

# FINAL TRANSCRIPT

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## **GTIV - Q2 2005 Gentiva Health Services Earnings Conference Call**

**Event Date/Time: Aug. 03. 2005 / 10:00AM ET**

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## PRESENTATION

### **Operator**

Ladies and gentlemen, and thank you very much for standing by. We do appreciate your patience today and good morning. Welcome to the Gentiva(r) Health Services second-quarter 2005 earnings conference call. At this point we do have all of your phone lines in a listen-only mode. However, after the executive team's presentation today there will be opportunities for your questions. (OPERATOR INSTRUCTIONS). As a reminder today's call is being recorded for replay purposes. That information will be announced at the conclusion of this quarter's earnings release. So with that being said let's get right to today's agenda, and here with our opening remarks is Gentiva Health Services Senior Vice President and Chief Marketing Officer, Ms. Mary Morrissey-Gabriel. Please go ahead, ma'am.

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

Thank you very much, 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 second-quarter 2005 earnings call. We hope that each of you has had a chance to review the Company's second-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 second 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 and the question-and-answer period is Al Perry, our President and COO, as well as other key executives. Let me remind participants on this morning's call that comments made by the 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 strategies and operations involve risks of competition, changing market conditions, changes in laws and regulations affecting our industry and numerous other factors discussed in our second quarter earnings release and in our filings with the

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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 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 those directly comparable GAAP financial measures. 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'll 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 now let me turn the call over to Gentiva's Chief Executive Officer, Ron Malone, for comments on the Company's second-quarter 2005 performance.

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**Ron Malone** - *Gentiva Health Services - CEO*

Thanks, Mary. Good morning, everyone, and thanks for joining us. While we can point to some positive achievements in the second quarter, our focus continues on a number of operational issues that we discussed on the last earnings call.

The first is our capacity to accept admissions from the increased home health and specialty referrals generated by our expanded sales force and the popularity of our specialty programs. The second is an increase in the employment, orientation and training of physical therapists resulting from the expansion of Gentiva Orthopedics and Gentiva Safe Strides<sup>SM</sup> programs.

Next is our need to realize gains in Home Healthcare from investments and to achieve better pricing from our non-government payers. And finally, our need to control costs by adjusting resources to match business volume, as well as exiting markets where conditions do not allow us to meet performance expectations within a reasonable timeframe.

All of these issues are critical to the development of Gentiva and the fulfillment of our long-term strategies. We made progress on each during the second quarter, but the result of our work is not yet reflected in the numbers. However, we expect to see improvement in performance in the second half of this year.

Let me give you several examples of what we're doing. We have conducted a branch-by-branch evaluation to ensure the investments of the past two quarters are achieving the desired results and we're making adjustments, where necessary. During the second quarter, we closed several offices where our returns did not warrant continued investment of time and money. However, we're also investing in new locations, including our first specialty-only branches beginning this quarter.

We've targeted markets in which we're redeploying resources to accelerate growth opportunities and increase capacity. We've placed a continued focus on growth of our specialty programs and have made progress in our initial efforts to raise prices in our commercial insurance and other category. As a result of these two initiatives, there's been a positive effect on our gross margin and an increase in our revenue per admission. We anticipate further improvement during the remainder of the year.

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And in the CareCentrix(r) segment, we were able to adjust our expenses downward when our customer enrollment declined, yet we responded successfully to a complex transition of CIGNA New England patients to our CareCentrix network. These are just a few of the initiatives under way, and we are focusing considerable time and energy on execution.

As far as achievements in the second quarter, we can point to a number of them. In the Home Healthcare segment, we reported a 21.3% increase in Medicare revenues due to increasing admissions, greater referral opportunities from our expanded sales team, improved capacity, and positive patient and referral source response to our specialty programs. Our Medicare revenues increased about 17% if we exclude the impact of the Heritage Home Care acquisition in Utah.

We continued our recruitment and hiring of physical therapists and other full-time clinicians. And we opened 16 new specialty locations during the quarter. We have continued to expand our specialty programs and are evaluating new ones as we take advantage of those growth opportunities.

Later this year we expect to pilot a new neurorehabilitation program focusing on patients with neurological conditions, including stroke. This is collaboration between Gentiva Rehab Without Walls(r) and our Home Healthcare branches. The program draws on the experience and expertise of both and extends Rehab Without Walls' superior outcomes to a larger patient population. It will be attractive to neurologists and other physicians who treat patients with neurological conditions.

Additionally, our referral sources continue to appreciate the quality of clinical care demonstrated by the national outcomes data that we published this year for both Gentiva Orthopedics and Gentiva Safe Strides. And in the future, we anticipate releasing outcomes data for our recently launched specialty, Gentiva Cardiopulmonary. The data is important in communicating the value of our specialty programs to physicians and referral sources. We will also use these outcomes to demonstrate to legislators and payers that the home healthcare industry can improve patient care and help to lower overall healthcare spending.

Our specialty programs have also added a new dimension to our business. They're driven by dedicated clinical management teams with specialized care protocols resulting in outcomes that compare favorably to those from inpatient facilities. Due to the growth in these programs, we've hired over 200 full-time clinicians in the first half of this year, and almost half of those are therapists. These therapists, many of whom are from outside the homecare industry, are finding a home with Gentiva where they can excel in their careers and provide dedicated outstanding care through the execution of these innovative programs. We'll continue to provide additional attention in terms of orientation and training to these clinicians so that they can achieve their full productivity as rapidly as possible.

