

# FINAL TRANSCRIPT

**Thomson StreetEvents<sup>SM</sup>**

## **GTIV - Q1 2005 Gentiva Health Services Earnings Conference Call**

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**Matt Ripperger**

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## PRESENTATION

**Operator**

Ladies and gentlemen, thank you for standing by and welcome to the Gentiva® Health Services first-quarter earnings conference call. At this time, all lines are in a listen-only mode. Later, there will be a question-and-answer session and instructions will be given at that time. (OPERATOR INSTRUCTIONS) As a reminder, today's call is being recorded. At this time, I'd like to turn the conference over to Mary Morrissey Gabriel.

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**Mary Morrissey-Gabriel** - *Gentiva Health Services, Inc. - SVP-Chief Marketing Officer*

Thank you, and thank you and good morning. Thank you for joining us this morning. I am Mary Morrissey Gabriel, Senior Vice President and Chief Marketing Officer of Gentiva Health Services, and this is Gentiva's first-quarter 2005 earnings call.

We hope that each of you has had a chance to review the Company's first-quarter earnings report, which we released after close of market yesterday. In a moment, I will turn the call over to our company's Chief Executive Officer, Ron Malone, for remarks on Gentiva's performance during the first quarter, and to John Potapchuk, our Chief Financial Officer, for a closer look at our financial results and outlook. Also joining us for the call on the question-and-answer period is Al Perry, our President and COO, as well as others key executives.

Let me remind participants on this morning's call that comments made by Gentiva executives and associates other than historical information should be considered forward-looking and are subject to various risk factors and uncertainties. For example, our

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strategies and our operations involve risks of competition, changing market conditions, changes in laws and regulations affecting our industry, and numerous other factors discussed in our first-quarter earnings release and in our filings with the Securities and Exchange Commission.

Accordingly, actual results may differ materially from those anticipated in any forward-looking projections or comments on this call today. Please refer to the forward-looking statement in our news release issued last evening, as well as similar language in our most recent 10-K.

We are also operating under the Securities and Exchange Commission Regulation FD. Our call this morning and comments within it will be consistent with our obligations under these SEC regulations. As such, we strongly encourage participants on this call with questions to present them during today's question-and-answer period because under Regulation FD, we have certain limitations on comments that can be made in individual inquiries.

We are also mindful of Securities and Exchange Commission Regulation G. Regulation G requires public companies that disclose or release non-GAAP financial measures to include in that release or disclosure a presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure. Because of this, we will not discuss non-GAAP financial measures on this call other than what is set forth in our earnings release.

I would also like to mention that Gentiva continues to have a policy of being open and responsive to inquiries related to our Company. In the Investor Relations section of our Company's web site, [Gentiva.com](http://Gentiva.com), you will find our press releases, our investor presentation, and many of our SEC filings. In accordance with Regulation G, a transcript of this call will be posted to the web site and available for the next 12 months. Additionally, you may access our earnings call replay for the next seven days.

We appreciate your continued interest in Gentiva Health Services and let me now turn the call over to Gentiva's Chief Executive Officer, Ron Malone, for comments on the Company's first-quarter 2005 performance.

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**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

Thanks, Mary. Good morning, everyone, and thanks for joining us. Our first quarter presented a mix of opportunities and challenges. Here are the highlights:

Medicare revenues increased 13.1%, excluding special items. The increase was primarily driven by growth in admissions, including admissions to specialty programs. This was our seventh consecutive quarter of double-digit Medicare growth. In fact, specialty programs accounted for more than two-thirds of our first-quarter Medicare revenue growth. We are continuing to take these specialty programs to new areas of the country with the addition of 12 new locations during the first quarter.

Our Medicaid and Local Government revenues declined 6.4% in the first quarter compared to the first quarter of 2004 due to our continuing strategy of limiting participation in certain lower margin programs. However, we believe we have completed our transition from most of those programs and we are beginning to see growth in skilled, intermittent business, with admissions up sequentially since the fourth quarter of 2004.

Commercial Insurance and Other revenues grew 9.1%, excluding the CIGNA business, driven by our relationship with TriWest Healthcare Alliance and other managed care customers. However, revenues from CIGNA declined 12%, due to lower-than-expected revenues from capitated plans. This caused our Commercial Insurance and Other payer group to report an overall 3.1% revenue decline.

And finally, there were two factors that affected our gross margin for the quarter. Although we had a 13.7% increase in Medicare admissions, there were still capacity challenges in our Home Healthcare business. That business is making dramatic changes

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to its workforce as it moves to a business mix more focused on therapies and as it continues to add full-time clinicians at an accelerated pace. For example, in the first quarter of 2005, we added over 140 full-time clinicians. By contrast, in the first quarter of 2004, we added 17 full-time clinicians.

One factor that affected gross margin in some markets was the decline in Medicare revenue per admission from the fourth quarter of 2004.

Clearly, we understand both our opportunities and our challenges and we know how to address them.

Among the opportunities, we continue to grow our specialty services. Some of you may have seen last month's news release on the favorable clinical outcome data from our Gentiva Safe Strides<sup>SM</sup> program for people with balance problems.

We're also seeing favorable clinical results and high patient satisfaction scores from our Gentiva Orthopedic Program, which has treated over 60,000 patients across the country since it was created in 2002. In addition, we are currently building outcome results from our recently launched Gentiva Cardiopulmonary Program. These outcomes are important tools in communicating the value of our specialty programs to patients, physicians and referral sources.

