SELECT MEDICAL HOLDINGS CORPORATION
SELECT MEDICAL CORPORATION

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Financial Statements and Management's Discussion and Analysis for the Year Ended December 31, 2007

SELECT MEDICAL HOLDINGS CORPORATION

SELECT MEDICAL CORPORATION

Consolidated Financial Statements With Report of Independent Auditors

Management's Discussion and Analysis of Financial Condition and Results of Operations

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Report of Independent Auditors

To the Board of Directors and Stockholders
of Select Medical Holdings Corporation:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of changes in stockholders' equity and comprehensive income and of cash flows present fairly, in all material respects, the financial position of Select Medical Holdings Corporation and its subsidiaries at December 31, 2007 and 2006, and the results of their operations and their cash flows for the years ended December 31, 2007 and 2006, and for the period from February 25, 2005 through December 31, 2005 ("Successor" as described in Note 1 to the consolidated financial statements) in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Philadelphia, PA
March 24, 2008

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Report of Independent Auditors

To the Board of Directors and Stockholders
of Select Medical Holdings Corporation:

In our opinion, the accompanying consolidated statements of operations, of changes in stockholders' equity and comprehensive income (loss) and of cash flows present fairly, in all material respects, the results of operations and cash flows of Select Medical Holdings Corporation and its subsidiaries for the period from January 1, 2005 through February 24, 2005 ("Predecessor" as defined in Note 1 to the consolidated financial statements) in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Philadelphia, PA
March 17, 2006

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Report of Independent Auditors

To the Board of Directors and Stockholder
of Select Medical Corporation:

In our opinion, the accompanying consolidated statements of operations, of changes in stockholder's equity and comprehensive income (loss) and of cash flows present fairly, in all material respects, the results of operations and cash flows of Select Medical Corporation and its subsidiaries for the period from January 1, 2005 through February 24, 2005 ("Predecessor" as defined in Note 1 to the consolidated financial statements) in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Philadelphia, PA
March 17, 2006

Consolidated Balance Sheets

(in thousands, except share and per share amounts)

	Select Medical Holdings Corporation		Select Medical Corporation	
	December 31, 2006	**December 31, 2007**	**December 31, 2006**	**December 31, 2007**
ASSETS				
Current Assets:				
Cash and cash equivalents	$ 81,600	$ 4,529	$ 81,600	$ 4,529
Restricted cash	4,335	-	4,335	-
Accounts receivable, net of allowance for doubtful accounts of $55,306 and $55,856 in 2006 and 2007, respectively	199,927	271,406	199,927	271,406
Current deferred tax asset	42,613	48,988	42,613	48,988
Prepaid income taxes	-	8,162	-	8,162
Other current assets	16,762	22,507	16,762	22,507
Total Current Assets	345,237	355,592	345,237	355,592
Property and equipment, net	356,336	487,026	356,336	487,026
Goodwill	1,323,572	1,499,485	1,323,572	1,499,485
Other identifiable intangibles	79,230	79,172	79,230	79,172
Assets held for sale	4,855	14,607	4,855	14,607
Other assets	73,294	59,164	68,412	54,895
Total Assets	$ 2,182,524	$ 2,495,046	$ 2,177,642	$ 2,490,777
LIABILITIES AND STOCKHOLDERS' EQUITY				
Current Liabilities:				
Bank overdrafts	$ 12,213	$ 21,124	$ 12,213	$ 21,124
Current portion of long-term debt and notes payable	6,209	7,749	6,209	7,749
Accounts payable	72,597	73,847	72,597	73,847
Accrued payroll	55,084	59,483	55,084	59,483
Accrued vacation	27,360	33,080	27,360	33,080
Accrued interest	36,759	36,781	25,270	25,342
Accrued restructuring	225	15,484	225	15,484
Accrued other	60,499	78,242	60,499	95,242
Income taxes payable	1,937	-	1,937	-
Due to third party payors	12,886	15,072	12,886	15,072
Total Current Liabilities	285,769	340,862	274,280	346,423
Long-term debt, net of current portion	1,532,294	1,747,886	1,224,509	1,438,776
Non-current deferred tax liability	32,075	22,966	30,721	23,380
Other non-current liabilities	31,564	52,266	31,564	52,266
Total Liabilities	1,881,702	2,163,980	1,561,074	1,860,845
Commitments and Contingencies				
Minority interest in consolidated subsidiary companies	2,566	5,761	2,566	5,761
Preferred stock - Authorized shares (liquidation preference is $467,395 and $491,194 in 2006 and 2007, respectively)	467,395	491,194	-	-
Stockholders' Equity:				
Common stock of Holdings, $0.001 par value, 250,000,000 shares authorized, 204,904,000 shares and 205,166,000 shares issued and outstanding in 2006 and 2007, respectively	205	205	-	-
Common stock of Select, $0.01 par value, 100 shares issued and outstanding	-	-	-	-
Capital in excess of par	(295,256)	(291,247)	464,283	478,911
Retained earnings	121,024	130,716	146,774	150,203
Accumulated other comprehensive income (loss)	4,888	(5,563)	2,945	(4,943)
Total Stockholders' Equity	(169,139)	(165,889)	614,002	624,171
Total Liabilities and Stockholders' Equity	$ 2,182,524	$ 2,495,046	$ 2,177,642	$ 2,490,777

The accompanying notes are an integral part of this statement.

Select Medical Holdings Corporation
Consolidated Statements of Operations
(in thousands)

	Predecessor	Successor		
	Select Medical Corporation		For the Year Ended December 31,	
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	2006	2007
Net operating revenues	$ 277,736	$ 1,580,706	$ 1,851,498	$ 1,991,666
Costs and expenses:				
Cost of services	244,321	1,244,361	1,484,632	1,660,049
General and administrative	122,509	59,494	43,514	42,863
Bad debt expense	6,588	18,213	18,810	37,572
Depreciation and amortization	5,933	37,922	46,668	57,297
Total costs and expenses	379,351	1,359,990	1,593,624	1,797,781
Income (loss) from operations	(101,615)	220,716	257,874	193,885
Other income and expense:				
Loss on early retirement of debt	(42,736)	-	-	-
Merger related charges	(12,025)	-	-	-
Other income (expense)	267	1,092	-	(167)
Interest income	523	767	1,293	2,103
Interest expense	(4,651)	(102,208)	(131,831)	(140,155)
Income (loss) from continuing operations before minority interests and income taxes	(160,237)	120,367	127,336	55,666
Minority interest in consolidated subsidiary companies	330	1,776	1,414	1,537
Income (loss) from continuing operations before income taxes	(160,567)	118,591	125,922	54,129
Income tax expense (benefit)	(59,794)	49,336	43,521	18,699
Income (loss) from continuing operations	(100,773)	69,255	82,401	35,430
Income from discontinued operations, net of tax (includes pre-tax gain of $13,950 in 2006)	522	3,072	12,478	-
Net income (loss)	(100,251)	72,327	94,879	35,430
Less: Preferred dividends	-	23,519	22,663	23,807
Net income (loss) available to common stockholders	$ (100,251)	$ 48,808	$ 72,216	$ 11,623

The accompanying notes are an integral part of this statement.

Select Medical Corporation
Consolidated Statements of Operations
(in thousands)

	Predecessor	Successor		
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	For the Year Ended December 31, 2006	For the Year Ended December 31, 2007
Net operating revenues	$ 277,736	$ 1,580,706	$ 1,851,498	$ 1,991,666
Costs and expenses:				
Cost of services	244,321	1,244,361	1,484,632	1,660,049
General and administrative	122,509	59,494	43,514	42,863
Bad debt expense	6,588	18,213	18,810	37,572
Depreciation and amortization	5,933	37,922	46,668	57,297
Total costs and expenses	379,351	1,359,990	1,593,624	1,797,781
Income (loss) from operations	(101,615)	220,716	257,874	193,885
Other income and expense:				
Loss on early retirement of debt	(42,736)	-	-	-
Merger related charges	(12,025)	-	-	-
Other income (expense)	267	3,018	1,366	(4,494)
Interest income	523	767	1,293	2,103
Interest expense	(4,651)	(83,752)	(97,288)	(105,497)
Income (loss) from continuing operations before minority interests and income taxes	(160,237)	140,749	163,245	85,997
Minority interest in consolidated subsidiary companies	330	1,776	1,414	1,537
Income (loss) from continuing operations before income taxes	(160,567)	138,973	161,831	84,460
Income tax expense (benefit)	(59,794)	56,470	56,089	29,315
Income (loss) from continuing operations	(100,773)	82,503	105,742	55,145
Income from discontinued operations, net of tax (includes pre-tax gain of $13,950 in 2006)	522	3,072	12,478	-
Net income (loss)	$ (100,251)	$ 85,575	$ 118,220	$ 55,145

The accompanying notes are an integral part of this statement.

Select Medical Holdings Corporation

Consolidated Statement of Changes in Stockholders' Equity and Comprehensive Income (Loss)

(in thousands)

	Common Stock Issued	Common Stock Par Value	Capital in Excess of Par	Retained Earnings	Accumulated Other Comprehensive Income	Comprehensive Loss
Predecessor:						
Balance at January 1, 2005	101,954	$ 1,020	$ 275,281	$ 230,535	$ 9,107	
Net loss				(100,251)		$ (100,251)
Changes in foreign currency translation					(1,019)	(1,019)
Total comprehensive loss						$ (101,270)
Issuance of common stock	267	3	1,020			
Repurchase of non-employee options			(1,617)			
Tax benefit of stock option exercises			1,507			
Balance at February 24, 2005	102,221	$ 1,023	$ 276,191	$ 130,284	$ 8,088	

	Common Stock Issued	Common Stock Par Value	Capital in Excess of Par	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income
Successor:						
Capitalization of Successor Company at February 25, 2005	148,253	$ 148	$ (310,092)			
Net income				$ 72,327		$ 72,327
Unrealized gain on interest rate swap, net of tax					$ 3,539	3,539
Changes in foreign currency translation					1,818	1,818
Total comprehensive income						$ 77,684
Issuance of common stock	808	1	808			
Issuance and vesting of restricted stock	56,347	56	10,247			
Stock option expense			9			
Accretion of dividends on preferred stock				(23,519)		
Balance at December 31, 2005	205,408	205	(299,028)	48,808	5,357	
Net income				94,879		$ 94,879
Unrealized gain on interest rate swap, net of tax					1,438	1,438
Changes in foreign currency translation					924	924
Sale of foreign subsidiary					(2,831)	(2,831)
Total comprehensive income						$ 94,410
Issuance and vesting of restricted stock	200	1	3,769			
Cancellation of restricted stock awards	(680)	(1)				
Repurchase of common shares	(24)	-	(10)			
Stock option expense			13			
Accretion of dividends on preferred stock				(22,663)		
Balance at December 31, 2006	204,904	205	(295,256)	121,024	4,888	
Net income				35,430		$ 35,430
Unrealized loss on interest rate swap, net of tax					(10,451)	(10,451)
Total comprehensive income						$ 24,979
Cumulative impact of change in accounting for uncertainties in income taxes (FIN No. 48 - Note 11)				(1,931)		
Issuance and vesting of restricted stock	200		3,923			
Exercise of stock options	65		66			
Stock option expense			23			
Repurchase of common shares	(3)		(3)			
Accretion of dividends on preferred stock				(23,807)		
Balance at December 31, 2007	205,166	$ 205	$ (291,247)	$ 130,716	$ (5,563)	

The accompanying notes are an integral part of this statement.

Select Medical Corporation
Consolidated Statement of Changes in Stockholder's Equity and Comprehensive Income (Loss)
(in thousands)

	Common Stock Issued	Common Stock Par Value	Capital in Excess of Par	Retained Earnings	Accumulated Other Comprehensive Income	Comprehensive Loss
Predecessor:						
Balance at January 1, 2005	101,954	$ 1,020	$ 275,281	$ 230,535	$ 9,107	
Net loss				(100,251)		$ (100,251)
Changes in foreign currency translation					(1,019)	(1,019)
Total comprehensive loss						$ (101,270)
Issuance of common stock	267	3	1,020			
Repurchase of non-employee options			(1,617)			
Tax benefit of stock option exercises			1,507			
Balance at February 24, 2005	102,221	$ 1,023	$ 276,191	$ 130,284	$ 8,088	

	Common Stock Issued	Common Stock Par Value	Capital in Excess of Par	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income
Successor:						
Capitalization of Successor Company at February 25, 2005	-	$ -	$ 431,167			
Expenses paid on behalf of Holdings			(10,490)			
Adjustment to initial capitalization			(8,686)			
Net income				$ 85,575		$ 85,575
Unrealized gain on interest rate swap, net of tax					$ 2,414	2,414
Changes in foreign currency translation					1,818	1,818
Total comprehensive income						$ 89,807
Additional investment by Holdings			18,495			
Dividends paid to Holdings				(24,441)		
Contribution related to restricted stock awards and stock option issuances by Holdings			10,313			
Balance at December 31, 2005	-	-	440,799	61,134	4,232	
Net income				118,220		$ 118,220
Unrealized gain on interest rate swap, net of tax					531	531
Changes in foreign currency translation					1,013	1,013
Sale of foreign subsidiary					(2,831)	(2,831)
Total comprehensive income						$ 116,933
Federal tax benefit of losses contributed by Holdings			19,702			
Dividends paid to Holdings				(32,580)		
Contribution related to restricted stock awards and stock option issuances by Holdings			3,782			
Balance at December 31, 2006	-	-	464,283	146,774	2,945	
Net income				55,145		$ 55,145
Unrealized loss on interest rate swap, net of tax					(7,888)	(7,888)
Total comprehensive income						$ 47,257
Cumulative impact of change in accounting for uncertainties in income taxes (FIN No. 48 - Note 11)				(1,931)		
Federal tax benefit of losses contributed by Holdings			10,616			
Additional investment by Holdings			266			
Dividends declared to Holdings				(17,000)		
Dividends paid to Holdings				(32,785)		
Contribution related to restricted stock awards and stock option issuances by Holdings			3,746			
Balance at December 31, 2007	-	$ -	$ 478,911	$ 150,203	$ (4,943)	

The accompanying notes are an integral part of this statement.

