x	--	--	\$413	--	5.8x	5.0x	--	0.8x	0.8x	0.7x	--	1.0x
ASGN	nr	\$4.83	\$175.6	37.2x	41.4x	15.7x	--	--	\$223	8.3x	9.0x	6.4x	--	0.5x	0.5x	0.5x	--	2.1x
BRLI	nr	\$20.69	\$580.9	26.3x	21.5x	17.5x	13.3x	--	\$604	--	9.8x	--	--	1.6x	1.3x	--	--	0.4x
CCRN	2H	\$8.34	\$259.8	32.1x	46.3x	33.4x	26.9x	21%	\$304	9.3x	11.6x	10.0x	9.6x	0.5x	0.6x	0.6x	0.6x	1.6x
DGX	1L	\$48.91	\$8,920.4	12.6x	11.4x	10.2x	9.2x	9%	\$11,573	7.5x	7.2x	6.8x	6.5x	1.6x	1.5x	1.5x	1.4x	1.7x
EMS	1L	\$47.00	\$2,093.1	18.5x	15.1x	13.1x	11.7x	11%	\$2,166	7.7x	6.9x	6.2x	5.8x	0.8x	0.8x	0.7x	0.7x	0.3x
GXDX	nr	\$17.07	\$310.4	10.0x	13.5x	11.8x	--	--	\$178	3.1x	3.6x	3.6x	--	1.0x	0.8x	0.8x	0.7x	
IPCM	nr	\$24.89	\$412.9	21.3x	17.8x	14.8x	--	--	\$373	11.2x	9.1x	7.6x	6.2x	1.2x	1.0x	0.9x	0.8x	
LH	1L	\$74.20	\$7,902.3	15.1x	13.9x	12.6x	11.5x	10%	\$9,058	8.1x	7.7x	7.3x	6.9x	1.9x	1.9x	1.8x	1.7x	1.0x
NHWK	nr	\$2.31	\$54.5	4.0x	8.6x	6.8x	--	--	\$99	2.9x	4.8x	4.3x	--	0.6x	0.7x	0.6x	--	1.7x
MD	1M	\$52.28	\$2,471.1	14.1x	12.8x	11.7x	9.9x	8%	\$2,577	8.5x	7.6x	6.8x	6.0x	2.0x	1.8x	1.7x	1.5x	0.3x
RURL	nr	\$7.96	\$200.2	--	13.0x	--	--	--	\$440	--	6.3x	--	--	--	0.8x	--	--	3.0x
TMH	1M	\$12.03	\$774.7	11.2x	12.5x	11.1x	9.6x	5%	\$1,213	8.5x	8.2x	7.5x	6.8x	0.9x	0.8x	0.8x	0.7x	3.1x
				15.1x	13.5x	12.8x	11.6x	10%	\$30,289	8.1x	7.6x	6.8x	6.3x	0.9x	0.8x	0.8x	0.7x	1.6x
Additional Healthcare Sectors																		
Biotech				17.0x	14.8x	12.1x	10.5x			11.0x	9.4x	8.0x	6.2x	4.5x	3.9x	3.6x	3.3x	
Pharma				9.1x	9.1x	8.6x	9.6x			5.4x	5.7x	5.2x	5.7x	2.3x	2.0x	2.0x	2.2x	
Distrib.				16.4x	15.3x	13.8x	12.3x			8.5x	7.9x	7.5x	6.9x	0.3x	0.3x	0.2x	0.7x	
Payors				9.7x	9.5x	9.0x	8.3x			3.3x	3.8x	3.7x	3.5x	0.3x	0.3x	0.3x	0.2x	
Devices				16.1x	15.3x	13.4x	11.4x			9.2x	8.8x	8.0x	7.2x	2.5x	2.4x	2.2x	2.0x	
HCIT				30.3x	27.0x	20.4x	16.4x			14.4x	12.2x	9.6x	7.2x	3.4x	2.9x	2.5x	2.0x	
HC REITS				14.1x	14.8x	13.9x	13.0x			19.5x	15.1x	13.9x	13.1x	12.9x	12.1x	11.5x	10.8x	
** FMS Covered by CIR analyst Cora McCallum																		
Benchmarks																		
SP500		\$1,028		16.9x	13.0x	11.2x	9.9x	7.5%										0.9x
SP400		\$700		19.1x	15.9x	13.0x	11.0x	6.9%										0.7x
SP600		\$318		26.2x	17.5x	13.6x	11.5x	7.0%										0.0x

Source: Citi Investment Research and Analysis, Company Filings

Skilled Healthcare Group

Company description

Skilled Healthcare Group, Inc. provides integrated long-term healthcare services in the United States. Its skilled nursing facilities provide specialty care, such as chemotherapy, dialysis, enteral/parenteral nutrition, tracheotomy care, and ventilator care, as well as offer various services, including room and board, special nutritional programs, social services, recreational activities, and related healthcare and other services. These skilled nursing facilities include Express Recovery, a unit that provides skilled nursing care and rehabilitation therapy for patients recovering from conditions, such as joint replacement surgery, and cardiac and respiratory ailments. The company's assisted living facilities provide residential accommodations, activities, meals, security, housekeeping, and assistance in the activities of daily living to seniors who are independent or who require some support, but not the level of nursing care provided in a skilled nursing facility. Skilled Healthcare Group also provides ancillary services, such as physical, occupational, and speech therapy, as well as rehabilitation therapy service to third-party skilled nursing operators. In addition, the company offers hospice services comprising palliative and clinical care, education, and counseling with a focus on the physical, spiritual, and psychosocial needs of terminally ill individuals and their families.