One of the areas we are focusing on is capacity. In our news release, we talked about incurring short-term costs this year to improve clinical capacity and branch operations. As most of you know, our ability to say "yes" to referral sources is a critical differentiator in the marketplace and our full-time clinicians can make a significant contribution to our results when they reach full productivity.

Our investment in sales resources has yielded a strong referral flow. As a result of this increased demand, we took the opportunity to bring on a large number of full-time clinical associates during the quarter.

We also added a significant number of full-time and per diem therapists to support the growth of our specialty services. However, our experience tells us it can take up to 90 days for these associates to become fully productive. In addition, costs related to these additions include recruitment, orientation and training.

Regarding our branch operations, we are continuing to make investments to support growth, yet we are conscious of the need to get appropriate returns in each market. We are taking a closer look at our branch network and going forward, we're raising our expectations of minimum branch profitability.

During the quarter, we exited number of markets where we did not demonstrate acceptable returns. At the same time, we are in the process of opening a number of new locations during the year, including our first specialty-only branches. This is in addition to accelerating the rollout of the specialty programs in existing branches.

In our Commercial Insurance and Other payer category, we saw a greater-than-expected enrollment decline among CIGNA managed care members. I am pleased to report that we are now in the process of finalizing an amendment to our CIGNA contract to include a health plan that has not been part of our national agreement. In the meantime, we are adjusting our costs to align with the current volume of business.

I want to stress that we are committed to expanding our CareCentrix<sup>®</sup> business through both new and existing contracts. Our agreement with TriWest Healthcare Alliance reaches its one-year anniversary on June 1, and we are making additional investments in staff, which we hope will allow us to accelerate the growth of that business.

TriWest covers 2.7 million military personnel and their families, and our experience with this population will serve us well as we pursue additional government related business.

I also want to make note of our new segment reporting as a better way to communicate our operating results.

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The Home Healthcare Services segment comprises financial results generated by direct home nursing and therapy services, including specialty programs, Gentiva Rehab Without Walls®, and Gentiva Consulting. The CareCentrix segment comprises results from Gentiva's ancillary care benefit management and the coordination of integrated home care services for managed care organizations and health benefit plans.

The new segment reporting aligns our communications with the way we intend to run our businesses in the future, with greater separation between Gentiva's direct services and CareCentrix. It is also in line with our recently announced branding initiative, as we have positioned Gentiva Home Healthcare and CareCentrix as two separate and distinct brands.

Before I end my remarks, I want to say we're pleased to welcome the associates of Heritage Home Care Services to Gentiva following the completion of this acquisition earlier in the week. We expect Heritage to bring in annualized revenues of more than \$20 million and to be accretive to our 2005 results.

Our cash consideration for the selected assets and business of Heritage was \$11.5 million, exclusive of working capital requirements and transaction costs. We believe this is a good investment and we are excited about our ability to increase our reach in this growing market.

Since we announced the acquisition in early April, we have been working closely with Heritage managers and staff on an integration program to highlight the best attributes of both organizations. We have been very pleased with the response of Heritage employees and our integration is off to a great start.

With that, I would now like to turn the call over to our CFO, John Potapchuk, for a discussion of our financial performance and our outlook for 2005.

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**John Potapchuk** - *Gentiva Health Services, Inc - CFO*

Thanks, Ron, and welcome, everyone. Before I discuss Gentiva's first-quarter financial results and our outlook in more detail, I would like to briefly remind our audience of two items that affect our presentation format and the comparability of income statements for the 2005 and 2004 periods.

The first is our settlement of Medicare reimbursement appeals from 1997 that contributed about \$9 million to first-quarter 2004 revenues and pre-tax income. And the second item relates to a \$1 million revenue adjustment, representing an estimated repayment to Medicare that we recorded in the first quarter of 2004. These items are covered in our earnings releases and SEC filings.

Because of these items, we also disclosed Net Income - As Adjusted in our earnings release and reconciled such amounts to the reported GAAP presentation. We believe the "as-adjusted" presentation is useful to investors, since it reflects the Company's operating performance in a consistent matter, excluding the special items that I just mentioned.

Now I would like to review our first-quarter performance.

Our total net revenues were \$207.1 million versus almost \$213.9 million in the same period a year earlier. Net of the \$8.0 million of Medicare special items, first-quarter 2005 revenues were \$1.2 million higher than in the same period of 2004. Our net income as reported was \$4.1 million, or \$0.17 per diluted share, compared to \$9.2 million, or \$0.34 per diluted share, in the first quarter of 2004. As we noted in the news release, the 2004 results include \$0.18 per diluted share relating to Medicare special items. Net Income - As Adjusted was \$4.1 million, or \$0.17 per share, for the first quarter of '05 versus \$4.3 million, or \$0.16 per share, for the first quarter of 2004.

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We saw the following changes in our payer mix for the first quarter of 2005 versus the first quarter of 2004, excluding the special items. Medicare represented approximately 29.8% of our total net revenues for the first quarter of 2005, up from 26.5% in the same period of 2004. Medicaid and Local Government payers represented approximately 17.7% of total net revenues for the quarter, a decrease from 19% in the same period last year. And the Commercial Insurance and Other payer category represented 52.5% of total net revenues versus approximately 54.5% in the first quarter of 2004.

In this last category, we discussed the fact that non-CIGNA revenues increased 9.1%, while revenues from CIGNA declined 12%. As a result, CIGNA's contribution to Gentiva net revenues in the first quarter of 2005 was about 27.5%. This represented a decline from 30% of the total revenue reported in the first quarter of 2004.