Select Medical Holdings Corporation
Consolidated Statements of Cash Flows
(in thousands)

	Predecessor	Successor		
	Select Medical Corporation			
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	For the Year Ended December 31, 2006	2007
Operating activities				
Net income (loss)	$ (100,251)	$ 72,327	$ 94,879	$ 35,430
Adjustments to reconcile net income (loss) to net cash provided by operating activities:				
Depreciation and amortization	6,177	39,060	46,844	57,297
Provision for bad debts	6,661	18,600	18,897	37,572
Loss (gain) from disposal of assets and sale of business units	-	810	(11,507)	2,424
Loss on early retirement of debt (non-cash)	7,977	-	-	-
Non-cash stock compensation expense	-	10,312	3,782	3,746
Amortization of debt discount	-	881	1,176	1,325
Deferred income taxes	(63,863)	19,822	13,327	2,460
Minority interests	469	3,018	1,754	1,537
Changes in operating assets and liabilities, net of effects from acquisition of businesses:				
Accounts receivable	(48,976)	(2,908)	30,804	(75,540)
Other current assets	1,816	312	2,015	1,406
Other assets	(622)	4,887	6,441	6,251
Accounts payable	5,250	1,879	12,081	(112)
Due to third-party payors	667	(1,757)	711	2,186
Accrued expenses	203,751	(129,088)	6,447	10,031
Net cash provided by operating activities	19,056	38,155	227,651	86,013
Investing activities				
Purchases of property and equipment	(2,586)	(107,360)	(155,096)	(166,074)
Proceeds from sale of business units	-	-	74,966	9,605
Proceeds from sale of property	-	-	-	6,438
Changes in restricted cash	108	578	2,010	4,335
Acquisition of businesses, net of cash acquired	(108,279)	(3,272)	(3,361)	(236,980)
Net cash used in investing activities	(110,757)	(110,054)	(81,481)	(382,676)
Financing activities				
Borrowings on revolving credit facility	-	281,000	215,000	449,000
Payments on revolving credit facility	-	(196,000)	(300,000)	(329,000)
Proceeds from senior floating rate notes	-	175,000	-	-
Credit facility term loan borrowings	-	580,000	-	100,000
Payments on credit facility term loan	-	(4,350)	(5,800)	(6,550)
Proceeds from senior subordinated notes	-	660,000	-	-
Repayment of senior subordinated notes	-	(350,000)	-	-
Payment of deferred financing costs	-	(60,269)	-	-
Principal payments on seller and other debt	(528)	(4,161)	(721)	(1,323)
Proceeds from (repayment of) bank overdrafts	-	19,355	(7,142)	8,911
Repurchase of common and preferred stock	-	(1,687,994)	(41)	(14)
Proceeds from issuance of restricted stock	-	-	-	200
Proceeds from issuance of common stock	1,023	-	-	66
Payment of preferred stock dividends	-	(175,000)	-	-
Equity investment	-	724,042	-	-
Costs associated with equity investment of Holdings	-	(8,686)	-	-
Distributions to minority interests	(401)	(1,541)	(1,762)	(1,698)
Net cash provided by (used in) financing activities	94	(48,604)	(100,466)	219,592
Effect of exchange rate changes on cash and cash equivalents	(149)	644	35	-
Net increase (decrease) in cash and cash equivalents	(91,756)	(119,859)	45,739	(77,071)
Cash and cash equivalents at beginning of period	247,476	155,720	35,861	81,600
Cash and cash equivalents at end of period	$ 155,720	$ 35,861	$ 81,600	$ 4,529
Supplemental Cash Flow Information				
Cash paid for interest	$ 10,630	$ 59,725	$ 124,251	$ 134,527
Cash paid for taxes	$ 1,502	$ 10,712	$ 22,572	$ 9,009

The accompanying notes are an integral part of this statement.

Select Medical Corporation
Consolidated Statements of Cash Flows
(in thousands)

	Predecessor	Successor		
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	For the Year Ended December 31, 2006	2007
Operating activities				
Net income (loss)	$ (100,251)	$ 85,575	$ 118,220	$ 55,145
Adjustments to reconcile net income (loss) to net cash provided by operating activities:				
Depreciation and amortization	6,177	39,060	46,844	57,297
Provision for bad debts	6,661	18,600	18,897	37,572
Loss (gain) from disposal of assets and sale of business units	-	810	(11,507)	2,424
Non-cash loss (income) from interest rate swaps	-	(1,926)	(1,366)	4,327
Loss on early retirement of debt (non-cash)	7,977	-	-	-
Non-cash stock compensation expense	-	10,312	3,782	3,746
Deferred income taxes	(63,863)	26,956	13,327	2,460
Minority interests	469	3,018	1,754	1,537
Changes in operating assets and liabilities, net of effects from acquisition of businesses:				
Accounts receivable	(48,976)	(2,908)	30,804	(75,540)
Other current assets	1,816	312	2,015	1,406
Other assets	(622)	4,473	6,307	5,640
Accounts payable	5,250	2,254	12,081	(112)
Due to third-party payors	667	(1,757)	711	2,186
Accrued expenses	203,751	(139,707)	18,321	20,698
Net cash provided by operating activities	19,056	45,072	260,190	118,786
Investing activities				
Purchases of property and equipment	(2,586)	(107,360)	(155,096)	(166,074)
Proceeds from sale of business units	-	-	74,966	9,605
Proceeds from sale of property	-	-	-	6,438
Changes in restricted cash	108	578	2,010	4,335
Acquisition of businesses, net of cash acquired	(108,279)	(3,272)	(3,361)	(236,980)
Net cash used in investing activities	(110,757)	(110,054)	(81,481)	(382,676)
Financing activities				
Borrowings on revolving credit facility	-	281,000	215,000	449,000
Payments on revolving credit facility	-	(196,000)	(300,000)	(329,000)
Credit facility term loan borrowings	-	580,000	-	100,000
Payments on credit facility term loan	-	(4,350)	(5,800)	(6,550)
Proceeds from senior subordinated notes	-	660,000	-	-
Repayment of senior subordinated notes	-	(350,000)	-	-
Payment of deferred financing costs	-	(57,198)	-	-
Principal payments on seller and other debt	(528)	(4,161)	(721)	(1,323)
Proceeds from (repayment of) bank overdrafts	-	19,355	(7,142)	8,911
Dividends paid to Holdings	-	(9,988)	(32,580)	(32,787)
Repurchase of common and preferred stock	-	(1,687,994)	-	-
Proceeds from issuance of common stock	1,023	-	-	-
Equity investment by Holdings	-	724,042	-	266
Costs associated with equity investment of Holdings	-	(8,686)	-	-
Distributions to minority interests	(401)	(1,541)	(1,762)	(1,698)
Net cash provided by (used in) financing activities	94	(55,521)	(133,005)	186,819
Effect of exchange rate changes on cash and cash equivalents	(149)	644	35	-
Net increase (decrease) in cash and cash equivalents	(91,756)	(119,859)	45,739	(77,071)
Cash and cash equivalents at beginning of period	247,476	155,720	35,861	81,600
Cash and cash equivalents at end of period	$ 155,720	$ 35,861	$ 81,600	$ 4,529
Supplemental Cash Flow Information				
Cash paid for interest	$ 10,630	$ 53,183	$ 92,110	$ 101,766
Cash paid for taxes	$ 1,502	$ 10,712	$ 22,572	$ 9,009

The accompanying notes are an integral part of this statement.

1. Organization and Significant Accounting Policies

Business Description

Select Medical Corporation ("Select") was formed in December 1996 and commenced operations during February 1997 upon the completion of its first acquisition. Select Medical Holdings Corporation ("Holdings") was formed in October 2004. On February 24, 2005, Select merged with a subsidiary of Holdings which resulted in Select becoming a wholly-owned subsidiary of Holdings (the "Merger"). Holdings, Select and its subsidiaries are referred to herein as the "Company." Generally accepted accounting principles require that any amounts recorded or incurred (such as goodwill and compensation expense) by the parent as the result of the Merger or for the benefit of the subsidiary be "pushed down" and recorded in Select's consolidated financial statements. The Company's financial position, results of operations and cash flows prior to the Merger are presented separately in the consolidated financial statements as "Predecessor" financial statements, while the Company's financial position, results of operations and cash flows following the Merger are presented as "Successor" financial statements. Due to the revaluation of assets resulting from the purchase accounting associated with the Merger, the Pre-Merger financial statements are not comparable with those after the Merger in certain respects.

The Company provides long-term acute care hospital services and inpatient acute rehabilitative hospital care through its specialty hospital segment and provides physical, occupational, and speech rehabilitation services through its outpatient rehabilitation segment. The Company's specialty hospital segment consists of hospitals designed to serve the needs of acute patients and hospitals designed to serve patients that require intensive medical rehabilitation care. Patients in the Company's long-term acute care hospitals typically suffer from serious and often complex medical conditions that require a high degree of care. Patients in the Company's acute medical rehabilitation hospitals typically suffer from debilitating injuries including traumatic brain and spinal cord injuries, and require rehabilitation care in the form of physical, psychological, social and vocational rehabilitation services. The Company's outpatient rehabilitation business consists of clinics and contract services that provide physical, occupational and speech rehabilitation services. The Company's outpatient rehabilitation patients are typically diagnosed with musculoskeletal impairments that restrict their ability to perform normal activities of daily living. The Company operated 101, 96 and 87 specialty hospitals at December 31, 2005, 2006 and 2007, respectively. At December 31, 2005, 2006 and 2007, the Company operated 717, 544 and 999 outpatient clinics, respectively. At December 31, 2005, 2006 and 2007, the Company had operations in the District of Columbia and 35, 32 and 37 states, respectively. Also, at December 31, 2005 the Company had operations in Canada through its wholly-owned subsidiary, Canadian Back Institute Limited ("CBIL"), which was sold on March 1, 2006 (Note 3).

Merger and Related Transactions

On February 24, 2005, the Merger transaction was consummated and Select became a wholly-owned subsidiary of Holdings. Holdings is owned by an investor group that includes Welsh, Carson, Anderson, & Stowe, IX, LP ("Welsh Carson"), Thoma Cressey Bravo ("Thoma Cressey") and members of the Company's senior management. In the transaction, all of the former stockholders (except for certain members of management and other rollover investors) of Select received $18.00 per share in cash for common stock of Select. Holders of stock options issued by Select received cash equal to (a) $18.00 minus the exercise price of the option multiplied by (b) the number of shares subject to the options. After the Merger, Select's common stock was delisted from the New York Stock Exchange. The Merger and related transactions are referred to in this report as the "Merger."

The funds necessary to consummate the Merger were approximately $2,291.1 million, including approximately $1,827.7 million to pay the then current stockholders and option holders of Select, approximately $344.2 million to repay existing indebtedness and approximately $119.2 million to pay related fees and expenses.

The Merger transactions were financed by:

- a cash common and preferred equity investment in Holdings by Welsh Carson and other equity investors of $570.0 million;
- a senior subordinated notes offering by Holdings of $150.0 million;
- borrowing by Select of $580.0 million in term loans and $200.0 million on the revolving loan facility under a new senior secured credit facility;
- the issuance by Select of $660.0 million in aggregate principle amount of 7 ⅝% senior subordinated notes; and
- $131.1 million of cash on hand at Select at the closing date.

The Merger transactions were accounted for under the purchase method of accounting prescribed in Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations," ("SFAS No. 141"). As a result of a 26% continuing ownership interest in Holdings by certain stockholders ("Continuing Stockholders"), 74% of the purchase price was allocated to the assets and liabilities acquired at their respective fair values with the remaining 26% recorded at the Continuing Stockholders' historical book values as of the date of the acquisition in accordance with Emerging Issues Task Force Issue No. 88-16 "Basis in Leveraged Buyout Transactions" ("EITF 88-16"). As a result of the carryover of the Continuing Stockholders' historical basis, stockholders' equity of Holdings and Select have been reduced by $449.5 million.