Investment strategy

We rate the shares of Skilled Healthcare Group Hold/Speculative Risk (2S). We expect SKH shares to perform inline with the overall market over the next 12 months. We had previously lowered our estimate to reflect the 1% MDCR rate cut for F'10, but now need to moderate our occupancy and mix assumptions. While we believe the market has over-discounted RUG-IV risk (we think the stock would trade at a higher multiple if investors even had confidence that 2011 EPS could be flat yty), we don't see opportunity for visibility and multiple expansion until late 2010.

Valuation

Our \$8 12-month price target on SKH is constructed using a risk-adjusted target P/E multiple of 9.4x our FY2010 EPS estimate of \$0.87. Given SKH's market cap, we utilize the current S&P600 P/E (2010) roll the multiple forward onto our SKH earnings after risk adjusting for relative growth, earnings quality, reimbursement risk, FCF ROAIC and balance sheet leverage. Each of these factors are calculated to drive a premium or discount vs. the S&P600 multiple.

Risks

We rate SKH as Speculative risk due to high financial leverage, high exposure to California Medicaid (13-14% of revenue), and historical stock price volatility.

1. SKH is more geographically concentrated than peer SNF companies, with 66% of its licensed beds located in just two states (CA & TX). Thus, regulatory and Medicaid reimbursement risk is elevated on a relative basis vs. more diversified operators. CA currently faces the most critical budget issues, and over 1/3rd of SKH beds are located within CA.

2. Medicare reimbursement represents approximately 40% of revenues. Any reduction to the annual market basket inflation updates, whether through CMS' forecasting error adjustment mechanism or as a "pay for" as part of broader Medicare legislation, would negatively impact earnings power. Every 100bps reduction in Medicare rates is approximately 5% EPS risk to SKH.

3. The company's 18% EBITDAR margins are industry-high. We foresee greater risk that the margins decline over the next several years.

4. Onex Corporation owns 40% of total shares outstanding and can reasonably be expected to maximize the value of its position when and if such an opportunity presents itself. A possible strategic transaction presents upside risk to our target.

5. Although relatively highly levered, SKH retains the balance sheet liquidity to make acquisitions in 2010 that we have not included in our model. If accretive, such acquisitions could drive reported earnings above consensus estimates.

If the impact on the company from any of these factors proves to be greater than we anticipate, the stock will likely have difficulty achieving our target price. Likewise, if any of these factors proves to have less of an effect than we anticipate, the stock could materially outperform our target price.

Appendix A-1

Analyst Certification

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IMPORTANT DISCLOSURES

Skilled Healthcare Group (SKH)

Ratings and Target Price History

Fundamental Research

Analyst: Gary Taylor

Covered since April 29 2008

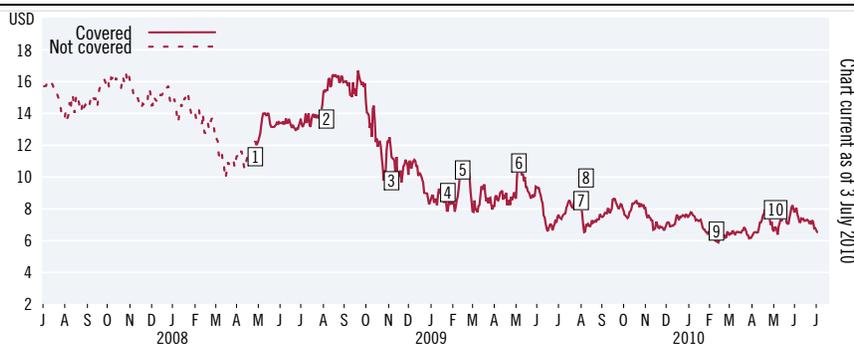


Chart current as of 3 July 2010

	Date	Rating	Target Price	Closing Price
1	28-Apr-08	*3H	*11.00	12.27
2	6-Aug-08	3H	*13.00	15.47
3	6-Nov-08	3H	*10.00	11.26
4	26-Jan-09	*2S	10.00	7.88

	Date	Rating	Target Price	Closing Price
5	16-Feb-09	2S	*11.00	10.04
6	6-May-09	2S	*14.00	10.64
7	3-Aug-09	2S	*9.00	8.15
8	9-Aug-09	2S	*8.00	6.56

	Date	Rating	Target Price	Closing Price
9	10-Feb-10	2S	*7.00	5.96
10	5-May-10	2S	*8.00	6.84

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Skilled Healthcare Group (SKH)

7 July 2010

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Skilled Healthcare Group (SKH)

7 July 2010

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