Turning to other financial measures, our gross profit in the first quarter of 2005 was approximately \$3.5 million lower than the corresponding period of 2004. As a percentage of net revenues, gross profit margins decreased about 3/10 of a percent, from 38.9% in the first quarter of 2004, including the special items, to 38.6% in the first quarter of 2005. However, if the special items in the 2004 period were excluded, our gross profit margins would have increased \$4.5 million, or about 200 basis points, from the prior year quarter.

There were two major drivers behind this gross margin improvement. The first was a favorable change in our business mix, as our increased Medicare business and revenue growth from our higher-margin specialty programs more than offset the anticipated revenue loss from reduced participation in certain low-margin Medicaid and Local Government programs.

The second was CareCentrix, as we benefited from the impact of changes to our HME provider network during 2004 and from the addition of new contracts such as TriWest. The impact of these two items resulted in a 2% improvement in gross margin between the 2004 and 2005 periods.

We also saw positive changes to gross margin percentages from increased Medicare reimbursement rates and lower workers' compensation and insurance expenses. However, these positive changes were mitigated by the cost of orientation and training of recently hired clinicians, and in certain markets, lower-than-anticipated Medicare revenue per admission.

Selling, general and administrative expenses of \$71.8 million for the first quarter of 2005 increased about \$5.4 million compared to the first quarter of 2004. The increase is attributable to: about \$3 million resulting from incremental field operating and administrative costs to service increased Medicare volume and develop and manage our specialty programs; also, \$1 million relating to higher selling and clinical care coordination expenses; and about \$1 million relating to costs associated with changes to the CareCentrix HME network.

In addition, SG&A costs for the first quarter of 2005 included an incremental \$1.3 million of recruiting and travel costs, relating primarily to the hiring and orientation of full-time clinicians and other personnel. These costs were offset somewhat by a favorable arbitration settlement of approximately \$800,000 during the first quarter of fiscal 2005.

Our pre-tax income as a percentage of net revenues was about 3.3% in the first quarter of 2005 compared to approximately 7.1% in the same period a year earlier. Excluding the special items, the 2004 figure would have been about 3.5%.

Net accounts receivable increased by \$5.0 million from the end of the fourth quarter and our Days Sales Outstanding, or DSO, at April 3, 2005 was 60 days, an increase of 3 days from the end of the fourth quarter. The increase in DSO during the quarter relates to claims processing delays associated with the TriWest account. We expect these processing issues to be resolved in the near term and our overall DSO to return to the 2004 year-end level or better.

At the end of the first quarter of 2005, cash, cash items, and short-term investments were \$103.6 million. As we mentioned in the news release, Gentiva repurchased 472,500 shares of common stock in the first quarter at a cost of about \$7.6 million, or an average cost per share of about \$16.08. From May 2003, when we first began our share repurchase program, through the end of the first quarter of 2005, we have repurchased 4.5 million shares in the open market at a cost of over \$60.4 million, or an

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average cost of about \$13.53 per share. As you may know we announced on April 14 that our Board of Directors has authorized the repurchase of up to an additional 1.5 million shares.

Turning to our segment performance, Home Healthcare Services' net revenues for the first quarter of 2005 were \$133.1 million. This was a 3% decrease from the \$137.2 million reported in the same period a year earlier, which included \$8.0 million of special items relating to Medicare. Net of the special items, first quarter 2005 segment net revenues rose 3% over the prior-year period.

Home Healthcare's operating contribution for the first quarter of 2005 was \$11.6 million as compared to \$21.3 million in the same quarter of 2004. Excluding special items, operating contributions decreased 12.4% from the \$13.3 million reported for the same period of 2004. The decline was due primarily to investments in recruiting full-time clinical associates and, in certain markets, a decline in Medicare revenue per permission.

CareCentrix net revenues for the first quarter of 2005 were \$78.9 million, a 3.9% decline from the \$82.1 million reported in the same period a year earlier. CareCentrix operating contribution for the first quarter of 2005 was \$6.8 million, up 6.7% from the \$6.4 million reported in the same period a year earlier. The increase was due to net improvements we made in reconfiguring our HME provider network and the impact of new business offset by lower revenues from CIGNA. I also want to note that on our last call, we mentioned a lawsuit against Gentiva, CIGNA and Dana Diabecare involving patient allegations of a denial of a medically necessary insulin infusion pump. I'm pleased to say that the suit has been dismissed.

As we mentioned in our news release, the EPS outlook is updated for several reasons, including: the postponement of our implementation of accounting rules on equity-based compensation; our recent acquisition of Heritage Home Care Services in Utah; a conservative view of revenues anticipated from our CIGNA relationship, based on our first-quarter experience; and our decision to incur short-term costs to improve clinical capacity and branch operations. As a result, we are changing our 2005 outlook for full-year net income to a range of \$0.75 to \$0.83 per diluted share from the previous outlook of \$0.72 to \$0.80 per diluted share on average shares outstanding of approximately 25 million. Our previous outlook reflected diluted shares of 26.2 million. The net revenue outlook remains unchanged, in a range between \$870 and \$890 million.

That completes our financial discussion. Now, I would like to return the call back to Ron before we take your questions.

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**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

Thanks, John. If we look at the results of the first quarter, our priorities are clear for the remainder of the year. We remain committed to Medicare growth and the expansion of our specialty services. We have made investments and the decisions required to improve the performance of the Home Healthcare business. We will continue to pursue additional commercial business by bringing in new accounts and developing the business from current accounts.

We're managing the business for the long-term. We are mindful that we need to do the right thing for our shareholders and that growth in earnings drives share price. We are very focused on execution.