The purchase price, including transaction-related fees, was allocated to the Company's tangible and identifiable intangible assets and liabilities based upon estimates of fair value, with the remainder allocated to goodwill. In accordance with the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"), no amortization of indefinite-lived intangible assets or goodwill has been recorded. The factors that were considered when determining the purchase price and that resulted in goodwill included the long-term growth and earnings prospects for Select. Holdings believed that as a private company, the management of Select would be better able to concentrate on the regulatory changes affecting its business and make long-term investment and operational decisions that would be harder to execute as a public company, where there is greater focus on quarter-to-quarter performance.

A summary of the Merger transactions is presented below (in thousands):

	Holdings	Select
Equity Contribution	$ 570,000	$ --
Cash contributions from Holdings	--	720,000
Exchange of shares of Select for equity of Holdings at $18.00 per share	151,992	151,992
Aggregate equity contribution	721,992	871,992
Continuing shareholders' basis adjustment	(449,510)	(449,510)
Equity contribution, net	272,482	422,482
Merger expenses paid	(8,686)	--
Expenses paid on behalf of Holdings	--	(10,491)
Proceeds from borrowings	1,590,000	1,440,000
Purchase price allocated	$1,853,796	$1,851,991
Fair value of net tangible assets acquired:		
Cash	$ 34,484	$ 34,484
Accounts receivable	280,891	280,891
Current deferred tax asset	69,858	69,858
Other current assets	20,955	20,955
Property and equipment	177,634	177,634
Non-current deferred tax asset	31,879	31,879
Other assets	12,970	11,165
Current liabilities	(267,831)	(267,831)
Long-term debt	(7,052)	(7,052)
Minority interest in consolidated subsidiary companies	(6,661)	(6,661)
Net tangible assets acquired	347,127	345,322
Capitalized debt issuance costs	55,392	55,392
Intangible assets acquired	92,988	92,988
Goodwill	1,358,289	1,358,289
	$1,853,796	$1,851,991

An unaudited pro forma statement of operations for the year ended December 31, 2005 as if the Merger occurred as of January 1, 2005 is as follows (in thousands):

	(unaudited) For the Year Ended December 31, 2005	
	Holdings	**Select**
Net revenue	$1,858,442	$1,858,442
Net loss	(39,044)	(24,098)

In connection with the Merger, Merger related charges of $152.5 million related to stock compensation expense which were comprised of $142.2 million related to the cancellation of all Select's vested and unvested outstanding stock options in connection with the Merger in the Predecessor period of January 1, 2005 through February 24, 2005 and an additional $10.3 million of stock compensation cost related to Holdings restricted stock and stock options that were issued in the Successor period February 25, 2005 through December 31, 2005. Also incurred were costs of $42.7 million related to the early extinguishment of Select's 9 ½% and 7 ½% senior subordinated notes which consisted of a tender premium cost of $34.8 million and the remaining unamortized deferred financing costs of $7.9 million. In addition, $12.0 million of other Merger related charges were incurred. These charges consisted of the fees of the investment advisor hired by the Special Committee of Select's Board of Directors to evaluate the Merger, legal and accounting fees, costs associated with the Hart-Scott-Rodino filing and costs associated with purchasing a six year extended reporting period under Select's directors and officers liability insurance policy.

Goodwill was allocated to each of the Company's reporting units based on their fair values at the date of the Merger. The Company performs impairment tests at least annually, or more frequently with respect to assets for which there are any impairment indicators. If the expected future cash flows (undiscounted) are less than the carrying amount of such assets, the Company recognizes an impairment loss for the difference between the carrying amount of the assets and their estimated fair value.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company, its majority owned subsidiaries, limited liability companies and limited partnerships the Company and its subsidiaries control through ownership of general and limited partnership or membership interests. All significant intercompany balances and transactions are eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain reclassifications to amounts previously reported have been made to conform with the current period presentation.

Cash and Cash Equivalents

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. Cash equivalents are stated at cost which approximates market value.

Restricted Cash

Restricted cash consists of cash used to establish a trust fund, as required by the Company's insurance program, for the purpose of paying professional and general liability losses and expenses incurred by the Company.

Accounts Receivable and Allowance for Doubtful Accounts

Substantially all of the Company's accounts receivable are related to providing healthcare services to patients. Collection of these accounts receivable is the Company's primary source of cash and is critical to its operating performance. The Company's primary collection risks relate to non-governmental payors who insure these patients and deductibles, co-payments and self-insured amounts owed by the patient. Deductible, co-payments and self-insured amounts are an immaterial portion of the Company's net accounts receivable balance and accounted for approximately 0.9% and 0.3% of the net accounts receivable balance before doubtful accounts at December 31, 2006 and December 31, 2007, respectively. The Company's general policy is to verify insurance coverage prior to the date of admission for a patient admitted to the Company's hospitals or in the case of the Company's outpatient rehabilitation clinics, the Company verifies insurance coverage prior to their first therapy visit. The Company's estimate for the allowance for doubtful accounts is calculated by generally reserving as uncollectible all governmental accounts over 365 days and non-governmental accounts over 180 days from discharge. This method is monitored based on historical cash collections experience. Collections are impacted by the effectiveness of the Company's collection efforts with non-governmental payors and regulatory or administrative disruptions with the fiscal intermediaries that pay the Company's governmental receivables.

The Company has historically collected substantially all of its third-party insured receivables (net of contractual allowances) which include receivables from governmental agencies. The Company reviews its overall reserve adequacy by monitoring historical cash collections as a percentage of net revenue less the provision for bad debts.

Uncollected accounts are written off the balance sheet when they are turned over to an outside collection agency, or when management determines that the balance is uncollectible, whichever occurs first.

Property and Equipment

Property and equipment are stated at cost net of accumulated depreciation. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets or the term of the lease, as appropriate. The general range of useful lives is as follows:

Leasehold improvements	5 years
Furniture and equipment	3 – 20 years
Buildings	40 years

In accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS No. 144"), the Company reviews the realizability of long-lived assets whenever events or circumstances occur which indicate recorded costs may not be recoverable.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentration of credit risk consist primarily of cash balances and trade receivables. The Company invests its excess cash with large financial institutions. The Company grants unsecured credit to its patients, most of whom reside in the service area of the Company's facilities and are insured under third-party payor agreements. Because of the geographic diversity of the Company's facilities and non-governmental third-party payors, Medicare represents the Company's only concentration of credit risk.

Income Taxes

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Management provides a valuation allowance for net deferred tax assets when it is more likely than not that such net deferred tax assets will not be recovered.

On January 1, 2007, the Company adopted Financial Accounting Standards Board ("FASB") Interpretation No. 48 ("FIN No. 48"), "Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109." FIN No. 48 clarifies the recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. See Note 11 for information concerning the Company's unrecognized tax benefits, interest and penalties.

Intangible Assets

Effective January 1, 2002, the Company adopted SFAS No.142. Under SFAS No. 142, goodwill and other intangible assets with indefinite lives are no longer subject to periodic amortization but are instead reviewed annually, or more frequently if impairment indicators arise. These reviews require the Company to estimate the fair value of its identified reporting units and compare those estimates against the related carrying values. For each of the reporting units, the estimated fair value is determined utilizing the expected present value of the future cash flows of the units.

Identifiable assets and liabilities acquired in connection with business combinations accounted for under the purchase method are recorded at their respective fair values. Deferred income taxes have been recorded to the extent of differences between the fair value and the tax basis of the assets acquired and liabilities assumed. Company management has allocated the intangible assets between identifiable intangibles and goodwill. Intangible assets other than goodwill primarily consist of the values assigned to trademarks, non-compete agreements, certificates of need, accreditation and contract therapy relationships. Management believes that the estimated useful lives established are reasonable based on the economic factors applicable to each of the intangible assets.

The approximate useful life of each class of intangible assets is as follows:

Goodwill	Indefinite
Trademarks	Indefinite
Certificates of need	Indefinite
Accreditation	Indefinite
Non-compete agreements	6-7 years
Contract therapy relationships	5 years

In accordance with SFAS No. 144, the Company reviews the realizability of long-lived assets and certain definite lived intangible assets whenever events or circumstances occur which indicate recorded costs may not be recoverable.

If the expected future cash flows (undiscounted) are less than the carrying amount of such assets, the Company recognizes an impairment loss for the difference between the carrying amount of the assets and their estimated fair value.

Due to Third-Party Payors

Due to third-party payors represents the difference between amounts received under interim payment plans from third-party payors, principally Medicare and Medicaid, for services rendered and amounts estimated to be reimbursed by those third-party payors upon settlement of cost reports.

Insurance Risk Programs

Under a number of the Company's insurance programs, which include the Company's employee health insurance program, its workers' compensation, professional liability insurance programs and certain components under its property and casualty insurance program, the Company is liable for a portion of its losses. In these cases the Company accrues for its losses under an occurrence-based principle whereby the Company estimates the losses that will be incurred in a respective accounting period and accrues that estimated liability. Where the Company has substantial exposure, actuarial methods are utilized in estimating the losses. In cases where the Company has minimal exposure, losses are estimated by analyzing historical trends. These programs are monitored quarterly and estimates are revised as necessary to take into account additional information. At December 31, 2006 and 2007 respectively, the Company had recorded a liability of $60.0 million and $58.9 million related to these programs.

Minority Interests

The interests held by other parties in subsidiaries, limited liability companies and limited partnerships owned and controlled by the Company are reported in the consolidated balance sheets as minority interests. Minority interests reported in the consolidated statements of operations reflect the respective interests in the income or loss of the subsidiaries, limited liability companies and limited partnerships attributable to the other parties, the effect of which is removed from the Company's consolidated results of operations.

Stock Options

The Company adopted SFAS No. 123R, "Share-Based Payment" ("SFAS No. 123R") in the Successor period beginning on February 25, 2005. As permitted by SFAS No. 123R under the Modified Prospective Application transition method, the Company has chosen to apply APB Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25") and related interpretations in accounting for its stock option plans in the Predecessor period from January 1, 2005 through February 24, 2005, and accordingly, no compensation cost has been recognized for options granted under the Predecessor stock option plans.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. The Company's pro forma net earnings were as follows:

	Predecessor
	Period from January 1 through February 24, 2005
	(in thousands)
Net loss available to common stockholders – as reported	$(100,251)
Add: Stock-based employee compensation, net of related tax effects, included in the determination of net loss as reported	87,927
Deduct: Total stock based employee compensation expense determined under fair value based method for all awards, net of related tax effects	14,931
Net loss available to common stockholders – pro forma	$(27,255)
Weighted average grant-date fair value (1)	--

(1) No stock options were granted in the period from January 1, 2005 through February 24, 2005.

Refer to Note 10 – "Stock Option and Restricted Stock Plans" for information on the Company's Successor stock option and restricted stock plans.

Revenue Recognition

Net operating revenues consists primarily of patient and contract therapy revenues and are recognized as services are rendered.

Patient service revenue is reported net of provisions for contractual allowances from third-party payors and patients. The Company has agreements with third-party payors that provide for payments to the Company at amounts different from its established billing rates. The differences between the estimated program reimbursement rates and the standard billing rates are accounted for as contractual adjustments, which are deducted from gross revenues to arrive at net operating revenues. Payment arrangements include prospectively determined rates per discharge, reimbursed costs, discounted charges, per diem and per visit payments. Retroactive adjustments are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined. Accounts receivable resulting from such payment arrangements are recorded net of contractual allowances.

A significant portion of the Company's net operating revenues are generated directly from the Medicare program. Net operating revenues generated directly from the Medicare program represented approximately 52% of the Company's consolidated net operating revenues for the period January 1 through February 24, 2005 (Predecessor), 57% for the period February 25 through December 31, 2005 (Successor), 53% for the year ended December 31, 2006, and 48% for the year ended December 31, 2007. Approximately 38% and 36% of the Company's gross accounts receivable at December 31, 2006 and 2007, respectively, are from this payor source. As a provider of services to the Medicare program, the Company is subject to extensive regulations. The inability of any of the Company's specialty hospitals or clinics to comply with regulations can result in changes in that specialty hospital's or clinic's net operating revenues generated from the Medicare program.

Contract therapy revenues are comprised primarily of billings for services rendered to nursing homes, hospitals, schools and other third parties under the terms of contractual arrangements with these entities.

Other Comprehensive Income (Loss)

The Company used the local currency as the functional currency for its Canadian operations. Income statement items were translated at average exchange rates prevailing during the year. The resulting translation adjustments impacting other comprehensive income (loss) were recorded as a separate component of stockholders' equity. The cumulative translation adjustment was included in accumulated other comprehensive income (loss) and was a gain of $1.8 million at December 31, 2005. The Company sold its Canadian operations on March 1, 2006 and removed the accumulated other comprehensive income (loss) related to the cumulative translation adjustment. This component of other comprehensive income (loss) was included in the calculation of the gain on the sale of the Company's Canadian operations.

Holdings

Included in other comprehensive income (loss) at December 31, 2006 and 2007 were a gain of $4.9 million (net of tax) and a loss of $5.6 million (net of tax), respectively, on interest rate swaps accounted for as cash flow hedges.

Select

Included in other comprehensive income (loss) at December 31, 2006 and 2007 were a gain of $2.9 million (net of tax) and a loss of $4.9 million (net of tax), respectively, on interest rate swaps accounted for as cash flow hedges.