Before I leave the Home Healthcare segment I must add that we are pleased with the integration and performance of Heritage in Utah. We have been impressed with the focus, discipline and dedication of the Heritage people, including their commitment to clinical excellence, their community involvement and their excitement about Gentiva and our mission to elevate patient care.

Turning to our CareCentrix segment, we've also had several achievements during the quarter. CareCentrix contributed a majority of our 8.5% revenue increase in the Commercial Insurance and Other category, excluding CIGNA revenues. We were able to take advantage of opportunities within our existing customer base by demonstrating the power of the CareCentrix value proposition. CIGNA revenues declined 3.7% in the second quarter versus the prior year period. However, CIGNA revenues were up sequentially between the first and second quarters of this year due to increased PPO and Open Access business.

On July 1st, we were pleased to become the primary provider of homecare services to CIGNA HMO, PPO and Open Access members in New England. We've successfully transitioned the additional CIGNA patients into the CareCentrix provider network.

We're continuing to strengthen and expand our managed care relationships as we grow our Medicare business. We also believe that our managed care experience and our knowledge of caring for the elderly give us a unique opportunity in the Medicare Advantage marketplace.

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Before I close, I'd like to comment briefly on developments related to government reimbursement. We were pleased to see that CMS has proposed a 2.5% increase in Medicare payment rates to Home Healthcare agencies for calendar year 2006, as well as a change in market definitions that should benefit rural agencies. We're also continuing to participate in discussions on pay for performance reimbursement for Medicare homecare patients. Gentiva is currently participating in industry efforts to help determine what those standards will be. We support efforts to improve the overall quality of care delivery and positive outcomes in our industry. We're proud of the fact Gentiva has a solid track record in keeping patients out of hospitals and emergency rooms, and we believe our Company will be well-positioned if pay for performance becomes part of the landscape.

We also welcome new third-party research on the quality and efficiency of homecare. You might find it worthwhile to read the RAND Corporation's study released in June, which said that homecare for people who have had joint replacements was superior to therapies provided by inpatient facilities in both positive outcomes and cost-effectiveness. RAND also found that the cost of care for institutional therapy was as much as \$8,000 higher per episode than homecare. We believe that clinical quality and cost-effectiveness will be significant drivers of industry growth in the future.

That concludes my remarks. I'd now like to turn the call over to our CFO, John Potapchuk, for a discussion of our financial performance for 2005.

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

Thanks, Ron, and welcome everyone. Before I discuss Gentiva's second quarter financial results in more detail, I'd like to briefly mention four items affecting our presentation format and the comparability of the income statements for the 2005 and 2004 periods.

The first is a \$4.2 million income tax benefit recorded in the second quarter of 2005, related to the favorable resolution of estimated liabilities with respect to tax filings for the years 1997 through 2000. Gentiva had agreed to assume responsibility for these items in connection with its split-off from Olsten Corporation in March of 2000.

The second item involves the pre-tax gain of \$946,000 from the sale of our investment in a Canadian homecare company, which was reported in the second quarter of 2004.

The third is our settlement of Medicare reimbursement appeals for 1997 that contributed about \$9.0 million to first half 2004 revenues and pre-tax income.

And the fourth item relates to a \$1 million revenue adjustment, representing an estimated repayment to Medicare that we recorded in the first half 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 reconcile 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 manner, excluding the special items that I just mentioned.

I should also note that our second quarter 2005 results -- both "As Reported" and "As Adjusted" -- included revenues generated by our Heritage acquisition from May 1 through the end of the quarter.

Now, I'd like to review our second quarter performance.

Our total net revenues were \$220.1 million versus \$208.2 million in the same period a year earlier. Our Net Income -- As Reported was \$8.7 million, or \$0.35 per diluted share, compared to \$6.0 million, or \$0.22 per diluted share, in the second quarter of 2004. Net Income -- As Adjusted was \$4.5 million or \$0.18 per diluted share, for the second quarter of 2005 versus \$5.4 million, or \$0.20 per diluted share, for the second quarter of 2004.

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We saw the following changes in our payer mix for the second quarter of 2005 versus the second quarter of 2004. First, Medicare represented 29.7% of our total net revenues for the second quarter of this year, up from 25.9% in the same period of last year. Medicaid and local government payers represented 17.2% of total net revenues for the quarter, a decrease from 18.7% in the same period last year. We did see an increase in skilled, intermittent visit business which partially offset declines in other programs, which is consistent with past quarters.

The Commercial Insurance and Other payer category represented 53.1% of total net revenues versus approximately 55.4% in the second quarter of 2004. In this last category, we discussed the fact that Commercial Insurance and Other revenues, excluding CIGNA, increased 8.5%, while revenues from CIGNA declined 3.7% during the quarter. As a result, CIGNA's contribution to Gentiva's net revenues in the second quarter of '05 was about 29.5%. This represented a decline from 32.3% of total net revenue reported in the second quarter of 2004.

Turning to other financial measures, our gross profit in the second quarter of 2005 was approximately \$3.2 million higher than the corresponding period of 2004. As a percentage of net revenues, gross profit margin decreased about 6/10 of a percent, from 37.6% in the second quarter of '04 to 37% in the second quarter of 2005.