That sums up our prepared comments for the quarter. We would now like to take your questions.

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## QUESTIONS AND ANSWERS

### Operator

(OPERATOR INSTRUCTIONS) Art Henderson, Jefferies & Co.

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**Art Henderson** - Jefferies & Co. - Analyst

Good morning. I was wondering if you could indicate what you have in your guidance coming from Heritage this year -- how much EPS you have in your guidance?

**John Potapchuk** - Gentiva Health Services, Inc - CFO

Art, this is John. We had disclosed that on an annualized basis, revenue is in excess of \$20 million. And when you work through from the acquisition date, May 1, to the end of the year, we are expecting about \$0.02 to \$0.03 on Heritage.

**Art Henderson** - Jefferies & Co. - Analyst

So then you have the \$0.06 to \$0.08 for stock options expensed, so the short-term costs that you talk about to improve clinical capacity and facility operations is basically \$0.05 to \$0.08 decline.

**John Potapchuk** - Gentiva Health Services, Inc - CFO

I think it may have been 6 to 8, actually, from our earlier outlook -- if that's what you are trying to reconcile.

**Art Henderson** - Jefferies & Co. - Analyst

All right. So then if I just think about '06 stock options' expense, we should assume to be somewhere \$0.12 to \$0.16?

**John Potapchuk** - Gentiva Health Services, Inc - CFO

Well, we haven't given any sense on '06. For instance, as time goes on, some of the earlier options are already vested and they don't have expense associated with it. But we will take a look at that down the road. I might also mention that \$0.06 to \$0.08 operational changes -- it's a short-term cost we talked about, but also the lower revenue on CIGNA has an impact also.

**Art Henderson** - Jefferies & Co. - Analyst

Okay. Since you mentioned that, could you kind of explain what is going on with CIGNA in terms of the weakness that you're seeing in that business? And is this something that we are going to see going forward? It is hard to understand what is happening there.

**Ron Malone** - Gentiva Health Services, Inc. - CEO

Good morning. This is Ron. Let me try to make it as simple as I can. In the quarter, we saw a drop in membership in our capitated plans. We, as you may recall, service a wide number of plans in CIGNA, including PPO membership and HMO membership. The difference in those populations is that in the capitated plans, when you see a decrease in the enrollment, you see an immediate drop in revenue.

When CIGNA has a shift in membership from HMO into PPO or open access products, we then bill on an as-needed basis, a fee-for-service basis. So we are seeing an uptick in what we would term as PPO or open access related revenue, but I think we just took a conservative view based on the first quarter experience and the drop in enrollment in the managed or HMO plan. But we would expect that we would start to see services flow through from those that shifted into the PPO or open access categories.

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**Art Henderson** - *Jefferies & Co. - Analyst*

Okay. So is this kind of -- this seasonal thing, where you see people going in and out of plans at the beginning of the year? Is that maybe what caused this -- just shifting out of plans and going to PPOs or just exiting CIGNA altogether?

**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

I think that what you have is you have perhaps an 85% shift occurs in the beginning of the year. Because even if you look at -- and I would encourage you perhaps to listen to the replay of CIGNA's call as they explain their view toward products and that sort of thing -- and they talk about enrollment. When you would see members going out of CIGNA, new members coming into CIGNA, and you would see members making a change in plan elections.

So the first quarter is sometimes it takes a while to really understand what is going on it, to reconcile the membership back to the capitated plans. And then usually there is a lag when you see the shift in PPOs, there is a lag, because as I mentioned you're not getting that upfront payment anymore to take care of population. Now you're billing on fee-for-service as they need the services.

So if we look at the past few years, that is exactly what we have seen. You may have noted from our earlier conversations that we have seen a pretty brisk growth in the PPO business from CIGNA over the past few years. And it would seem that the way they are positioning their products, we would expect to see that in the future. We have simply taken a pretty conservative view because until we can see it and quantify it, we just thought that is best.

**Art Henderson** - *Jefferies & Co. - Analyst*

Makes sense. One less question and I'll jump back in the queue. The capacity issue that you talk about out in the field, is that something that you did not foresee coming? It seems to me like it kind of caught you by surprise, and I am just wondering how much in your SG&A going forward -- is it basically taking the \$71 million? Should we be annualizing that or where should we fall out there?

**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

I think there are probably a couple of comments I'd like to make might be useful. The first relates to capacity and the second relates to growing the business nationally.

On the capacity issue, we have known for some time that we needed to continue to recruit caregivers at an accelerated pace. I think the very, very good news is that our referral stream is robust. We are sitting here putting tremendous attention and resources behind our recruiting team in order to get in the resources we need that enable us to say yes.

Now the thing that, if anything, we could not predict is how successful we would be in attracting those people during the first quarter. Now, a significant number of those people, both as part of the 143 that we added that I mentioned net, were physical therapists. We also added physical therapists on our per diem ranks, those caregivers that are paid per visit.

And we have seen a couple of things in that population. One is we have seen a pretty quick ramp-up of those people being effective for us, and we have also seeing a turnover rate of 13%. It says to us that Gentiva is becoming a very good home for physical therapists that are interested in doing something interesting in homecare. So we took advantage of that flow -- and I realize that certainly it appears as a bold move, and perhaps we have conditioned you to think we are very, very conservative. But again, we see the opportunity to grab these referrals and to us it is very important to seize the moment as it relates to pulling these people in.