Financial Instruments and Hedging

Effective January 1, 2001, the Company adopted SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" ("SFAS No. 133"). The Company has in the past entered into derivatives to manage interest rate and foreign exchange risks. Derivatives are limited in use and not entered into for speculative purposes. The Company has entered into interest rate swaps to manage interest rate risk on a portion of its long-term borrowings. All derivatives are recognized at fair value on the balance sheet. The effective portion of gains or losses on interest rate swaps designated as hedges is initially deferred in stockholders' equity as a component of other comprehensive income (loss). These deferred gains or losses are subsequently reclassified into earnings as an adjustment to interest expense over the same period in which the related interest payments being hedged are recognized in expense. The ineffective portion of changes in fair value of the interest rate swaps are immediately recognized in the consolidated statement of operations.

Refer to Note 14 for information regarding interest rate swaps the Company entered into during 2005 and 2007.

Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), "Business Combinations ("SFAS No. 141R")" which replaces SFAS No. 141. SFAS No. 141R retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. This statement will be applied prospectively and will not result in any changes to the Company's historical financial statements.

In December 2007, FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB 51 ("SFAS No. 160")." SFAS No. 160 changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent's equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS No. 160 is effective for financial statements issued for years beginning after December 15, 2008, except for the presentation and disclosure requirements, which will apply retrospectively. Adoption of this statement by the Company will result in changes related to presentation and disclosure of the Company's minority interest and will not affect the Company's results of operations.

In February 2007, the FASB Issued SFAS No. 159, "Establishing the Fair Value Option for Financial Assets and Liabilities" ("SFAS No. 159"). SFAS No. 159 was to permit all entities to choose to elect, at specified election dates, to measure eligible financial instruments at fair value. An entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date, and recognize upfront costs and fees related to those items in earnings as incurred and not deferred. SFAS No. 159 applies to years beginning after November 15, 2007, with early adoption permitted for an entity that has also elected to apply the provisions of SFAS No. 157, "Fair Value Measurements ("SFAS No. 157")." An entity is prohibited from retrospectively applying SFAS No. 159, unless it chooses early adoption. SFAS No. 159 also applies to eligible items existing at November 15, 2007 (or early adoption date). The Company does not believe that the adoption of SFAS No. 159 will materially impact its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157. SFAS No. 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. The changes to current practice resulting from the application of this Statement relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements. SFAS No. 157 is effective for years beginning after November 15, 2007 and interim periods within those years. In February 2008, the FASB issued FASB Staff Position (FSP) 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13" (FSP 157-1) and FSP 157-2, "Effective Date of FASB Statement No. 157" (FSP 157-2). FSP 157-1 amends SFAS No. 157 to remove certain leasing transactions from its scope. FSP 157-2 delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of fiscal 2009. The Company does not believe that the adoption of SFAS No. 157 will materially impact its consolidated financial statements.

2. Acquisitions

For the Period from January 1 through February 24, 2005 (Predecessor) and the Period from February 25 through December 31, 2005 (Successor)

Effective as of January 1, 2005, the Company acquired SemperCare, Inc. for approximately $100.0 million in cash. The acquisition consisted of 17 long-term acute care hospitals in 11 states. The factors that were considered when determining the purchase price that resulted in goodwill included the earnings growth potential for these long-term acute care hospitals, general and administrative cost saving opportunities that could be achieved by utilizing Select's infrastructure and additional development opportunities in states with Certificate of Need regulations.

Information with respect to the purchase transaction is as follows (in thousands):

Cash paid, net of cash acquired	$105,085
Fair value of net tangible assets acquired:	
Accounts receivable	22,143
Other current assets	4,718
Property and equipment	9,265
Other assets	242
Current liabilities	(14,150)
Long-term debt	(1,203)
Net tangible assets acquired	21,015
Intangible assets acquired	2,000
Goodwill	82,070
	$105,085

The Company also acquired interests in three outpatient therapy businesses. Additionally, the Company repurchased minority interests of certain subsidiaries. Total consideration for these transactions totaled $6.5 million in cash.

For the Year Ended December 31, 2006

The Company repurchased minority interests of certain subsidiaries in the outpatient rehabilitation segment. Total consideration for these transactions totaled $3.3 million in cash.

For the Year Ended December 31, 2007

On May 1, 2007, Select completed the acquisition of substantially all of the outpatient rehabilitation division (the "Division") of HealthSouth Corporation. At the closing, Select acquired 540 outpatient rehabilitation clinics. The closing of the purchase of 29 additional outpatient rehabilitation clinics that was deferred pending certain state regulatory approvals was completed as of October 31, 2007 and resulted in the release of an additional $23.4 million of the purchase price. The aggregate purchase price of $245.0 million was reduced by approximately $7.0 million at closing for assumed indebtedness and other matters. The amount of the consideration was derived through arm's length negotiations. Select funded the acquisition through borrowings under its senior secured credit facility and cash on hand.

The results of operations of the Division have been included in the Company's consolidated financial statements since May 1, 2007. The Company has included the operations of the Division in its outpatient rehabilitation segment.

The purchase price was allocated to tangible and identifiable intangible assets and liabilities based upon estimates of fair value, with the remainder allocated to goodwill. In accordance with the provisions of SFAS No. 142, no amortization of goodwill has been recorded.

The purchase price allocation is as follows (in thousands):

Cash paid, net of cash acquired	$236,899
Fair value of net tangible assets acquired:	
Accounts receivable	35,743
Other current assets	12,596
Property and equipment	39,347
Other assets	808
Current liabilities	(14,104)
Long-term debt	(2,381)
Net tangible assets acquired	72,009
Non-compete, 5-year	5,100
Restructuring reserve	(18,700)
Goodwill	178,490
	$236,899

The Company also acquired an interest in a rehabilitation hospital and purchased the assets of two outpatient rehabilitation clinics. Consideration for these transactions totaled approximately $0.1 million in cash.

Information with respect to all businesses acquired in purchase transactions is as follows:

	Predecessor	**Successor**		
	Period from January 1 through February 24, 2005	**Period from February 25, through December 31, 2005**	**For the Year Ended December 31, 2006**	**For the Year Ended December 31, 2007**
		(in thousands)		
Cash paid (net of cash acquired)	$108,279	$3,276	$3,261	$236,980
Notes issued	--	60	--	--
	108,279	3,336	3,261	236,980
Liabilities assumed	19,924	148	--	36,458
	128,203	3,484	3,261	273,438
Fair value of assets acquired, principally accounts receivable and property and equipment	41,295	165	--	88,625
Non-compete agreement	2,000	--	--	5,100
Trademark	--	--	--	800
Minority interest relieved	--	666	1,581	--
Cost in excess of fair value of net assets acquired (goodwill)	$84,908	$2,653	$1,680	$178,913

The following pro forma unaudited results of operations have been prepared assuming the acquisition of the Division occurred at the beginning of the periods presented. The acquisitions of the other businesses acquired are not reflected in this pro forma as their impact is not material. These results are not necessarily indicative of results of future operations nor of the results that would have actually occurred had the acquisition been consummated as of the beginning of the period presented. Unaudited pro forma net revenue and net income for the years ended December 31, 2006 and 2007 for Select and Holdings as if the acquisition occurred as of January 1, 2006 and January 1, 2007 are as follows:

	(unaudited) For the Year Ended December 31,	
	2006	**2007**
	(in thousands)	
Net revenue	$2,162,162	$2,092,114
Net income:		
Select Medical Corporation	123,998	55,757
Select Medical Holdings Corporation	100,657	36,046

3. Discontinued Operations and Assets and Liabilities Held For Sale

On December 23, 2005, the Company agreed to sell all of the issued and outstanding shares of its wholly-owned subsidiary, CBIL, for approximately C$89.8 million (US$79.0 million). The sale was completed on March 1, 2006. CBIL operated 109 outpatient rehabilitation clinics in seven Canadian provinces. The Company operated all of its Canadian activity through CBIL. CBIL's operating results have been classified as discontinued operations and cash flows have been included with continuing operations for the period from January 1, 2005 through February 24, 2005 (Predecessor), for the period from February 25, 2005 through December 31, 2005 (Successor) and the year ended December 31, 2006. Previously, the operating results of this subsidiary were included in the Company's outpatient rehabilitation segment.

Summarized income statement information relating to discontinued operations of CBIL is as follows:

	Predecessor	Successor	
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	For the Year Ended December 31, 2006
		(in thousands)	
Net revenue	$10,051	$60,161	$12,902
Income from discontinued operations before income tax expense (1)	950	8,130	15,547
Income tax expense (2)	428	5,058	3,069
Income from discontinued operations, net of tax	$ 522	$ 3,072	$ 12,478

(1) Income from discontinued operations before income tax expense for the twelve months ended December 31, 2006 includes a gain on sale of approximately $14.0 million.

(2) The period from February 25 through December 31, 2005 (Successor) includes income tax of $1.4 million related to undistributed earnings of the Company's foreign subsidiary that were previously permanently reinvested.

In December 2006, the Company sold a group of legal entities that operated outpatient rehabilitation clinics. The Company recorded a note receivable in the amount of $8.4 million related to this sale. These legal entities were sold at an amount that approximated their carrying value. These legal entities were originally acquired as part of the Company's acquisition of the NovaCare Physical Rehabilitation and Occupational Health Group in 1999.

At December 31, 2006, the asset held for sale relates to a building that the Company acquired in connection with its acquisition of Kessler Rehabilitation Corporation in 2003. The building was sold in June 2007 for approximately $4.5 million and a loss on the sale of $0.5 million was recognized. Also during the year ended December 31, 2007, the Company sold land for approximately $1.9 million. No gain or loss was recognized on this sale. At December 31, 2007, the assets held for sale totaling $14.6 million relate to three properties the Company expects to sell with in the next year. The Company adjusted the carrying values of these properties to fair market value by recording an impairment loss of $2.7 million during the year ended December 31, 2007.

During the year ended December 31, 2007, the Company sold its interest in four business units for aggregate consideration of $12.2 million. The Company received cash of $9.6 million and recorded notes receivable of $2.6 million related to these transactions.

4. Property and Equipment

Property and equipment consists of the following:

	December 31, 2006	December 31, 2007
	(in thousands)	
Land	$ 24,263	$ 40,582
Leasehold improvements	56,777	72,010
Buildings	106,126	171,736
Furniture and equipment	116,881	175,964
Construction-in-progress	100,478	104,862
	404,525	565,154
Less: accumulated depreciation and amortization	48,189	78,128
Total property and equipment	$ 356,336	$ 487,026

Depreciation expense was $5.3 million for the period from January 1, 2005 through February 24, 2005 (Predecessor), $30.4 million for the period from February 25, 2005 through December 31, 2005 (Successor), $38.7 million for the year ended December 31, 2006, and $48.6 million for the year ended December 31, 2007.

5. Intangible Assets

Goodwill and certain other indefinite-lived intangible assets are no longer amortized, but instead are subject to periodic impairment evaluations under SFAS No. 142, “Goodwill and Other Intangible Assets.” The Company’s most recent impairment assessment was completed during the fourth quarter of 2007, which indicated that there was no impairment with respect to goodwill or other recorded intangible assets. The majority of the Company’s goodwill resides in its specialty hospital reporting unit. In performing periodic impairment tests, the fair value of the reporting unit is compared to the carrying value, including goodwill and other intangible assets. If the carrying value exceeds the fair value, an impairment condition exists, which results in an impairment loss equal to the excess carrying value. Impairment tests are required to be conducted at least annually, or when events or conditions occur that might suggest a possible impairment. These events or conditions include, but are not limited to, a significant adverse change in the business environment, regulatory environment or legal factors; a current period operating or cash flow loss combined with a history of such losses or a projection of continuing losses; or a sale or disposition of a significant portion of a reporting unit. The occurrence of one of these events or conditions could significantly impact an impairment assessment, necessitating an impairment charge. For purposes of goodwill impairment assessment, the Company has defined its reporting units as specialty hospitals, outpatient rehabilitation clinics and contract therapy with goodwill having been allocated among reporting units based on the relative fair value of those divisions when the Merger occurred in 2005 and based on subsequent acquisitions.

To determine the fair value of its reporting units, the Company used a discounted cash flow approach. Included in this analysis are assumptions regarding revenue growth rates, internal development of specialty hospitals and outpatient rehabilitation clinics, future EBITDA margin estimates, future selling, general and administrative expense rates and the industry's weighted average cost of capital. The Company also must estimate residual values at the end of the forecast period and future capital expenditure requirements. Each of these assumptions requires the Company to use its knowledge of (1) its industry, (2) its recent transactions, and (3) reasonable performance expectations for its operations. If any one of the above assumptions changes or fails to materialize, the resulting decline in the Company's estimated fair value could result in a material impairment charge to the goodwill associated with any one of the reporting units.