Gross margin was negatively affected by continuing investments in orientation, training and benefits associated with the recently hired clinicians as we transitioned more of our skilled clinical care to a dedicated, full-time work force. However, gross margin was positively affected by a favorable change in our business mix, with increased Medicare business and revenue growth from higher margin specialty programs more than offsetting the decline in revenue from certain lower margin Medicaid and Local Government programs. Selling, general and administrative expenses of \$72.7 million for the second quarter of 2005 increased about \$4.9 million compared to the second quarter of 2004. The increase is attributable to several factors, including the following: \* First, over \$1 million in costs associated with the Heritage operations following its acquisition in May of 2005. \* Second, about \$3.5 million resulting from incremental field operating and administrative costs to service increased Medicare volume and to develop and manage our specialty programs. \* Third, over \$1 million of cost related to higher selling and patient care coordination expenses. \* And finally, there were incremental costs relating primarily to the hiring and orientation of both full-time clinicians and other personnel. These items were offset by reduced corporate general and administrative expenses that were \$1.5 million lower than the same period of 2004.

Our pre-tax income as a percentage of net revenues was about 3.3% in the second quarter of 2005, which was comparable to the first quarter of 2005 percentage, but below the 4.7% in the same period a year earlier. Excluding the special item, the 2004 figure would have been about 4.3%.

Net accounts receivable increased by \$5.4 million from the end of the first quarter, and our days sales outstanding, or DSO, at July 3, 2005 was 59 days, an improvement of 1 day from the end of the first quarter. At July 3, 2005, cash, cash items and short-term investments were \$83.4 million compared to \$103.6 million as of April 3, 2005 as we used cash in the second quarter for the Heritage acquisition, additional share repurchases and operating needs.

Speaking of share repurchases, we bought nearly 284,000 shares of our common stock in the second quarter at a cost of about \$4.7 million, for an average cost per share of about \$16.56. From the beginning of our first share repurchase program about two years ago through the end of the second quarter of 2005, we have repurchased nearly 4.8 million shares in the open market at a cost of over \$65 million, or an average cost of about \$13.72 per share.

During the first six months of 2005, we used about \$10 million in cash from operating activities as a result of several factors, including the timing of payments for certain current liabilities, the funding of Heritage's working capital requirements as we waited for receipt of standard notifications from CMS, which allow us to bill Medicare for services provided by this acquired business. We received this notification of the assignment of the provider numbers from CMS earlier this week. And we also continued to experience claim processing delays associated with the TriWest account. We expect these processing issues to be resolved in the near-term and are encouraged by cash receipts from this account during the latter part of July. Resolution of

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these items and improved operating performance in the second half of the year are expected to result in positive operating cash flow of over \$20 million for the full year 2005.

Turning to our segment performance, Home Healthcare services net revenues for the second quarter of 2005 were \$137.7 million. This was a 7.7% increase from the \$127.8 million reported in the same period a year earlier. For the first six months of 2005, the Home Healthcare services segment net revenues were \$270.8 million, an increase of \$4.8 million, or 2.1%, from the \$265.0 million for the same period of '04. Excluding the special items in 2004, first-half 2005 net revenues for the Home Healthcare segment increased by 5.4% over the prior year period. Home Healthcare Services operating contribution for the second quarter of this year was \$12.1 million as compared to \$13.9 million in the same quarter of '04, a decrease of 6.5%. For the first six months of '05, Home Healthcare operating contribution was \$23.7 million. This was approximately \$11.5 million lower than the \$35.2 million reported in the prior year period. Excluding the special items in 2004, the decline in operating contribution was \$2.5 million compared to the prior year period. The lower operating contribution for Home Healthcare Services during both the second quarter and the six-month periods was due primarily to costs associated with the recruiting, orientation and deployment of full-time clinical associates, and incremental field operating and administrative costs to service increased Medicare volume and develop and manage our specialty programs.

CareCentrix net revenues for the second quarter of 2005 were \$87.1 million, a 1.8% increase from the \$85.5 million reported in the same period a year earlier. Net revenues from CIGNA declined \$2.4 million in the quarter. For the first six months of '05, CareCentrix net revenues were \$166.0 million, a \$1.6 million decline from the \$167.6 million reported in the prior year period. The decrease was due primarily to a first-half decline in CIGNA revenue of \$10.2 million, offset by growth in both the TriWest account as well as other managed care business.

CareCentrix operating contribution for the second quarter of 2005 was \$7.2 million, down \$1.3 million from the \$8.5 million reported in the same period a year earlier. The decrease was due to costs associated with transitioning CIGNA HMO members in New England and an increase in the provision for doubtful accounts, as well as the impact of changes in the complement of services for certain other customers. For the first six months of 2005, CareCentrix operating contribution was \$14 million, about a \$900,000 decrease from the \$14.9 million reported a year earlier.

Before I end my remarks, I want to add that we have affirmed our financial outlook for 2005, with revenues in a range of \$870 million to \$890 million and net income in a range of \$0.75 to \$0.83 per diluted share. I might also point out that the net income range excludes the tax benefits that we reported in the second quarter.

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

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**Ron Malone** - *Gentiva Health Services - CEO*

Thanks, John. To sum up, we will continue the work that we started in the second quarter... \* by focusing on stronger performance and branch operations. \* reducing or eliminating our presence in markets which do not offer an acceptable return. \* making continued investments in capacity, but only where they are producing solid results. \* driving a more positive trend in gross margin through the orientation, training and full productivity of our clinicians. \* and by achieving better pricing from our non-government payers \* and continuing to adjust our resources to maximize the volume of business especially in CareCentrix. We believe these elements are key to improving performance through the end of 2005 and sustaining our performance in future years.