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On our specialty programs, we opened about 12 sites in the first quarter and anticipate opening between perhaps, say, more than 20 in the second quarter. And we are fueling and getting ready for that expansion. Now on the second point I would make is we are always looking at where we have made investments and seeing if those investments have paid off. We are now operating more than 260 sites in nursing. And as you can imagine, some of those sites are doing very, very well and others are disappointing us. So we are always backing up and really looking at where we have placed additional personnel, additional investments, whether they are inside or outside, and seeing if we are getting a return on that.

Some markets, particularly I think of some in the Northeast, are simply more difficult for us to penetrate, and over time we will make decisions as to whether ongoing investments making any sense for us. So perhaps some of that is helpful for you, Arthur.

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**Art Henderson** - *Jefferies & Co. - Analyst*

Great. Thank you.

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**Operator**

Matt Ripperger, Smith Barney.

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**Matt Ripperger** - *Smith Barney - Analyst*

Just a couple questions. It looks like CIGNA contributed about \$57 million in revenues in the quarter, which is just taking the percent you gave again against total revenues. I wanted to see if you could help us get some clarity in terms of what your conservative assumptions are for CIGNA going forward, and should we expect any further attrition in this business in the latter part of '05?

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**John Potapchuk** - *Gentiva Health Services, Inc - CFO*

Matt, at this point, as we said, we have taken a conservative approach based on first-quarter numbers. So you're absolutely right with the number on \$57 million for the quarter. At this point, what we have done is, in essence, annualize that number and assumed some level of very conservative growth on the PPO side. Because as Ron explained earlier, that is something that there will be some expectation of that, but it is not as predictable. So we are taking a wait-and-see (multiple speakers).

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**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

Which is simply not as apparent to us at this point in time. We have seen an uptick, but again, I will be more comfortable when I am able to quantify what that means for the future. I will say, though, that you'll see most of that -- as I indicated when Art asked his question -- you'll see most of that churn at the first of the year. And I think (multiple speakers) certainly CIGNA has posted improved performance, new products and we are pretty optimistic about what we might see there.

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**Matt Ripperger** - *Smith Barney - Analyst*

I just want to make sure I'm clear. In essence, you're annualizing the \$57 million, you're assuming modest growth on the PPO side. Are you assuming any further attrition on the capitated HMO side?

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**John Potapchuk** - *Gentiva Health Services, Inc - CFO*

No.

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**Matt Ripperger** - *Smith Barney - Analyst*

In essence, the quarterly build from here should be marginally better than what you reported this first quarter?

**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

That is what we would hope for.

**Matt Ripperger** - *Smith Barney - Analyst*

And does that build into -- does that take into account the amendment you referred to, where you're adding more CIGNA regional plans that are not currently in the national contract?

**John Potapchuk** - *Gentiva Health Services, Inc - CFO*

No, it does not.

**Matt Ripperger** - *Smith Barney - Analyst*

Can you help quantify what that could mean to your current run rate for CIGNA?

**John Potapchuk** - *Gentiva Health Services, Inc - CFO*

Well, we have not signed anything yet, Matt, so I want to -- I will take a pass on that at the moment. I will say, though, built into our overall guidance for the year, there is some expectation of new business coming in -- I will say in the \$10 to \$15 million range. Any expansion of the relationship with CIGNA or new business opportunities all would fall into that category.

**Matt Ripperger** - *Smith Barney - Analyst*

Okay. Absent this, giving your exposure to CIGNA, which granted has been coming down -- it's now 27% versus 30 a year ago -- is there anything internally that you are focusing on to try to help insulate yourself to this payer going forward? Such as new payer opportunities or external growth opportunities or anything along those lines so that the volatility associated with this client is lower going forward?

**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

First of all, I want to tell you we have a long relationship with CIGNA and we very much appreciate them as a customer. We have worked very hard to contribute to their success in the efforts they have mounted over the past year, year-and-a-half. We are also, though, mindful that there is we believe tremendous opportunity to share that message out among other customers, and we have added to our sales resources. As we indicated, we are adding some resources, particularly targeted on getting the business transferred into our CareCentrix system from the TriWest Healthcare Alliance. I think there is a lot of opportunity out there.

You asked about external opportunities. I would tell you that we look at and we discuss many opportunities. Some of those, as you can imagine, are immediate opportunities and others are exploratory. We are interested certainly in opportunities that relate to our current businesses as well as branching out into closely aligned businesses.

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And again, as I said earlier we certainly appreciate the relationship with CIGNA; however, there are 17 other customers in CareCentrix right now that represent further opportunity to grow them. We believe there are prospects out there that we have not yet signed that also represent opportunity. And we are mindful that anyone looking at that relationship -- we know the percentage that it represents, and we are pleased to see the progress we have displayed in bringing on new business that helps diversify, yet we certainly would love to see the CIGNA business grow again as well.

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**Matt Ripperger** - *Smith Barney - Analyst*

If I could just ask one last question related to that. As you look out, are there any incremental new risks related to this business, related to -- I think the rate that you're currently contracted with CIGNA comes up for renewal at the beginning of next year. So is that a risk?

Number two, is there any risk or provision that they have where they could carve out any part of the business that they currently direct through you, such as HME by going directly to an equipment company, or maybe O&P services?

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**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

CIGNA has over the life of the contract certainly moved some products in and out, over the course. I think that CIGNA went to an extraordinary effort last year to evaluate the best way to distribute the HME/DME products, and we believe that they are very satisfied with the method that they chose. I think we have always, though, ourselves insisted that we sit down and renegotiate those rates because it is never clear about what utilization would be in forward years. So given that we are a large provider to CIGNA but they are a very large customer impact on our revenue and margins, we need that flexibility to look at pricing and adjust it year-to-year. And we have always done that, even when we had multi-year -- as you know this contract expires at the end of '06, but we have always had some methodology in there for adjusting price on an annual basis.