Intangible assets consist of the following:

	As of December 31, 2006	
	Gross Carrying Amount	**Accumulated Amortization**
	(in thousands)	
Amortized intangible assets		
Contract therapy relationships	$ 20,456	$ (7,501)
Non-compete agreements	20,809	(6,819)
Total	$ 41,265	$ (14,320)
Indefinite-lived intangible assets		
Goodwill	$1,323,572	
Trademarks	47,058	
Certificates of need	3,523	
Accreditations	1,704	
Total	$ 1,375,857	

	As of December 31, 2007	
	Gross Carrying Amount	Accumulated Amortization
	(in thousands)	
Amortized intangible assets		
Contract therapy relationships	$ 20,456	$ (11,592)
Non-compete agreements	25,909	(11,219)
Total	$ 46,365	$ (22,811)
Indefinite-lived intangible assets		
Goodwill	$1,499,485	
Trademarks	47,858	
Certificates of need	6,421	
Accreditations	1,339	
Total	$ 1,555,103	

Amortization expense for intangible assets with finite lives follows:

	Predecessor	Successor		
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	For the Year Ended December 31, 2006	For the Year Ended December 31, 2007
		(in thousands)		
Amortization expense	$576	$6,509	$7,811	$8,491

Amortization expense for the Company's intangible assets primarily relates to the amortization of the value associated with the non-compete agreements entered into in connection with the acquisitions of the Division, Kessler Rehabilitation Corporation and SemperCare Inc. and the value assigned to the Company's contract therapy relationships. The useful lives of the Division's non-compete, Kessler non-compete, SemperCare non-compete and the Company's contract therapy relationships are approximately five, six, seven and five years, respectively. Amortization expense related to these intangible assets for each of the next five years commencing January 1, 2008 is approximately as follows (in thousands):

Year	Amount
2008	$8,831
2009	8,831
2010	4,247
2011	1,306
2012	339

The changes in the carrying amount of goodwill for the Company's reportable segments for the years ended December 31, 2006 and 2007 are as follows:

	Specialty Hospitals	Outpatient Rehabilitation	Total
		(in thousands)	
Balance as of January 1, 2006	$1,221,776	$ 83,434	$ 1,305,210
Tax adjustments related to Merger (1)	5,359	10,800	16,159
Goodwill acquired during year	398	1,282	1,680
Earnout payments	-	100	100
Other	-	423	423
Balance as of December 31, 2006	1,227,533	96,039	1,323,572
Goodwill acquired during year	423	178,490	178,913
Goodwill related to sale of business	-	(3,000)	(3,000)
Balance as of December 31, 2007	$1,227,956	$271,529	$1,499,485

(1) In conjunction with recording the gain on sale of CBIL (Note 3), the Company determined that deferred taxes should have been recorded as of the date of the Merger related to differences between the Company's book and tax investment basis in CBIL. Also during 2006, the Company determined that additional deferred taxes should have been recorded as of the date of the Merger related to a step-up in fair value of a fixed asset and a difference in timing related to the deductibility of an accrued expense. These adjustments are not considered to be material on a qualitative or quantitative basis.

6. Restructuring Reserves

In 2003, the Company recorded a restructuring reserve in connection with the acquisition of Kessler Rehabilitation Corporation which was accounted for as additional purchase price. The remaining amount of this reserve was $0.2 million at both December 31, 2006 and 2007 and related to lease termination costs.

In connection with the acquisition of the Division (Note 2), the Company recorded an estimated liability of $18.7 million in 2007 for business restructuring which was accounted for as additional purchase price. This reserve primarily included costs associated with workforce reductions and lease termination costs in accordance with the Company's restructuring plan.

The following summarizes the Company's restructuring activity:

	Lease Termination Costs	Severance	Other	Total
		(in thousands)		
January 1, 2005 – Predecessor	$3,225	$1,699	--	$4,924
Amounts paid during the period from January 1 through February 24, 2005	(197)	(392)	--	(589)
February 24, 2005 – Predecessor	3,028	1,307	--	4,335
Amounts paid during the period from February 25 through December 31, 2005	(2,638)	(1,307)	--	(3,945)
December 31, 2005 – Successor	390	--	--	390
Amounts paid in 2006	(165)	--	--	(165)
December 31, 2006 – Successor	225	--	--	225
2007 acquisition restructuring reserve	12,063	5,775	$862	18,700
Amounts paid in 2007	(1,611)	(1,830)	--	(3,441)
December 31, 2007 – Successor	$10,677	$3,945	$862	$15,484

The Company expects to pay out the remaining lease termination costs through 2017 and severance costs through 2008.

7. Long-Term Debt and Notes Payable

The components of long-term debt and notes payable are shown in the following tables:

	Holdings	
	December 31,	
	2006	2007
	(in thousands)	
7 ⅝ % senior subordinated notes	$ 660,000	$ 660,000
Senior secured credit facility	569,850	783,300
10% senior subordinated notes	132,785	134,110
Senior floating rate notes	175,000	175,000
Seller notes	413	633
Other	455	2,592
Total debt	1,538,503	1,755,635
Less: current maturities	6,209	7,749
Total long-term debt	$1,532,294	$1,747,886

	Select	
	December 31,	
	2006	2007
	(in thousands)	
7 ⅝ % senior subordinated notes	$ 660,000	$ 660,000
Senior secured credit facility	569,850	783,300
Seller notes	413	633
Other	455	2,592
Total debt	1,230,718	1,446,525
Less: current maturities	6,209	7,749
Total long-term debt	$1,224,509	$1,438,776

Senior Secured Credit Facility

On March 19, 2007, Select entered into an Amendment No. 2 and Waiver to its senior secured credit facility (“Amendment No. 2”), and on March 28, 2007, Select entered into an Incremental Facility Amendment with a group of lenders and JPMorgan Chase Bank, N.A. as administrative agent. Amendment No. 2 increased the general exception to the prohibition on asset sales under Select’s senior secured credit facility from $100.0 million to $200.0 million, relaxed certain financial covenants starting March 31, 2007 and waived Select’s requirement to prepay certain term loan borrowings following its fiscal year ended December 31, 2006. The Incremental Facility Amendment provided to Select an incremental term loan of $100.0 million, the proceeds of which was used to pay a portion of the purchase price for the HealthSouth transaction.

After giving effect to the Incremental Facility Amendment, Select’s senior secured credit facility provides for senior secured financing of up to $980.0 million, consisting of:

- a $300.0 million revolving loan facility that will terminate on February 24, 2011, including both a letter of credit sub-facility and a swingline loan sub-facility, and

- a $680.0 million term loan facility that matures on February 24, 2012.

The interest rates per annum applicable to loans, other than swingline loans, under Select's senior secured credit facility are, at its option, equal to either an alternate base rate or an adjusted LIBOR rate for a one, two, three or six month interest period, or a nine or twelve month period if available, in each case, plus an applicable margin percentage. The alternate base rate is the greater of (1) JPMorgan Chase Bank, N.A.'s prime rate and (2) one-half of 1% over the weighted average of rates on overnight Federal funds as published by the Federal Reserve Bank of New York. The adjusted LIBOR rate is determined by reference to settlement rates established for deposits in dollars in the London interbank market for a period equal to the interest period of the loan and the maximum reserve percentages established by the Board of Governors of the United States Federal Reserve to which Select's lenders are subject. The applicable margin percentage for borrowings under Select's revolving loans is subject to change based upon the ratio of Select's total indebtedness to Select's consolidated EBITDA (as defined in the credit agreement). The applicable margin percentage for revolving loans is currently (1) 1.50% for alternate base rate loans and (2) 2.50% for adjusted LIBOR loans. The applicable margin percentages for the term loans are (1) 1.00% for alternate base rate loans and (2) 2.00% for adjusted LIBOR loans. The average interest rate for the year ended December 31, 2007 was 6.9%.

On the last business day of each calendar quarter Select is required to pay a commitment fee in respect of any unused commitment under the revolving credit facility. The annual commitment fee is currently 0.50% and is subject to adjustment based upon the ratio of Select's total indebtedness to its consolidated EBITDA (as defined in the credit agreement). Availability under the revolving credit facility at December 31, 2007 was approximately $150.3 million. Select is authorized to issue up to $50.0 million in letters of credit. Letters of credit reduce the capacity under the revolving credit facility and bear interest at applicable margins based on financial ratio tests. Approximately $29.7 million in letters of credit were outstanding at December 31, 2007.

The senior secured credit facility requires scheduled quarterly payments on the term loans each equal to $1.7 million per quarter through December 31, 2010, with the balance of the term loans paid in four equal quarterly installments thereafter.

The senior secured credit facility requires Select to comply on a quarterly basis with certain financial covenants, including an interest coverage ratio test and a maximum leverage ratio test, which financial covenants will become more restrictive over time except as modified by Amendment No. 2. In addition, the senior secured credit facility includes various negative covenants, including with respect to indebtedness, liens, investments, permitted businesses and transactions and other matters, as well as certain customary representations and warranties, affirmative covenants and events of default including payment defaults, breach of representations and warranties, covenant defaults, cross defaults to certain indebtedness, certain events of bankruptcy, certain events under ERISA, material judgments, actual or asserted failure of any guaranty or security document supporting the senior secured credit facility to be in full force and effect and change of control. If such an event of default occurs, the lenders under the senior secured credit facility are entitled to take various actions, including the acceleration of amounts due under the senior secured credit facility and all actions permitted to be taken by a secured creditor. As of December 31, 2007, Select is in compliance with all debt covenants related to the senior secured credit facility.

Select's senior secured credit facility is guaranteed by Holdings and substantially all of Select's current subsidiaries and will be guaranteed by substantially all of Select's future subsidiaries and secured by substantially all of its existing and future property and assets and by a pledge of its capital stock and the capital stock of its subsidiaries.

Senior Subordinated Notes

On February 24, 2005, EGL Acquisition Corp. sold $660.0 million of 7 ⅝ % Senior Subordinated Notes (the "Notes") due 2015 which Select assumed in the Merger. The net proceeds of the offering were used to finance a portion of the Merger consideration as discussed in Note 1, refinance certain of Select's existing indebtedness, and pay related fees and expenses. The Notes are unconditionally guaranteed on a senior subordinated basis by all of Select's wholly-owned subsidiaries (the "Subsidiary Guarantors"). Certain of Select's subsidiaries that were not wholly-owned by Select did not guarantee the Notes (the "Non-Guarantor Subsidiaries"). The guarantees of the Notes are subordinated in right of payment to all existing and future senior indebtedness of the Subsidiary Guarantors, including any borrowings or guarantees by those subsidiaries under the senior secured credit facility. The Notes rank equally in right of payment with all of Select's existing and future senior subordinated indebtedness and senior to all of Select's existing and future subordinated indebtedness. The notes were not guaranteed by Holdings.

Prior to February 1, 2010, Select may redeem all or a portion of the Notes at a price equal to 100% of the principal amount plus accrued and unpaid interest to the redemption date and a "make whole" premium. Thereafter, Select will be entitled at its option to redeem all or a portion of the Notes at the following redemption prices (expressed in percentages of principal amount on the redemption date), plus accrued interest to the redemption date, if redeemed during the 12-month period commencing on February 1st of the years set forth below:

Year	Redemption Price
2010	103.813%
2011	102.542%
2012	101.271%
2013 and thereafter	100.000%

Select is not required to make any mandatory redemption or sinking fund payments with respect to the Notes. However, upon the occurrence of any change of control of Select, each holder of the Notes shall have the right to require Select to repurchase such holder's notes at a purchase price in cash equal to 101% of the principal amount thereof on the date of purchase plus accrued and unpaid interest, if any, to the date of purchase.

The indenture governing the Notes contains customary events of default and affirmative and negative covenants that, among other things, limit Select's ability and the ability of its restricted subsidiaries to incur or guarantee additional indebtedness, pay dividends or make other equity distributions, purchase or redeem capital stock, make certain investments, enter into arrangements that restrict dividends from subsidiaries, transfer and sell assets, engage in certain transactions with affiliates and effect a consolidation or merger. As of December 31, 2007, Select is in compliance with all debt covenants related to the senior subordinated notes.

Senior Floating Rate Notes

On September 29, 2005, Holdings, whose primary asset is its investment in Select, issued $175.0 million of Senior Floating Rate Notes, due 2015 (the "Holdings Notes"). The Holdings Notes are senior unsecured obligations of Holdings and bear interest at a floating rate, reset semi-annually, equal to 6-month LIBOR plus 5.75%. Simultaneously with the financing, the Company entered into an interest rate swap arrangement, effectively fixing the interest rate of the notes. The Holdings Notes are not guaranteed by Select or any of its subsidiaries.

Payment of interest expense on the Holdings Notes is expected to be funded through periodic dividends from Select. The terms of Select's existing senior secured credit facility, as well as the indenture governing the 7⅝ % Senior Subordinated Notes, and certain other agreements, restrict Select and certain of its subsidiaries from making payments or transferring assets to Holdings, including dividends, loans or other distributions. Such restrictions include prohibition of dividends in an event of default and limitations on the total amount of dividends paid to Holdings. In the event these agreements do not permit such subsidiaries to provide Holdings with sufficient distributions to fund interest and principal payments on the Holdings Notes when due, Holdings may default on its notes unless other sources of funding are available.

Proceeds from the offering were used to pay a special dividend of $175.0 million to stockholders of Holdings in September 2005. The payment of the special dividend triggered a payment obligation of $14.5 million under Holdings' long-term incentive compensation plan, which was paid in September 2005 (Note 9).