That sums up our prepared comments for the second quarter and first six months. We will now take your questions.

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## QUESTIONS AND ANSWERS

### Operator

(OPERATOR INSTRUCTIONS) Sheryl Skolnick with Fulcrum Global Partners.

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### Sheryl Skolnick - Fulcrum Global Partners - Analyst

Thank you very much. A couple of items. What is happening with the Medicare unit volumes in your business? And do you think that -- and I sense that internally with a 17% growth rate of revenue, was it mostly from volume? To what extent did price contribute? And to the extent that it even was mostly from volume, are you being constrained by the lack of productivity from these 200 clinicians, or is there some other reason why, relative to others in the industry, you are running a lower volume growth rate?

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### John Potapchuk - Gentiva Health Services - CFO

First of all, on the growth rate volume-wise for the quarter, same-store --excluding Heritage -- we were between 14% and 15% of volume growth, which is somewhat comparable. I think in the first quarter we were just slightly under 14% in terms of the volume growth. So we are still experiencing robust growth from that standpoint. I think there clearly still is an issue involving acclimating and orienting the full-time caregivers. Clearly, there is a productivity period that we talked about in past calls as we bring on these new clinicians. So you mentioned constraints. Maybe there is some from that standpoint.

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### Sheryl Skolnick - Fulcrum Global Partners - Analyst

Okay. And how far along do you think you are in the process of orienting and training the new clinicians, as well as any others in your organization that might need, for example, some refocusing especially now that you are really going after more of the specialty business? What I am trying to get at is you started this, I think, more in the beginning of the second quarter, end of the first, but more in the beginning of the second quarter. And my sense is that the business is doing about what I thought. Clearly, others are disappointed. So I am trying to get a sense of just how long folks will have to wait until we see the kinds of year-over-year comparisons that we've been more used to seeing from the Company.

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### Ron Malone - Gentiva Health Services - CEO

I think, Sheryl, we started really the process of retraining, refocusing, as you put it, during the second quarter. But we still feel like we have quite a bit of work to do there. The new clinicians that were hired in the first quarter were brought in in a fairly linear fashion throughout the quarter. So there is still a lot of work to be done with those. One thing I would note: we mentioned that we had brought on, that a high part of our mix was physical therapists, and we said therapists and the bulk of those were physical therapists. Many of those come to us from outside of homecare, not experienced particularly in dealing with Medicare. So it's are taking more training in that area than I would have anticipated. Their productivity is, really can ramp up pretty quickly, but still to get them very familiar with all the nuances of operating in a Medicare certified environment is taking us a bit longer than I expected.

I think one of the other things that I would add is we have, as part of growing our specialty programs, there is a considerable amount of managed care business in that mix. And I just like to -- I get it on the table that that is causing some issues in our margin, as well. We have a project underway to change the pricing -- and I'm talking specifically about non-CareCentrix Commercial Insurance flowing through the branch system. That is causing us -- that is lower revenue per admission than we see on the Medicare side. And as we've looked at a bit of pressure over the past couple of years on caregiver wages, other ancillaries, mileage, benefits, those things, we realized that we had to have better pricing in order to continue to service those payers.

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

So, I'm sorry, but does that mean that you might take less volume in order to get better margins from those payers?

**Ron Malone** - *Gentiva Health Services - CEO*

That does mean that precisely, that we -- it is payer by payer, really branch by branch, but we simply have to have better pricing in order to support those payers.

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

And it takes a while to get to that point because you've got to wait till' your contracts are renegotiated and to your satisfaction, but there might be some softness in those volumes and those margins until that happens?

**Ron Malone** - *Gentiva Health Services - CEO*

That's right, and some of those payers will have to understand our resolve before we will be able to agree to terms, I'm sure.

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

Okay, great. I will jump back in the queue.

**Operator**

Larry Marsh, Lehman Brothers.

**Larry Marsh** - *Lehman Brothers - Analyst*

Thanks, Ron and John. A couple questions. It sounds like you added another 55 to 60 full-time clinicians in this quarter versus the first quarter. Is that right? And what are you targeting for the full year in terms of full-time adds?

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

From a, in the second quarter we actually added a total of 113 full-time clinicians, over a significant number that came with the Heritage acquisition. So excluding Heritage, we actually added a net of 46 in the second quarter. And as you recall, it was over 140 in the first quarter. And certainly there is still unfilled capacity out there. And the issue of having sufficient number of caregivers is a significant one that we're very focused on. So as the year goes on, as the opportunities arise to add caregivers, we certainly will look for that.

**Ron Malone** - *Gentiva Health Services - CEO*

One thing I would add is that we would anticipate in the third quarter probably being in the range of maybe 40 to 50 if we stay on track. So we could, in the second half of the year, add 100 or so. We have really worked with our recruiting team to make sure that we are bringing on those caregivers in a more -- against a more disciplined schedule, if you will, so that we can time the training and better anticipate the results of bringing them on. So I think we have better control over the hiring process than we might have had two or three quarters in the past.

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**Larry Marsh** - *Lehman Brothers - Analyst*

Okay. So would it be fair looking at the Q4 that you would be a net adder of clinicians, as well?

**Ron Malone** - *Gentiva Health Services - CEO*

We would expect to be at a net add of perhaps 40 or 50 in that quarter, as well, bringing the total somewhere in that maybe broadly 80 to 100 category in the second half of the year.