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**Matt Ripperger** - *Smith Barney - Analyst*

But there was no price adjustment reflected in this first quarter of '05?

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**John Potapchuk** - *Gentiva Health Services, Inc - CFO*

Yes, there was.

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**Matt Ripperger** - *Smith Barney - Analyst*

So in addition to the attrition, there was some kind of reduction in price?

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**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

Price went up.

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**Matt Ripperger** - *Smith Barney - Analyst*

All right, great. Thank you.

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**Operator**

Larry Marsh, Lehman Brothers.

**Brian Hogan** - *Lehman Brothers - Analyst*

This is actually Brian Hogan for Larry. Quick question on the cash flow front. I believe last quarter you talked about operating cash flow being in the \$27 to \$29 million range for the year, and I see that you have a use of cash. Is it still your expectation that you will be in that \$27 to \$29 million range?

**John Potapchuk** - *Gentiva Health Services, Inc - CFO*

I think we may have indicated 26 to 30, but we are still expecting that same level of cash flow. I think this quarter, as I mentioned, with the TriWest processing and this quarter we have annual insurance premiums coming on, there was an expectation that it would be lower. But we expect to recover and hit that original target.

**Brian Hogan** - *Lehman Brothers - Analyst*

Okay. And then on your revenue guidance, that remained unchanged although you said you're more conservative, obviously, on the CIGNA front. Is the offset the additional revenues that you'll be receiving from the Heritage acquisition?

**John Potapchuk** - *Gentiva Health Services, Inc - CFO*

Absolutely, yes.

**Brian Hogan** - *Lehman Brothers - Analyst*

And then my last question is on the gross margin front. You had said that gross margin was somewhat brought down by the 140-plus clinicians that you had to train and brought on in the first quarter. Going forward, should we look at the Q1 gross margin level as consistent for the rest of the year or can we assume that you will not be bringing on 140 clinicians each quarter for the rest of the year?

**John Potapchuk** - *Gentiva Health Services, Inc - CFO*

A couple of things. We will certainly look for opportunities in selected markets to bring on those clinicians. But with that said, bringing on the 140 in the first quarter, there clearly were productivity issues in the sense that they were busy with orientation and training. And I think that certainly in the guidance there is an expectation of some modest pickup on the margins as a result of that going forward.

**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

I would also add that we are examining both the process and the way we measure the process for bringing on those clinicians to ensure that we are getting them trained and up to speed as quickly as we can.

**Brian Hogan** - *Lehman Brothers - Analyst*

Okay, so we should look for some modest gross margin improvement as the year progresses?

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**John Potapchuk** - *Gentiva Health Services, Inc - CFO*

In the Home Healthcare, yes.

**Brian Hogan** - *Lehman Brothers - Analyst*

Thank you.

**Operator**

Eric Gommel, Legg Mason.

**Eric Gommel** - *Legg Mason Wood Walker - Analyst*

Are you seeing -- you talked about competition I think in the Northeast. Are you seeing increased competition for patients generally in your markets from other home healthcare providers?

**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

I think that -- I really don't think so. I think that what you see when I mention the Northeast is there are certain pockets around the country where you may have a very large, integrated delivery system that seems to have a stranglehold -- lacking a more elegant term -- on their referrals, and that as we invest in a market, we sit and look at that and say, we know we have the staying power to be successful, but does it make any sense to do so, given the conditions in an individual market, which, by the way, could be a suburb of a major city. We're not talking about necessarily states.

But I don't think we have seen it. I think what we have seen that is notable from a competitive point of view is in markets like Florida, since Medicare introduced PPS, we have seen a large number of new agencies pop up. This is a business that, while I think it is difficult to differentiate yourself as a small operator, they are nevertheless not getting any barriers to entry. And so they are going to come in and really aggravate the situation because it's putting people out there asking for referrals. So I think in that sense broadly, there is more competition since Medicare has become a more favorable reimbursement source in late 2000.

**Eric Gommel** - *Legg Mason Wood Walker - Analyst*

On the Medicare side, it looks like you're pursuing the higher rehab patients. What are your thoughts on the potential for refinement to the payment system for PPS for homecare? I guess your expectations and timing, what are your thoughts on that?

**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

Well we won't know. We would, I think like most, expect to report imminently whether that would take place or not. Whether changes would be precipitated by that report, we don't know. I will say though that that adjustment in the methodology for therapies is -- it stands out as a nonlinear adjustment. And since a minority of our cases that involve therapy go over that threshold, I think if you had a more linear methodology it might actually benefit providers such as ourselves. I will say, though, that while we are very proud of our Safe Strides program and the results it's producing, but we have also invested in a nursing-centric cardiopulmonary program. That will only be a little bit more slow to roll out in that we really need a sponsoring and a close relationship with a hospital in an individual market in order to impact the outcomes there.

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But we are not shying away from any part of the patient population. We simply believe that we can drive better clinical care and improve referral flow by specializing in disease states using the sort of program that we have put together, including both focused leadership that have experience in that disease state, as well as specialized treatment protocols working with referring physicians. So we would not shy away from doing really any disease state out there, and we believe that people should have absolutely open access to Homecare. We believe strongly in homecare and we are not going to focus the Company narrowly to drive just particular therapies.