Prior to September 15, 2009, Holdings may redeem all or a portion of the Holdings Notes at a price equal to 100% of the principal amount plus accrued and unpaid interest to the redemption date and a "make-whole" premium. Thereafter, Holdings may redeem some or all of the Holdings Notes at the redemption prices set forth below:

Year	Redemption Price
2009	102.00%
2010	101.00%
2011	100.00%

Prior to September 15, 2008, Holdings may redeem either all of the outstanding Holdings Notes or up to 35% of the aggregate principal amount of the Holdings Notes with the proceeds of one or more equity offerings at a redemption price equal to par plus the coupon on the Holdings Notes at the time notice of redemption is given.

Holdings is not required to make any mandatory redemption or sinking fund payments with respect to the Holdings Notes. However, upon the occurrence of any change of control of Holdings, each holder of the Holdings Notes shall have the right to require Holdings to repurchase such notes at a purchase price in cash equal to 101% of the principal amount thereof on the date of purchase plus accrued and unpaid interest, if any, to the date of purchase.

The indenture governing the Holdings Notes contains customary events of default and affirmative and negative covenants that, among other things, limit Holdings' ability and the ability of its restricted subsidiaries, including Select, to: incur additional indebtedness and issue or sell preferred stock; pay dividends on, redeem or repurchase capital stock; make certain investments; create certain liens; sell certain assets; incur obligations that restrict the ability of its subsidiaries to make dividends or other payments; guarantee indebtedness; engage in transactions with affiliates; create or designate unrestricted subsidiaries; and consolidate, merge or transfer all or substantially all of its assets and the assets of its subsidiaries on a consolidated basis. As of December 31, 2007, Holdings is in compliance with all debt covenants related to the senior floating rate notes.

10% Senior Subordinated Notes

On February 24, 2005, Holdings issued 10% senior subordinated notes to WCAS Capital Partners IV, L.P., an investment fund affiliated with Welsh Carson, Rocco A. Ortenzio, Robert A. Ortenzio and certain other investors who are members of or affiliated with the Ortenzio family, for an aggregate purchase price of $150.0 million. The senior subordinated notes had preferred and common shares attached which were recorded at the estimated fair market value on the date of issuance. These shares were recorded as a discount to the senior subordinated notes and are amortized using the interest method.

Maturities of the Company’s long-term debt for the years after 2007 are approximately as follows:

	Select Medical Holdings Corporation	Select Medical Corporation
	(in thousands)	
2008	$ 7,749	$ 7,749
2009	8,897	8,897
2010	6,912	6,912
2011	602,242	602,242
2012	160,725	160,725
2013 and beyond	969,110	660,000

8. Stockholders’ Equity

Preferred Stock

Holdings is authorized to issue 25,000,000 shares of participating preferred stock and had 22,163,769.18 shares and 22,163,323.08 shares outstanding at December 31, 2006 and 2007, respectively. Holdings repurchased 1,487 shares of participating preferred stock during the year ended December 31, 2006, and 446 shares of participating preferred stock during the year ended December 31, 2007. The participating preferred stock accrues dividends at an annual dividend rate of 5%, compounded quarterly on March 31, June 30, September 30 and December 31 of each year. Dividends earned during the year ended December 31, 2006 and the year ended December 31, 2007 amounted to $22.7 million and $23.8 million, respectively and were charged against retained earnings. Each share of participating preferred stock is entitled to one vote on all matters submitted to stockholders of Holdings. The participating preferred stock ranks senior to the common stock with respect to dividend rights and rights upon liquidation. The liquidation preference is equal to the original cost of a share of the preferred stock ($26.90 per share) plus all accrued and unpaid dividends thereon less the amount of any previously declared and paid special dividends.

In connection with Holdings' issuance of the Holdings Notes, Holdings paid in September 2005 a special dividend of $175.0 million, which included $17.9 million of accreted dividends, on the preferred stock (Note 7).

Upon the redemption of the participating preferred stock occurring due to a change of control or the conversion and redemption of the participating preferred stock occurring due to a sale of common stock of Holdings through a public offering, each holder of participating preferred stock will receive cash equal to the original cost of a share of the preferred stock ($26.90 per share) plus all accrued and unpaid dividends thereon less the amount of any previously declared and paid special dividends and a number of shares of common stock equal to the number of participating preferred shares owned.

Common Stock

As part of the Merger, common stock of the Predecessor was retired. Holdings is authorized to issue 250,000,000 shares of $0.001 par value common stock. During the year ended December 31, 2006, Holdings repurchased 24,384 shares of common stock, rescinded 679,990 shares of common stock that were related to a restricted stock grant and issued 200,000 shares of common stock that were related to restricted stock grants. During the year ended December 31, 2007, Holdings repurchased 3,000 shares of common stock and issued 265,106 shares of common stock of which 200,000 were restricted stock issuances.

Holdings owns all of the issued and outstanding shares of Select's common stock.

9. Long-Term Incentive Compensation

On June 2, 2005, Holdings adopted a Long-Term Cash Incentive Plan ("cash plan"). The total number of units available under the cash plan for awards may not exceed 100,000. If any awards are terminated, forfeited or cancelled, units granted under such awards are available for award again under the cash plan. The purposes of the cash plan are to attract and retain key employees, motivate participating key employees to achieve the long-range goals of the Company, provide competitive incentive compensation opportunities and further align the interests of participating key employees with Holdings' stockholders.

Payment of cash benefits is based upon (i) the value of the Company upon a change of control of Holdings or upon a qualified initial public offering of Holdings or (ii) a redemption of Holdings' preferred stock or special dividends paid on Holdings' preferred stock. Until the occurrence of an event that would trigger the payment of cash on any outstanding units is deemed probable by the Company, no expense for any award is reflected in the Company's financial statements.

As a result of the special dividend of $175.0 million paid to Holdings' preferred stockholders on September 29, 2005, certain provisions of the Holdings' long-term incentive compensation plan were met and resulted in a payment of $14.5 million to certain members of senior management of the Company. The expense of $14.5 million in long-term compensation was included in general and administrative expense in the period from February 25, 2005 through December 31, 2005 (Successor).

10. Stock Option and Restricted Stock Plans

Predecessor Stock Option Plans

All stock options related to the Predecessor stock incentive plans (Select Medical Corporation Second Amended and Restated 1997 Stock Option Plan and the 2002 Non-Employee Directors' Plan) were canceled in connection with the Merger. Stock option holders received as consideration a cash payment equal to (i) $18.00 minus the exercise price of the option multiplied by (ii) the number of unexercised shares subject to the option (whether vested or not). Select paid a total of $142.2 million in cash to stock option holders to cancel these options. Of this amount $115.0 million was paid to individuals that are classified as general and administrative positions and $27.2 million to individuals classified as cost of services positions.

Successor Stock Option and Restricted Stock Plans

The Company adopted SFAS No. 123R, "Share-Based Payment"in the Successor period beginning on February 25, 2005. Holdings adopted the Select Medical Holdings Corporation 2005 Equity Incentive Plan (the "Plan"). The equity incentive plan provides for grants of restricted stock and stock options of Holdings. In addition, on August 10, 2005 the Board of Directors of Holdings authorized a director stock option plan ("Director Plan") for non-employee directors. On November 8, 2005 the Board of Directors of Holdings formally approved the previously authorized stock option plan for non-employee directors, under which Holdings can issue options to purchase up to 250,000 shares of Holdings' common stock.

The options generally vest over five years and have an option term not to exceed ten years. The fair value of the options granted was estimated using the Black-Scholes option pricing model assuming an expected volatility of 28%, no dividend yield, an expected life of five years and a risk free rate of 4.8% in 2006 and expected volatility of 34%, no dividend yield, an expected life of five years and a risk free rate of 4.5% in 2007.

Holdings granted 200,000 shares of common stock of Holdings as restricted stock awards during both the years ended December 31, 2006 and December 31, 2007. In addition, during the year ended December 31, 2006, Holdings cancelled 679,990 shares of common stock related to restricted stock awards. These awards range in value from $0.08 to $0.50 per share and generally vest over five years with a term not to exceed ten years. The fair value of the restricted stock awards were determined by using the price exchanged for common stock of Holdings that occurred in close proximity to the issuance of restricted stock awards and then applying an estimated discount for the lack of control and lack of marketability attributes of the restricted stock. Both the discount for lack of control and the discount for lack of marketability were estimated by using two methodologies to yield a range of results. The estimated range of discount for lack of control is 10% to 20% and the range of discount for lack of marketability is 35% to 40%. Stock compensation expense for each of the next five years, based on restricted stock awards granted as of December 31, 2007, is estimated to be as follows:

	2008	**2009**	**2010**	**2011**	**2012**
	(in thousands)				
Stock compensation expense	$2,101	$1,097	$183	$3	$0

Stock option transactions and other information related to the Plan are as follows:

	Price Per Share	**Shares**	**Weighted Average Exercise Price**
	(in thousands, except per share amounts)		
Balance, January 1, 2006	$ 1.00	1,984	$ 1.00
Granted	1.00-2.50	1,913	2.42
Canceled	1.00-2.50	(124)	1.22
Balance, December 31, 2006	1.00-2.50	3,773	1.71
Granted	2.50	1,219	2.50
Exercised	1.00-2.50	(65)	1.02
Canceled	1.00-2.50	(371)	2.01
Balance, December 31, 2007	$ 1.00-2.50	4,556	$ 1.91

Additional information with respect to the outstanding options as of December 31, 2007 for the Plan is as follows:

Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life	Number Exercisable
	(in thousands, except per share amounts)		
$ 1.00	1,794	7.14	707
2.50	2,762	8.60	371

Transactions and other information related to the Director's Plan are as follows:

	Price Per Share	Shares	Weighted Average Exercise Price
	(in thousands, except per share amounts)		
Balance, January 1, 2006	$ 1.00	60	$ 1.00
Granted	2.50	30	2.50
Balance, December 31, 2006	1.00-2.50	90	1.50
Granted	2.50	30	2.50
Balance, December 31, 2007	$1.00-2.50	120	$1.75

Additional information with respect to the outstanding options as of December 31, 2007 for the Director's Plan is as follows:

Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life	Number Exercisable
	(in thousands, except per share amounts)		
$ 1.00	60	7.61	24
2.50	60	9.24	6

The Company recognized the following stock compensation expense related to restricted stock and stock option awards:

	Predecessor	Successor		
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	For the Year Ended December 31, 2006	For the Year Ended December 31, 2007
	(in thousands)			
Stock compensation expense:				
Included in general and administrative	$115,025	$10,134	$3,551	$3,555
Included in cost of services	27,188	178	231	191
Total	$142,213	$10,312	$3,782	$3,746

11. Income Taxes

Significant components of the Company's tax provision from continuing operations for the period from January 1 through February 24, 2005 (Predecessor), the period from February 25 through December 31, 2005 (Successor), the years ended December 31, 2006 and 2007 are as follows:

	Holdings			
	Predecessor	Successor		
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	For the Year Ended December 31, 2006	For the Year Ended December 31, 2007
	(in thousands)			
Current:				
Federal	$3,632	$26,585	$24,706	$11,004
State and local	437	2,929	5,488	5,235
Total current	4,069	29,514	30,194	16,239
Deferred	(63,863)	19,822	13,327	2,460
Total income tax provision	$ (59,794)	$49,336	$ 43,521	$ 18,699

	Select			
	Predecessor	Successor		
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	For the Year Ended December 31, 2006	For the Year Ended December 31, 2007
	(in thousands)			
Current:				
Federal	$3,632	$26,585	$37,274	$21,620
State and local	437	2,929	5,488	5,235
Total current	4,069	29,514	42,762	26,855
Deferred	(63,863)	26,956	13,327	2,460
Total income tax provision	$ (59,794)	$56,470	$ 56,089	$ 29,315

The differences between the expected income tax provision from continuing operations and income taxes computed at the federal statutory rate of 35% were as follows:

	Holdings			
	Predecessor	Successor		
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	For the Year Ended December 31, 2006	For the Year Ended December 31, 2007
Expected federal tax rate	35.0%	35.0%	35.0%	35.0%
State and local taxes, net of federal benefit	4.6	5.7	3.0	0.7
Other permanent differences	-	3.4	0.9	1.5
Valuation allowance	(1.5)	(1.4)	2.7	3.8
Tax loss on sale of subsidiaries	-	-	(6.9)	(6.5)
Other	(0.9)	(1.1)	(0.1)	-
Total	37.2%	41.6%	34.6%	34.5%

	Select			
	Predecessor	Successor		
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	For the Year Ended December 31, 2006	For the Year Ended December 31, 2007
Expected federal tax rate	35.0%	35.0%	35.0%	35.0%
State and local taxes, net of federal benefit	4.6	4.8	2.3	0.3
Other permanent differences	-	2.9	0.7	1.0
Valuation allowance	(1.5)	(1.2)	2.2	2.4
Tax loss on sale of subsidiaries	-	-	(5.4)	(3.6)
Other	(0.9)	(0.9)	(0.1)	(0.4)
Total	37.2%	40.6%	34.7%	34.7%