**Larry Marsh** - *Lehman Brothers - Analyst*

Okay. And then the follow-up. While you addressed it broadly in your prepared comments, what would give you confidence that you will see a healthy increase in performance in the second half versus the first half, even with the addition of all these clinicians?

**Ron Malone** - *Gentiva Health Services - CEO*

Well, certainly, the . . . I'll ask John in just a moment to walk you through a bit of a bridge there, if you will, but I think that we brought on an unusually high bolus of those clinicians in the first quarter. We wouldn't expect to have that high a number of adds in either of the quarters in the second half of the year. And we would have expected to make progress on the ones we hired in the second half should they be fully productive in the second half of the year. So our hiring rate, if you will, second half is going to be a little bit lower than the first half. But maybe, John, you could add some comments on sort of the bridge around the issue of confidence that Larry mentioned.

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

I think Larry, and maybe I'll expand beyond the margins, I mean if -- and I'm sure this question will come up sometime during the call. I mean if we reported, excluding the special item, about \$0.34 in the first half of the year, to get to our full-year guidance, we need about between 41 and 49 in the second half of the year. If we were to take that on a pre-tax basis, while we reported about \$14 million in the first half, we need to be somewhere between \$17 (million) and \$20 (million) in the second half of the year. And I think a couple of things that Ron mentioned certainly help us get there.

The issue of improving our managed care pricing and also our revenue per admission through education and training, that is a process that is ongoing that is going to result in improved results, as well as productivity issues as those caregivers become fully productive. And also, there is some redeployment of resources. I think it is fair to say that we took out toward the end of the quarter a few dozen people. And there will be some additional targeted reductions in the second half of the year. Those items certainly have some impact, but I think some other things, just to point out, and these other items give or take a little bit. Each of them may have an impact of roughly \$1 million, and there are things like the full six-month impact of the Utah acquisition, versus having two months. The fact that we have closed a handful of branches that in the first half of the year resulted in losses of about \$1 million. They have gone away.

The fact that in July we had CIGNA New England, as well as some additional business development opportunities in CareCentrix. And the fact that we continue to show accelerating growth in our specialty programs. All four of those items are, in my mind, pretty solid. That, coupled with the productivity and the increased revenue, it really is the bridge in my mind to get to the second-half results.

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**Larry Marsh** - *Lehman Brothers - Analyst*

Okay, good. Thanks for the breakdown. And just a quick follow-up. Are you still suggesting that Heritage could be \$0.02 to \$0.03 accretive in '05? And it sounds like you are, I guess, backing off your \$26 (million) to \$30 million cash flow from ops expectations for this year?

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

Slightly. We certainly expect the positive results on the cash flow. Maybe, Larry, a couple of words there. The fact that in the second quarter we had to wait for this tie-in notice from CMS, which we just received last week. As a result we had to fund for the quarter, \$3.5 million of working capital. We're making progress now on TriWest, but that didn't happen until the end of July. So there is certainly an incremental receivables on TriWest that to the tune of 5 to \$7 million. And then we did make certain payments in June, as I mentioned, certain current liabilities. Just to point out a couple, you may recall a couple of years ago we had taken a charge on repaying Medicare for PEPs. They started recovering that in the second quarter to the tune of \$1 (million) to \$2 million. We also had some settlements on some workers comp claims, and the last point there was a lease that we took responsibility for in connection with our split-off from Olsten. And there was a buyout that we made in the second quarter to pay down that lease. So all of those things contributed to the negative operating cash flow. But those things are either going to turn around or certainly not repeat in the second half.

**Larry Marsh** - *Lehman Brothers - Analyst*

Okay.

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

And Larry, your first follow-up question, I apologize, we do anticipate Heritage to be \$0.02 to \$0.03 accretive, yes.

**Larry Marsh** - *Lehman Brothers - Analyst*

Okay. I'll stop there. Thanks.

**Operator**

Legg Mason, Eric Gommel.

**Eric Gommel** - *Legg Mason - Analyst*

When it comes to the market for therapists, are you finding this to be more competitive relative to some of the other post-acute care providers, and are you having to -- are you forced to pay a higher wage, and how is that impacting your gross profit margin?

**Ron Malone** - *Gentiva Health Services - CEO*

Eric, it's Ron. Good morning. I don't believe we are paying higher wages than other providers asking for comparable work. I do believe we are paying higher wages than a typical physical therapist would earn in an acute hospital setting. And I think also we are presenting that physical therapist, which are generally more experienced therapists for our type of work, with a significantly better opportunity to drive their earnings and their career development long-term. As I mentioned in last quarter's call, our current annualized turnover rate among our full-time therapists was in the low to mid-teen range, which indicates to us we are

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giving those people a good home. Once we are attracting them in and they are getting acclimated to our environment, which includes working more independently than some of them have worked in the past and coming to grasp the nuances of working in a Medicare certified environment, they are sticking and I think they are very pleased with what they are seeing there. I think that, overall, we are seeing some shortages in some markets. There are more acute markets than others. There are scattered markets about the country where contract PT is sort of the norm; in some cases we are kind of breaking that norm ourselves and even looking at the opportunity to make sure we fully employ all the physical therapists that are available to us. But I don't think that has changed dramatically in the past few quarters.