And again, I think as our introduction or our move into the cardiopulmonary space just underscores that. I think it's a great opportunity for homecare to be one of the critical solutions to the healthcare crisis in America as it relates to certainly cost and access. And we would not shy away from other programs that focus on more difficult patient situations, such as diabetes care or wound care. We have a tremendous amount of that now.

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**Eric Gommel** - *Legg Mason Wood Walker - Analyst*

Just one last question. On the CIGNA contract, just remind the renewal dates. The actual renewal of the whole contract is next year, or is it just a pricing renewal?

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**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

At the end of '06 officially.

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**Eric Gommel** - *Legg Mason Wood Walker - Analyst*

Thank you.

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**Operator**

John Ransom, Raymond James.

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**John Ransom** - *Raymond James - Analyst*

What changed in the calculus toward doing an acquisition after kind of shying away from that for a couple years? Was it the opportunity? Was it a good price? Was it the fact that maybe organically you had some challenges this year that you were not anticipating? What was it that changed your thoughts there?

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**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

When we launched out as essentially a new company after the sale of the specialty pharmaceuticals business, we very clearly as a team said, we need to really focus on our own business here. We know that there will be acquisition opportunities but there are not going to all go away overnight. We also set standards about where we wanted to look. What were the conditions that we would look at, essentially a set of filters, if you will. And I think, frankly, we are not looking at anybody out there that has a Medicare certification. We think quality is all over the map, so we are looking for high-quality companies in areas with growing demographics where we have either weak or no market presence, one of the two, and they have good people.

And we are keenly focused on, what do you have left over after two years. To us immediate accretion is far less a consideration than picking the right long-term decisions about how we invest the Company's money. And I think that -- I don't think that

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anything happened other than just probably a maturation in the Company in looking and finding that intersection of the right opportunity in the right space at the right price, so you had timing. It is really a matter of --

**John Potapchuk** - *Gentiva Health Services, Inc - CFO*

I think that is exactly what happened and I might say that -- I'm not sure it is fair to categorize the past, shying away from acquisitions because I would say in the last year or so we have been very proactive in looking. But we were looking at situations where all the three things that Ron mentioned intersected at the same time, the opportunity, the fair price, and the geography. And we certainly found it with Heritage. We are very excited about it.

**John Ransom** - *Raymond James - Analyst*

Okay, a couple other things. Is there a -- when you look at your CareCentrix business, roughly what percentage of that business are you getting paid to perform the service yourself compared to you serving as, for lack of a better word, a general contractor, and arranging for either the DME or the service to be provided by others? And has that percentage moved meaningfully at all over the past couple of years?

**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

Frankly, I guess the intercompany that you see us report explains how much we provide ourselves. And a component of our decision to look at these businesses differently is that we do not view them as mutually dependent. I think that is a fair way to put it. Whereas if you look in some years back, certainly the CareCentrix unit was an important source of referrals into the specialty pharmaceuticals business.

But the business has really matured over the years. For instance, today we will go in and identify the source of pain for a customer and really start a relationship at that source of pain, perhaps dealing with a part of a plan or wherever; whereas a few years ago we had sort of an all-or-nothing type of approach. So I think that we have matured. The product has matured. We have become -- I know we certainly have invested and I think we are very good purchasers of those services today. So that is kind of what led us to where we are.

**John Ransom** - *Raymond James - Analyst*

Speaking of pain, Ron, is there a threshold of pain with the CIGNA relationship that you would be unwilling to accept? Because it seems -- I guess from the outside looking in, it seems like you're willing to tolerate pretty low margins and a lot of volatility and kind of a low-growth situation. And so I just wonder what crosses the line in terms of being not an acceptable relationship from your standpoint.

**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

We would expect all of our major relationships in the Company, the ones that we can -- certainly you can't look at every referral source -- but we expect situations to be profitable. We do, I think, a pretty good analysis of what our costs are. As you may recall, we have four regional care centers that support the CareCentrix business. So we look at the revenue and certainly the margin coming in and all the components of that. We look at how running revenue and buying power from a company like CIGNA allows us to leverage that and take that set of services to other companies.

I suppose there are theoretical limits for sure, but we have found over the past, particularly I would say year-and-a-half, CIGNA is very willing to work with us on more innovative solutions that allow this to continue as a win-win relationship.

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**John Ransom** - *Raymond James - Analyst*

So you continue to be happy with it despite some of the short-term nicks and knocks around expectations?

**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

I tell you, to us, when we first identified some challenges within the CIGNA membership, we sort of said that we think every major managed care organization has gone through this in the past. And in all likelihood, CIGNA would confront their underwriting challenges, they would right the ship, they would bring in the type of customers and plan mix and introduce new products that make sense for them. And I think that is probably what we're seeing unfold.

**John Ransom** - *Raymond James - Analyst*

Thank you.

**Operator**

Sheryl Skolnick, Fulcrum Global Partners.

**Sheryl Skolnick** - *Fulcrum Global Partners - Analyst*

Thank you for updating us on the lawsuit being dismissed. Congratulations on that. I have two general questions, and the first one is I would like to turn to your Medicare revenues. If I heard you correctly, the revenues themselves were up about 13% and the units were up about 13%, and that is on and as-adjusted basis on the revenues. So my question is, given that you did see and have focused on a shift to the specialty businesses, which presumably give you a higher revenue per admission or per episode, and given that you -- I am curious as to why we saw what I -- I will ask the question.

It looks like revenue per episode or revenue per admission, however you are measuring that, was essentially flat in the quarter. Is that true, number one? And if so, why was it? I would think if you're shifting that mix to more of a specialty unit, maybe with a longer length of -- I just don't understand it. It just doesn't make any sense to me. So if you can walk me through that, I would appreciate it.