A summary of deferred tax assets and liabilities is as follows:

	Holdings	
	December 31,	
	2006	2007
	(in thousands)	
Deferred tax assets – current		
Allowance for doubtful accounts	$14,555	$7,440
Compensation and benefit related accruals	18,743	26,746
Malpractice insurance	10,856	10,867
Restructuring reserve	90	6,216
Other accruals, net	2,769	2,899
Net deferred tax asset – current	47,013	54,168
Deferred tax assets (liabilities) – non-current		
Expenses not currently deductible for tax	101	101
Net operating loss carry forwards	20,886	24,693
Restricted stock	(2,918)	(1,426)
Interest rate swaps	(3,397)	3,708
Depreciation and amortization	(36,719)	(41,595)
Other	-	3,134
Net deferred tax liability – non-current	(22,047)	(11,385)
Net deferred tax asset before valuation allowance	24,966	42,783
Valuation allowance	(14,428)	(16,761)
	$10,538	$26,022

	Select	
	December 31,	
	2006	2007
	(in thousands)	
Deferred tax assets – current		
Allowance for doubtful accounts	$14,555	$7,440
Compensation and benefit related accruals	18,743	26,746
Malpractice insurance	10,856	10,867
Restructuring reserve	90	6,216
Other accruals, net	2,769	2,899
Net deferred tax asset – current	47,013	54,168
Deferred tax assets (liabilities) – non-current		
Expenses not currently deductible for tax	101	101
Net operating loss carry forwards	20,886	24,693
Restricted stock	(2,918)	(1,426)
Interest rate swaps	(2,043)	3,294
Depreciation and amortization	(36,719)	(41,595)
Other	-	3,134
Net deferred tax liability – non-current	(20,693)	(11,799)
Net deferred tax asset before valuation allowance	26,320	42,369
Valuation allowance	(14,428)	(16,761)
	$11,892	$25,608

The valuation allowance is primarily attributable to the uncertainty regarding the realization of state net operating losses and other net deferred tax assets of loss entities. The net deferred tax assets at December 31, 2007 of approximately $26.0 million and $25.6 million for Holdings and Select, respectively, consist of items which have been recognized for financial reporting purposes, but will reduce tax on returns to be filed in the future and include the use of net operating loss carryforwards. The Company has performed the required assessment of positive and negative evidence regarding the realization of the net deferred tax assets in accordance with SFAS No. 109, "Accounting for Income Taxes." This assessment included a review of legal entities with three years of cumulative losses, estimates of projected future taxable income and the impact of tax-planning strategies that management plans to implement. Although realization is not assured, based on the Company's assessment, it has concluded that it is more likely than not that such assets, net of the existing valuation allowance, will be realized.

Federal net operating loss carry forwards totaling $2.6 million will expire in 2021 and thereafter. As a result of the acquisition of Kessler Rehabilitation Corporation and SemperCare, Inc., the Company is subject to the provisions of Section 382 of the Internal Revenue Code which provide for annual limitations on the deductibility of acquired net operating losses and certain tax deductions. These limitations apply until the earlier of utilization or expiration of the net operating losses. Additionally, if certain substantial changes in the Company's ownership should occur, there would be an annual limitation on the amount of the carryforwards that can be utilized.

The total state net operating losses are approximately $470.0 million and $453.0 million for Holdings and Select, respectively, with various expirations.

Reserves for Uncertain Tax Positions:

The Company adopted FIN No. 48 on January 1, 2007. Upon adoption, the Company recognized a $6.0 million increase to reserves for uncertain tax positions and a $4.1 million increase to deferred tax assets with a net adjustment to the beginning balance of retained earnings of $1.9 million. Including the cumulative effect of the increases in reserves and deferred tax assets, at the beginning of 2007, the Company had approximately $18.3 million of unrecognized tax benefits.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of multiple state jurisdictions. The Company was subject to Canadian income tax prior to the disposition of its Canadian operations on March 1, 2006. Significant judgment is required in evaluating the Company's tax positions and determining its provision for income taxes. During the ordinary course of business, there are many transactions and calculations for which the ultimate tax determination is uncertain. The Company establishes reserves for tax-related uncertainties based on estimates of whether, and the extent to which, additional taxes will be due. These reserves are established when it is believed that certain positions might be challenged despite the Company's belief that its tax return positions are fully supportable. The Company adjusts these reserves in light of changing facts and circumstances, such as the outcome of a tax audit. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate. Accruals for uncertain tax positions are provided for in accordance with the requirements of FIN No. 48.

The reconciliation of the Company's unrecognized tax benefits is as follows (in thousands):

Gross tax contingencies – January 1, 2007	$ 21,305
Reductions for tax positions taken in prior periods	(2,249)
Additions for current period tax positions taken	2,357
Gross tax contingencies – December 31, 2007	$ 21,413

As of December 31, 2007, the Company had $21.4 million of unrecognized tax benefits of which $7.1 million, if fully recognized, would affect the Company's effective income tax rate. The remaining amount would not affect the effective income tax rate and would be accounted for as a reduction in goodwill if recognized.

As of December 31, 2007, changes to the Company's gross unrecognized tax benefits that are reasonably possible in the next 12 months are not material. The Company's policy is to include interest and penalties related to income taxes in income tax expense. As of December 31, 2007, the Company had accrued interest and penalties related to income taxes of $1.4 million, net of federal income tax benefits, on the balance sheet. Interest and penalties recognized for the year ended December 31, 2007 was $0.5 million net of federal income tax benefits.

The Company has substantially concluded all U.S. federal income tax matters for years through 2004. Substantially all material state, local and foreign income tax matters have been concluded for years through 2001. The federal income tax return for 2005 is currently under examination.

12. Retirement Savings Plan

The Company sponsors a defined contribution retirement savings plan for substantially all of its employees. Employees who are not classified as HCE's (highly compensated employees) may contribute up to 30% of their salary; HCE's may contribute up to 6% of their salary. The Company matches 50% of the first 6% of compensation employees contribute to the plan. The employees vest in the employer contributions over a three-year period beginning on the employee's hire date. The expense incurred by the Company related to this plan was $1.2 million for the period from January 1 through February 24, 2005 (Predecessor), $7.0 million for the period from February 25 through December 31, 2005 (Successor), $9.0 million during the year ended December 31, 2006, and $5.7 million during the year ended December 31, 2007.

13. Segment Information

SFAS No. 131, "Disclosure about Segments of an Enterprise and Related Information," establishes standards for reporting information about operating segments and related disclosures about products and services, geographic areas and major customers.

The Company's reportable segments consist of (i) specialty hospitals and (ii) outpatient rehabilitation. All other represents amounts associated with corporate activities and non-healthcare related services. The outpatient rehabilitation reportable segment has two operating segments: outpatient rehabilitation clinics and contract therapy. These operating segments are aggregated for reporting purposes as they have common economic characteristics and provide a similar service to a similar patient base. The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company evaluates performance of the segments based on Adjusted EBITDA. Adjusted EBITDA is defined as net income (loss) before interest, income taxes, stock compensation expense, long-term incentive compensation, depreciation and amortization, income from discontinued operations, loss on early retirement of debt, Merger related charges, other income (expense) and minority interest.

The following table summarizes selected financial data for the Company's reportable segments:

	Predecessor Period from January 1 through February 24, 2005			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	Total
	(in thousands)			
Net revenue	$ 202,781	$ 73,344	$ 1,611	$ 277,736
Adjusted EBITDA	44,384	9,848	(7,701)	46,531
Total assets	904,754	239,019	87,640	1,231,413
Capital expenditures	1,165	408	1,013	2,586

	Successor Period from February 25 through December 31, 2005			
	Specialty Hospitals	**Outpatient Rehabilitation**	**All Other**	**Total**
	(in thousands)			
Net revenue	$1,169,702	$ 407,367	$ 3,637	$1,580,706
Adjusted EBITDA	263,760	56,109	(36,466)	283,403
Total assets (1):				
Select Medical Corporation	1,656,224	293,720	213,425	2,163,369
Select Medical Holdings Corporation	1,656,224	293,720	218,441	2,168,385
Capital expenditures	101,158	3,342	2,860	107,360

	Successor Year Ended December 31, 2006			
	Specialty Hospitals	**Outpatient Rehabilitation**	**All Other**	**Total**
	(in thousands)			
Net revenue	$1,378,543	$ 470,339	$2,616	$ 1,851,498
Adjusted EBITDA	283,270	64,823	(39,769)	308,324
Total assets:				
Select Medical Corporation	1,742,803	258,773	176,066	2,177,642
Select Medical Holdings Corporation	1,742,803	258,773	180,948	2,182,524
Capital expenditures	146,291	6,527	2,278	155,096

	Successor Year Ended December 31, 2007			
	Specialty Hospitals	**Outpatient Rehabilitation**	**All Other**	**Total**
	(in thousands)			
Net revenue	$1,386,410	$603,413	$1,843	$1,991,666
Adjusted EBITDA	217,175	75,437	(37,684)	254,928
Total assets (2):				
Select Medical Corporation	1,882,476	513,397	94,904	2,490,777
Select Medical Holdings Corporation	1,882,476	513,397	99,173	2,495,046
Capital expenditures	146,901	14,737	4,436	166,074

(1) The Outpatient Rehabilitation segment includes $75.3 million in assets held for sale related to the sale of CBIL (Note 3).
(2) The Specialty Hospital segment includes $14.6 million in real estate assets held for sale (Note 3).

A reconciliation of Adjusted EBITDA to income (loss) from continuing operations before income taxes is as follows:

	Predecessor Period from January 1 through February 24, 2005			
	Specialty Hospitals	Outpatient Rehabilitation	All Other	Select Medical Corporation
	(in thousands)			
Adjusted EBITDA	$ 44,384	$ 9,848	$ (7,701)	
Depreciation and amortization	3,934	1,460	539	
Stock compensation expense	-	-	142,213	
Income (loss) from operations	$ 40,450	$ 8,388	$(150,453)	$ (101,615)
Loss on early retirement of debt				(42,736)
Merger related charges				(12,025)
Other income				267
Interest expense, net				(4,128)
Minority interest				(330)
Loss from continuing operations before income taxes				$ (160,567)

	Successor Period from February 25 through December 31, 2005				
	Specialty Hospitals	Outpatient Rehabilitation	All Other	Select Medical Holdings Corporation	Select Medical Corporation
	(in thousands)				
Adjusted EBITDA	$ 263,760	$ 56,109	$ (36,466)		
Depreciation and amortization	23,421	8,445	6,056		
Stock compensation expense	-	-	10,312		
Long-term incentive compensation (1)	-	-	14,453		
Income (loss) from operations	$ 240,339	$ 47,664	$ (67,287)	$ 220,716	$ 220,716
Other income				1,092	3,018
Interest expense, net				(101,441)	(82,985)
Minority interest				(1,776)	(1,776)
Income from continuing operations before income taxes				$ 118,591	$ 138,973

	Successor Year Ended December 31, 2006				
	Specialty Hospitals	Outpatient Rehabilitation	All Other		
	(in thousands)				
Adjusted EBITDA	$ 283,270	$ 64,823	$ (39,769)		
Depreciation and amortization	30,731	12,964	2,973		
Stock compensation expense	-	-	3,782		
				Select Medical Holdings Corporation	Select Medical Corporation
Income (loss) from operations	$ 252,539	$ 51,859	$ (46,524)	$ 257,874	$ 257,874
Other income				-	1,366
Interest expense, net				(130,538)	(95,995)
Minority interest				(1,414)	(1,414)
Income from continuing operations before income taxes				$ 125,922	$ 161,831

	Successor Year Ended December 31, 2007				
	Specialty Hospitals	Outpatient Rehabilitation	All Other		
	(in thousands)				
Adjusted EBITDA	$ 217,175	75,437	(37,684)		
Depreciation and amortization	37,085	17,458	2,754		
Stock compensation expense	-	-	3,746		
				Select Medical Holdings Corporation	Select Medical Corporation
Income (loss) from operations	$ 180,090	$ 57,979	$ (44,184)	$ 193,885	$ 193,885
Other expense				(167)	(4,494)
Interest expense, net				(138,052)	(103,394)
Minority interest				(1,537)	(1,537)
Income from continuing operations before income taxes				$ 54,129	$ 84,460

(1) Included in general and administrative expenses on the Company's consolidated statement of operations.

14. Fair Value of Financial Instruments

Financial instruments include cash and cash equivalents, notes payable and long-term debt. The carrying amount of cash and cash equivalents approximates fair value because of the short-term maturity of these instruments.

The Company is exposed to the impact of interest rate changes. The Company's objective is to manage the impact of the interest rate changes on earnings and cash flows. On June 13, 2005, Select entered into an interest rate swap agreement to hedge Select's interest rate risk for a portion of its term loans under its senior secured credit facility. The effective date of the swap transaction was August 22, 2005. The swap is designated as a cash flow hedge of forecasted LIBOR based variable rate interest payments. The notional amount of the interest rate swap is $200.0 million, and the underlying variable rate debt is associated with Select's senior secured credit facility. The variable interest rate of the debt was 7.0% and the fixed rate of the swap was 6.3% at December 31, 2007. The swap is for a period of five years, with quarterly resets on February 22, May 22, August 22 and November 22 of each year.