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**Eric Gommel** - *Legg Mason - Analyst*

And my follow-up question. I think a lot of the questions before me lead them to my question. From a gross margin basis, in modeling and looking at going forward the next couple quarters, is the second quarter sort of the base to work from, or do you see continued pressure on that line?

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

I think it is fair to use the second quarter as a base and from that, as I mentioned earlier, the issue of improved productivity and the issue of improved revenue per admission and improved commercial pricing would generate some uptick (inaudible).

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**Eric Gommel** - *Legg Mason - Analyst*

Okay. Thanks.

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**Operator**

Matthew Ripperger, Smith Barney.

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**Jie Bao** - *Smith Barney Citigroup - Analyst*

This is Jie Bao filling in for Matt. A couple of questions here. In terms of the discussions on margins and you talked about hiring of clinicians and you also mentioned a little bit about full-time, increasing to full-time, staff. And has that been the shift from part-time to full-time, is that a big part that also has some impact on the margins?

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**Ron Malone** - *Gentiva Health Services - CEO*

Well, typically it would in the near-term. If we stopped hiring new clinicians and you held our population static, you would see improved productivity as those clinicians learned our environment, learned how to work in our environment. I think that the primary difference is, in that case, in order to get their full dedicated time and to stabilize that work force, which we believe has implications on many areas of our business, including the long-term quality care we provide as well as our costs inside the branch. We are going to pay more up front because we are going to pay those people to come into our environment and fully absorb what we need them to learn in order to be productive for us. Whereas a per diem, somebody who is paid per visit or per encounter, is going to be far less tethered to the organization, and we are simply -- those are sort of use as you go. But there are trade-offs in using these. So they do put at least a short-term strain on margins.

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**Jie Bao** - *Smith Barney Citigroup - Analyst*

Can you just remind us or quantify what percent of your nursing and clinician staff is full-time now? And what is your sort of a two-year plan in terms of increasing that percentage?

**Ron Malone** - *Gentiva Health Services - CEO*

Well, we wouldn't move it toward 100% at this point because we would want some elasticity to account for seasonal shifts in demand. As we have noted before, right now is about our low point of the year for demand of services. I would say the full-time complement is just north of 10% of our total workforce that we would use. Because, I believe we noted in a previous call, they are actually fulfilling about 50% or so of our visit activity. So we have over time, we have several opportunities in recasting that workforce. We could see the -- I mean you can back into the math. We see perhaps 70(%) or 75% or so of our visit encounters accomplished by full-timers; we probably see some -- our dedicated and busy per diems become full-timers. We have some people who are moderately busy today and become more busy, and frankly, we will get out of the system those that simply want to have a very casual relationship with us. Because those are the most expensive clinicians for us to use, those that would say, "I would like to have one or two patients, but that's all." That's a very expensive relationship for us to maintain, particularly given the regulatory and training requirements associated with those caregivers.

**Jie Bao** - *Smith Barney Citigroup - Analyst*

One more question. I wanted to just -- I'm sorry for being repetitive here, but you talked about your taking specific actions to improve performance for the second half of the year. Can you just outline maybe the top three actions in terms of -- you talked about commercial pricing and just the specific actions that you are taking. And if you can quantify what marginal cost opportunities that those actions represent, that would be very helpful.

**Ron Malone** - *Gentiva Health Services - CEO*

Well, I'll outline some steps we are taking and stop short of giving you a specific expectation for the outcome. I think, first, we are working hard to make sure that the caregivers that we have hired become productive as quickly as possible. We've taken a very hard look at the amount and type of commercial and managed care business, flowing through our normal branch network. I am not talking about CareCentrix business, but I am talking about the \$120 million or so, on an annualized basis, of non-CareCentrix commercial business flowing through our branches.

We have a project underway to change that pricing, and we are going to deploy -- we are deploying more resources and attention to accelerating those price changes in order that we generate a fair return. I'll double back to that in a moment. We mentioned that we closed -- I think John said a handful of branches in the first, in the second quarter. We are looking very closely, and we will likely close some other markets where market conditions are just not going to allow us to get an acceptable level of return in the time frame that we believe makes sense. And we will, in some cases, redeploy some of that into higher growth areas and do anticipate opening new locations in the second half of the year.

The managed care margins that I mention is really, in our mind, this is a critical area for us to improve, and let me explain for just a moment how that comes about. Physicians, particularly those who refer patients to us, really come to appreciate the quality of care provided by those -- particularly those specialty programs, but also in traditional home health. In order for us to work with managed care companies in that space, we are going to have to have acceptable rates. I would love to drive physician satisfaction very high by saying yes to everything, but in order to do that we have to have an acceptable contract on the other end, at the end of that payer relationship. So, frankly, we are working with our field organization, our sales organization, as well as some specialists we have to work directly with those managed care payers. In some cases, as an earlier questioner implied, we will curtail our growth rate in certain markets because we are not going to continue to accept those managed care cases at rates less than that which gives this Company a fair return. I hope that is helpful.

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**Jie Bao** - *Smith Barney Citigroup - Analyst*

That is. Thank you.

**Operator**

Art Henderson, Jefferies & Co.

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

Just a couple of questions. Your guidance that you reaffirmed today, could you refresh my memory? Does that include some share repurchases factored into that guidance? And if so, how much?

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

We do have an authorization from, I think it was the middle of April, of an additional 1.5 million shares. And we bought back, as I mentioned, Arthur, 284,000 in the quarter. So we still have plenty of room on the share repurchase. We've been doing it pretty consistently for the last two years now, so you would expect that there is some in there, but again, it is based on market conditions. And I certainly do not, at this point in the guidance, I haven't dialed in taking out the entire remaining 1.5 million shares. There is some amount in there, but a modest amount.