**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

There were some markets -- your assumption is generally correct. We did see lower-than-expected revenue per admit in the Medicare category. But we have done a considerable amount of analysis and really limited that end to less than two dozen markets. A number of those are really markets that brought on a number of new caregivers and introduced new specialty programs within the past few months.

So we're going through a set of actions ourselves to look at how we bring those folks in, what impact the introduction of both new caregivers and a new specialty service might have on our existing business that would cause a drop in revenue per admission there. And all within the context of being very mindful that the best people to determine the amount of care and the way that is done are people on the street, like they are trained in our compliance standards, and dealing face-to-face with the patient.

But we have already done a tremendous amount of analysis to understand. And where we saw the issue, again, is probably roughly 20 branches, certainly less than two dozen, where we saw the interception of those new specialty programs with a good number of new caregivers. We would not expect -- frankly, when you bring on a large number -- or bring on any number

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of new caregivers, you would not expect those caregivers to be productive to start out with, when they're going through training. And then as they start accepting cases, we would expect them to be less efficient at areas of documentation, and where you have large numbers of caregivers coming into a market, you put stress on the entire branch, frankly, to absorb those new caregivers and try to get them up. And generally, that's what we saw.

We saw the impact I think of the stress and it unfortunately is a good news/bad news type of situation. The good news is we have a strong, really robust referral stream. It's our job to get out there and figure out how to capture that and we were fortunate enough to get those caregivers that want to come to work for us. And I guess the bad news is that it is just a lot of time and trouble to get them up and productive quickly and it does put a lot of stress on the system.

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**Operator**

Tony Campbell, Knott Partners.

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**Tony Campbell - Knott Partners - Analyst**

Ron, I don't know if you can answer this, but I'm going to ask it anyway. You have added a bunch of people; it's cost us \$0.05 to \$0.08 in the short-term, so everybody's looking at the expense. I'd like to get sense of -- and you probably know some metric -- what sort of additional revenue and earnings would you expect to produce by increasing your staff by that much?

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**John Potapchuk - Gentiva Health Services, Inc - CFO**

Tony, this is John. I think just to give you an example -- maybe something like this might help you a little bit. If you take the fact that we have 260 (ph) some odd branches out there -- let's just use 200 for purposes of the example. If you look at the second half of the year, let's say, if each of those branches does one more episode per week, what that amounts to is in the course of that last six months, you're going to have, say, 5200 new episodes.

And let's say on average -- I think we have said that visits per episode, while we haven't quoted them, say they're in the mid-teens. Say 15. That means that that one episode per branch is going to take about 78,000 visits. Now in the course of that last six months, that's about 3000 visits per week. And if you have a full-time caregiver that could do maybe 30 visits per week, that is 100 caregivers you need for just that one episode per week increase.

What that could amount to, each episode, there are variations obviously, but use an average of \$2500 an episode. That is \$13 million. So that just gives you a little sense of the scale of what that could mean, if that helps.

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**Tony Campbell - Knott Partners - Analyst**

That's very helpful.

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**Ron Malone - Gentiva Health Services, Inc. - CEO**

One thing I would like to also add is we approach building this, a workforce made up of a higher percentage of full-time clinicians, we approach that very carefully. As you may recall, two-and-a-half years ago or so, that number is probably 200 or 200 and change. And as we have moved along, we have found that A, the turnover rate is lower among this group. Their dedication level and their productivity has reached the threshold, the goals that we set for them. The quality of their work because they are dedicated to us, we believe the clinical delivery is higher, but also the administrative processes are better.

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As I mentioned earlier, the turnover rate we are experiencing right now with our PTs is in the 13% range. I'm sure there are people out there that would die to have turnover rates like that. So we believe it is the right long-term strategy. And as John says, one or two new episodes taken over -- when you start leveraging over 250 sites can have enormous impact.

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**John Potapchuk** - *Gentiva Health Services, Inc - CFO*

As Ron mentioned, our referral stream is robust. There are unfilled cases out there now, so --.

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**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

Our sales team led by Mary Gabriel has done a great job. Anyway, thank you very much.

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**Tony Campbell** - *Knott Partners - Analyst*

Ron, just one comment maybe. My understanding is it is very hard to recruit large numbers of these kinds of people. Is that correct?

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**Ron Malone** - *Gentiva Health Services, Inc. - CEO*

It is very difficult to do. It is also -- we certainly have seen an uptick in the expense to do so. We have been very aggressive in deploying our own recruiting staff to get these people up, to get them into the system. Because we believe that for the foreseeable future in our business, he or she who has the caregivers wins. Because the primary differentiator before you can tout outcomes or systems or anything else is to be able to say yes, I can admit your patient into our homecare agency. So we see it as what I would say is a primal differentiator in the market, and it's something that -- we simply have to make bold moves and we simply have to get right with this group of people.

Anyway, thank you very much, Tony. I'd like to thank each of you for your participation this morning and for your continued interest in Gentiva. We will continue to keep you informed of our progress and we look forward to speaking with all of you again on our second quarter earnings call. Good morning. Thank you very much.

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**Operator**

Ladies and gentlemen, this conference will be available for replay started today, Thursday, May 5 at 1:30 PM Eastern time, and it will be available through next Thursday, May 12, at midnight Eastern time. You may access the AT&T Executive playback service by dialing 320-365-3844 and then entering the access code of 780226. (OPERATOR INSTRUCTIONS) And that does conclude our conference for today. Thank you for your participation and for using AT&T's Executive Teleconference. You may now disconnect.

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