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

Okay. And could you remind us, the 2.5% market update that has been proposed by CMS, how much would that impact your earnings if it were to happen today? What kind of impact would that be to your business just from an EPS standpoint?

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

I think, Arthur, as you know in past years, whenever there has been a suggested or approved rate hike, given the fact that we are in 35 different states, we pretty much have gone along with that national average. So on a \$2.5 million basis, a 2.5% basis, that would amount to somewhere between \$1.5 million, \$1.7 million per quarter from a -- given our current Medicare volume.

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

Okay, so incremental revenue is what you're talking about?

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

That's exactly right. So, in theory, if all of that comes to fruition, that could be anywhere from \$0.03 to \$0.04 a quarter.

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

Okay.

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

That is strictly just the math on the rate hike, just in terms of what happens on the cost side next year in terms of wages, mileage, benefits, I'm not dialing that in . . .

**Ron Malone** - *Gentiva Health Services - CEO*

I would encourage everyone, Art, to be mindful that those increases are being given to offset projected increases in cost. So we wouldn't expect to see all those -- a net drop in the industry.

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

Understood. Ron, just a quick question for you. Obviously it seems like this year, particularly in the starting of the second quarter, starting the first quarter and crossing over to the second quarter, you have been focusing a lot more internally on the business, and you've mentioned several things that you have been working on. Would you characterize this year so far as almost kind of being a restructuring year at Gentiva?

**Ron Malone** - *Gentiva Health Services - CEO*

Well, I think it is clear that we've put a tremendous amount of effort in the past couple years to build -- to get the organization growing. And I would suggest that perhaps we are dealing with some growth pains right now. We have mentioned earlier the need to rationalize our headcount a bit, make sure that the investments we made are paying off because today we are operating more than 250 branch sites. So we are making investment in a pretty wide area of real estate and as we go, we are learning where we are getting the best returns. We are making adjustments. So I would stop short of thinking it as like a restructuring. But certainly it is -- the good news is we have been successful in generating a lot of business and a lot of traction with specialty programs and really raising the level of referral opportunities coming into the Company. And now we are really very, very focused at doubling back and saying, "Okay, we've been successful bringing us business, now we have to get the returns that we deserve for the hard work we are doing."

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

I think one of the problems that investors have, or at least that I've discovered in looking at the businesses, the visibility on a quarter-to-quarter basis is pretty tough. And clearly, obviously, some people had expectations things were going to be better this quarter than they actually were. But I was wondering if you guys might consider at some point issuing quarterly guidance, just the next quarter, just so that we have a basis on where to kind of look from. Because when you look at the full year, obviously, stacking it up in the back half of the year puts -- understandably what you are doing now, but I think a quarter ago it would have been helpful to kind of know where you might flesh out here in this quarter. It is just a suggestion.

**Ron Malone** - *Gentiva Health Services - CEO*

We will take that under advisement. I thought for sure you were going to say we should just drop guidance altogether.

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

Well, I guess that's another way of looking at it.

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**Ron Malone** - *Gentiva Health Services - CEO*

I think that, frankly, during the first quarter we certainly had a view of some short and long-term adjustments we need to make in the business model, produce better results. We simply did not get all of that done as quickly as we would've liked. Things like the closure of those six branches we mentioned were done in a very orderly fashion so as not to -- to make sure that the clinical care was transferred the way it should have been and all that. And I think it is, in a way, that we think is the right way to manage the business. We do also continue to manage the business clearly with the long-term in mind. As I mentioned last quarter, you know we could improve results in the first quarter by simply not hiring the number of people we did. We believe that that would curtail a long-term opportunity. I have a lot of confidence that the operating team, particularly the team in the Home Healthcare branch business, clearly knows what they need to do to improve performance, and I think they are locked on doing just that.

**Operator**

Sheryl Skolnick, Fulcrum Global Partners.

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

Thank you so much. First, a clarification, if I may. Ron, you spoke about something that I want to make sure I understand, and that you said "the income opportunity for the hired clinicians." You're not suggesting that they are getting paid to increase the number of visits or the acuity of visits or anything like that, are you?

**Ron Malone** - *Gentiva Health Services - CEO*

No, no one in the Company is paid to do that.

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

I didn't think so, but I didn't want to leave that as an open item because it sounds a little bit odd.

**Ron Malone** - *Gentiva Health Services - CEO*

No, no, no, they are given an opportunity to be more productive and simply to make more money in this industry than they would be in like an acute setting, without a doubt.

**Operator**

Okay, and part of that may be because of the pressures in the acute care business coupled with the opportunities that you are offering simply at a higher hourly rate implied in their full-time package?

**Ron Malone** - *Gentiva Health Services - CEO*

That's right. They can really drive higher productivity as sort of independent clinicians out there doing work for us than they could in a more prescribed setting.

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

The second thing I would ask you to comment on is, let's all recognize that the fourth quarter of '04 contained 14 weeks. That is a very tough comp. I hate to bring that up. We spent a lot of time in the second quarter of last year talking about it if memory serves, but you've got 14 weeks, and I guess what I would say is, doesn't that exacerbate the difficulty of the fourth quarter comp this year? Because you've got a week less worth of revenue? As well as expenses?

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

Cheryl, if you go back to last year, that extra week, I think we had indicated that that extra week amounted to somewhere around \$12 million of revenue.

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

Right.

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

And if you take out that \$12 million from last year's '04 second half, what you will see is we were relatively flat in the first half of the year versus the second half of the year from a revenue standpoint. This year, we have Heritage that is in there, and we have certainly improved capacity given the full-time caregivers that we've hired, and we've had, certainly, acceleration by opening up new specialty programs. So I think, and I will say right now, we are not anticipating the same impact of the hurricanes in the second half of the year that we had last year. So maybe that helps a little bit.

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

So, it is possible for you to achieve a revenue consistent with, or maybe even slightly above, the fourth quarter even without the extra week because you simply have more business?

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

Right. Exactly.

**Ron Malone** - Gentiva Health Services - CEO

That is correct.

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

So, maybe that helps in understanding why it is not going to be so difficult, and then, finally, well there's actually two things -- one is just the data item that I think you're going to tell me no on, but I'll ask anyway. Can you give us any sense of what your revenue per episode or revenue per Medicare admission is?

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

We've been pretty consistent I guess. I'm not giving detailed Medicare operating information. So I think we will hold to that at this point.

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

I was afraid you would say that. And then, so the final question is, if we think about your business right now is hiring these clinicians as a substitute for making acquisitions? Okay? Because it sounds -- given the number of clinicians if I heard the count right -- ex the acquisition, you are probably going to have between 200 and 250 more clinicians this year then you did last before turnover.

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

That's correct.

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

So that's pretty significant. I'm not sure what size and so maybe the question I can ask is twofold. One, what would be the equivalent size of an acquisition if you went out and bought 250 clinicians through an acquisition? And then, second, what is the anticipated return on that investment? So how much revenue might it represent at the Company's current margins?

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

Off the top of my head, Cheryl, I would say you are probably looking somewhere in the \$30 (million) to \$40 million range.

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

In terms of revenue opportunity?

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

Right, right.

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

And are there very many homecare companies out there that you could buy that would generate that kind of standards and loyalty that you would expect from the workforce?

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

There are some out there, and then it becomes a question of valuation and how much you would have to pay for that relative to ...

**Ron Malone** - Gentiva Health Services - CEO

It becomes an issue, not only of valuation, but as you imply, Cheryl, of fit -- geographic fit, cultural fit, the mix that we're looking for. I know of some companies now that are heavily skewed toward either one or two states of Medicaid business that fall into that category. But that is something we have heretofore not been as interested in.

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

Right, so in essence, do we look at the costs that you are incurring right now to bring those clinicians up to full productivity almost as if you bought a company that was of this sort of revenue opportunity, but needed significant investments?

**Ron Malone** - Gentiva Health Services - CEO

I think you might also look at the process of opening these specialty practices in a similar fashion, notwithstanding what we mentioned earlier around the managed care in the mix. You still understand that we front the operating -- we opened 16 new specialty programs in the second quarter. That meant 16 new program directors and upfront addition of new clinicians to fuel the growth of those programs. We are not, by the way, the real --the issue around managed care is really pervasive in that business. It is not isolated by any stretch to the specialty programs. In fact, the specialty programs probably have a little less of it than the general business.

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

So it's one of the knocks against the managed care business for a long time and that's why others say they don't like it. But I guess the final way I can ask this question is, so how much did this investment actually cost you in the first half in terms of earnings?

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

I guess, Cheryl, without giving you a specific number because I would hate to fine-tune it in too minute a fashion, but if you look at the fact that even taking this quarter, our margins are down 6/10 of a percent from the prior year -- our gross margin, that is. And given the changes in our mix of business, and we've commented on this in past quarters, that generally that change in mix of business one would expect to improve the margin to the tune of 1 to 1.5 percentage points. You've got a couple of, 200 basis points or so, in terms of gross margin that relate to the whole issue of bringing these caregivers on. Certainly there are some costs that won't go away, increased wages and mileage and that sort of thing. But there is a component of that -- it is productivity. That, certainly, in my mind has had the effect on the first half.

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

It might have been 100 basis points or something like that, or 150 basis points?

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

I think that's fair.

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

So that might be, if I did the math correctly, somewhere between \$2 (million) and \$2.5 million of additional expense or costs in this quarter? I know you don't want to be pinned down, but if that's fair, that's what it have would cost?

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

Those numbers are right in line with mine.

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

Okay, just so that we understand what kind of returns we should demand from you later on.

**Ron Malone** - *Gentiva Health Services - CEO*

That's fair. Alright.

**Operator**

We appreciate all of your interest in today's call. However, with a quick glance at the clock we are just over our one-hour mark. So with that, Mr. Malone and our host panel, I will turn the call back to you for any closing remarks.

**Ron Malone** - *Gentiva Health Services - CEO*

I would like to thank each of you for participating this morning and for your continued interest in Gentiva. We will continue to keep you informed of our progress and look forward to speaking with you all again on our third quarter earnings call. Take care.

**Operator**

Ladies and gentlemen your host is making today's conference available for digitized replays for one week starting at 1:30 PM Eastern daylight time August 3, all the way through 11:59 PM August 10th. To access AT&T's executive replay service please dial 320-365-3844, at the voice prompt enter today's conference ID of 783618. That does conclude our earnings release for the second quarter. Thank you very much for your participation as well as for using AT&T's Executive Teleconference service. You may now disconnect.

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