On September 19, 2005, Select entered into an additional interest rate swap agreement to hedge Holdings' interest rate risk for its senior floating rate notes. The effective date of the swap transaction was September 29, 2005. The swap is designated as a cash flow hedge of forecasted LIBOR based variable rate interest payments. The notional amount of the interest rate swap is $175.0 million, and the underlying variable rate debt is associated with Holdings' $175.0 million senior floating rate notes due 2015. The variable interest rate of the debt was 11.3% and the fixed rate of the swap was 10.2% at December 31, 2007. The swap is for a period of four years, with semi-annual resets on March 15 and September 15 of each year.

On March 8, 2007, Select entered into an additional interest rate swap agreement to hedge Select's interest rate risk for a portion of its term loans under its senior secured credit facility. The effective date of the swap transaction was May 22, 2007. The swap is designated as a cash flow hedge of forecasted LIBOR based variable rate interest payments. The notional amount of the interest rate swap is $200.0 million, and the underlying variable rate debt is associated with Select's senior secured credit facility. The variable interest rate of the debt was 7.0% and the fixed rate of the swap was 6.8% at December 31, 2007. The swap is for a period of three years, with quarterly resets on February 22, May 22, August 22 and November 22 of each year.

On November 16, 2007, Select entered into an additional interest rate swap agreement to hedge Select's interest rate risk for a portion of its term loans under its senior secured credit facility. The effective date of the swap transaction was November 23, 2007. The swap is designated as a cash flow hedge of forecasted LIBOR based variable rate interest payments. The notional amount of the interest rate swap is $100.0 million, and the underlying variable rate debt is associated with Select's senior secured credit facility. The variable interest rate of the debt was 7.0% and the fixed rate of the swap was 6.3% at December 31, 2007. The swap is for a period of three years, with quarterly resets on February 22, May 22, August 22 and November 22 of each year.

The interest rate swaps have been designated as hedges and qualify under the provision of SFAS No. 133 as effective hedges, except for the swap associated with the Holdings' $175.0 million senior floating rate notes due 2015 as it relates to Select's financial statements. This interest rate swap does not qualify under SFAS No. 133 as an effective hedge as the cash flow stream being hedged relates to the amount of dividend payments to Holdings necessary to fund interest payments on Holdings' $175.0 million senior floating rate notes. This resulted in a gain of $1.9 million, a gain of $1.4 million and a loss of $4.3 million being recognized in the other income (loss) section of Select's consolidated statement of operations for the period of February 25 through December 31, 2005 (Successor), and the years ended December 31, 2006 and 2007, respectively. On the consolidated statements of Holdings, this interest rate swap qualifies as an effective hedge.

The interest rate swaps are reflected at fair value in the consolidated balance sheet and the related gain of $1.4 million, net of tax, and the loss of $10.5 million, net of tax, was recorded in Holdings' stockholders' equity as a component of other comprehensive income (loss) for the years ended December 31, 2006 and 2007, respectively. Select recorded a gain of $0.5 million, net of tax, and a loss of $7.9 million, net of tax, for the years ended December 31, 2006 and 2007, respectively, related to the swaps in stockholder's equity as a component of other comprehensive income (loss). The Company will test for ineffectiveness whenever financial statements are issued or at least every three months using the Hypothetical Derivative Method.

Borrowings under Select's senior secured credit facility which are not subject to the swaps have variable rates that reflect currently available terms and conditions for similar debt. The carrying amount of this debt is a reasonable estimate of fair value.

The carrying value of the 7 ⅝% Senior Subordinated Notes was $660.0 million and the estimated fair value was $567.6 million at December 31, 2007.

The carrying value of the senior floating rate notes was $175.0 million and the estimated fair value was $152.3 million at December 31, 2007.

15. Related Party Transactions

The Company is party to various rental and other agreements with companies owned by related parties affiliated through common ownership or management. The Company made rental and other payments aggregating $0.3 million for the period from January 1 through February 24, 2005 (Predecessor), $1.7 million for the period from February 25 through December 31, 2005 (Successor), $2.3 million during the year ended December 31, 2006, and $2.3 million during the year ended December 31, 2007 to the affiliated companies.

As of December 31, 2007, future rental commitments under outstanding agreements with the affiliated companies are approximately as follows (in thousands):

2008	$3,069
2009	3,096
2010	3,073
2011	3,068
2012	3,158
Thereafter	20,454
	$35,918

16. Commitments and Contingencies

Leases

The Company leases facilities and equipment from unrelated parties under operating leases. Minimum future lease obligations on long-term non-cancelable operating leases in effect at December 31, 2007 are approximately as follows (in thousands):

2008	$ 100,215
2009	77,477
2010	55,894
2011	38,165
2012	27,174
Thereafter	174,423
	$473,348

Total rent expense for operating leases, including cancelable leases, for the period from January 1 through February 24, 2005 (Predecessor) was $18.0 million, for the period from February 25 through December 31, 2005 (Successor) was $96.7 million, for the year ended December 31, 2006 was $118.4 million, and for the year ended December 31, 2007 was $131.9 million.

Facility rent expense for the period from January 1 through February 24, 2005 (Predecessor) was $13.6 million, for the period from February 25 through December 31, 2005 (Successor) was $68.0 million, for the year ended December 31, 2006 was $84.0 million, and for the year ended December 31, 2007 was $98.5 million.

Construction Commitments

At December 31, 2007, the Company has outstanding commitments under construction contracts related to new construction, improvements and renovations at the Company's long-term acute care properties and inpatient rehabilitation facilities totaling approximately $8.7 million.

Patient Care Obligation

The Company acquired a long-term obligation to care for an indigent, ventilator dependent, quadriplegic individual through its acquisition of Kessler Rehabilitation Corporation. In September 2005, the Company recorded a one time benefit of $3.8 million related to the termination of this liability.

Other

In March 2000, the Company entered into three-year employment agreements with three of its executive officers. Under these agreements, the three executive officers currently receive a combined total annual salary of $2.4 million subject to adjustment by the Company's Board of Directors. The employment agreements also contain a change in control provision and provides that the three executive officers will receive long-term disability insurance. At the end of each 12-month period beginning March 1, 2000, the term of each employment agreement automatically extends for an additional year unless one of the executives or the Company gives written notice to the other not less than three months prior to the end of that 12-month period that they do not want the term of the employment agreement to continue.

The Company has entered into change in control agreements with six other members of senior management.

A subsidiary of the Company has entered into a naming, promotional and sponsorship agreement with an NFL team for the team's headquarters complex that requires a payment of $2.6 million in 2008. Each successive annual payment increases by 2.3% through 2025. The naming, promotional and sponsorship agreement is in effect until 2025.

Litigation

On August 24, 2004, Clifford C. Marsden and Ming Xu filed a purported class action complaint in the United States District Court for the Eastern District of Pennsylvania on behalf of the public stockholders of Select against Martin F. Jackson, Robert A. Ortenzio, Rocco A. Ortenzio, Patricia A. Rice and Select. In February 2005, the Court appointed

James Shaver, Frank C. Bagatta and Capital Invest, die Kapitalanlagegesellschaft der Bank Austria Creditanstalt Gruppe GmbH as lead plaintiffs ("Lead Plaintiffs").

On April 19, 2005, Lead Plaintiffs filed an amended complaint, purportedly on behalf of a class of shareholders of Select, against Martin F. Jackson, Robert A. Ortenzio, Rocco A. Ortenzio, Patricia A. Rice, and Select as defendants. The amended complaint continues to allege, among other things, failure to disclose adverse information regarding a potential regulatory change affecting reimbursement for Select's services applicable to long-term acute care hospitals operated as hospitals within hospitals, failure to disclose improper revenue practices and the issuance of false and misleading statements about the financial outlook of Select. The amended complaint seeks, among other things, damages in an unspecified amount, interest and attorneys' fees. The Company believes that the allegations in the amended complaint are without merit and intends to vigorously defend against this action. In April 2006, the Court granted in part and denied in part Select and the individual officers' preliminary motion to dismiss the amended complaint. In February 2007, the Court vacated in part its previous decision on Select's and the individual officers' motion to dismiss and dismissed Plaintiffs' claims regarding Select's alleged improper revenue practices. The Plaintiffs asked the court to reconsider this ruling, and in June 2007, the court denied the Plaintiffs' request. Select and the individual officers have answered the amended complaint. On October 25, 2007, the court certified a class of investors who purchased Select stock between July 29, 2003 and May 11, 2004, inclusive. The court also appointed class representatives and class counsel. In November 2007, Select filed a petition requesting that the United States Court of Appeals for the Third Circuit review the District Court's certification ruling on an interlocutory basis. On March 6, 2008, the Court of Appeals denied this petition. The discovery period ended on February 15, 2008. The defendants intend to file a motion for summary judgment on or before March 28, 2008. The Company does not believe this claim will have a material adverse effect on its financial position, cash flows or results of operations. However, due to the uncertain nature of such litigation, the Company cannot predict the outcome of this matter.

The Company is subject to legal proceedings and claims that arise in the ordinary course of its business, which include malpractice claims covered under insurance policies. In the Company's opinion, the outcome of these actions will not have a material adverse effect on the financial position, cash flows or results of operations of the Company.

To cover claims arising out of the operations of the Company's specialty hospitals and outpatient rehabilitation facilities, the Company maintains professional malpractice liability insurance and general liability insurance. The Company also maintains umbrella liability insurance covering claims which, due to their nature or amount, are not covered by or not fully covered by the Company's other insurance policies. These insurance policies also do not generally cover punitive damages and are subject to various deductibles and policy limits. Significant legal actions as well as the cost and possible lack of available insurance could subject the Company to substantial uninsured liabilities.

Health care providers are often subject to lawsuits under the qui tam provisions of the federal False Claims Act. Qui tam lawsuits typically remain under seal (hence, usually unknown to the defendant) for some time while the government decides whether or not to intervene on behalf of a private qui tam plaintiff (known as a relator) and take the lead in the litigation. These lawsuits can involve significant monetary damages and penalties and award bounties to private plaintiffs who successfully bring the suits. A qui tam lawsuit against Select was filed on June 10, 2003 in the United States District Court for the District of Nevada. The action was originally under seal, during which time the federal government was conducting an investigation of matters alleged by this complaint, as is required by law. Select received subpoenas for patient records and other documents, and other follow-up requests, apparently related to the federal government's investigation. In July 2007, the federal government declined to intervene in the case, but stated that it would continue its investigation. In August 2007, the judge ordered the complaint to be unsealed and served upon the defendants by the relators. All other previous filings in this matter remain under seal. In December 2007, Select was served with the relator's First Amended Complaint, also filed in December 2007, rather than the original complaint filed in June 2003. The First Amended Complaint confirms the three relators in this qui tam lawsuit are two former employees of Select's Las Vegas, Nevada subsidiary who were terminated by Select in 2001 and a former employee of Select's Florida subsidiary who Select asked to resign. The First Amended Complaint names, as defendants, Select Medical Corporation, Sports Therapy Arthritis Rehabilitation, Inc. (STAR), and Sports and Orthopedic Rehabilitation Services of Florida (SORS). The First Amended Complaint includes three counts alleging violations of the federal False Claims Act through the submission of false claims, false statements to get false claims paid, and conspiracy to violate the False Claims Act. Specifically, the First Amended Complaint alleges that Defendants: used unlicensed personnel to provide therapy services to Medicare patients and did not follow the Medicare billing rules for group therapy; Defendants billed Medicare patients for services beyond the Medicare approved amount, or for services not eligible for reimbursement; over-billed Medicare for therapy services; resubmitted denied Medicare claims; used billing numbers on Medicare claims belonging to therapists no longer employed by Select or its subsidiaries; waived co-pays from patients without commercial insurance; and granted discounts to patients who paid cash which were not reported on the clinics' books. Select sued the former Las Vegas employees in state court in Nevada in 2001 for, among other things, return of misappropriated funds. Select's lawsuit has been transferred to the federal court in Las Vegas where it could be consolidated with the qui tam lawsuit. The former Las Vegas employees' counterclaims against Select in Select's lawsuit have been dismissed. While the government has investigated but chosen not to intervene in two previous qui tam lawsuits filed against Select, the Company cannot provide assurance that the government will not intervene in the Nevada qui tam case at a later date or any other existing or future qui tam lawsuit against the Company. While litigation is inherently uncertain, the Company believes, based on the limited information currently available to the Company, that the Nevada qui tam action will not have a material adverse effect on the Company's financial position, cash flows or results of operations.

17. Supplemental Disclosures of Cash Flow Information

Non-cash investing and financing activities are comprised of the following for the years ended December 31, 2005, 2006 and 2007:

	Predecessor	Successor		
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	For the Year Ended December 31, 2006	2007
		(in thousands)		
Dividends declared to Holdings (Select Medical Corporation)	$ --	$ --	$ --	$17,000
Notes issued with acquisitions (Note 2)	--	60	--	--
Liabilities assumed with acquisitions (Note 2)	19,924	148	--	36,458
Notes recorded related to sale of business (Note 3)	--	--	8,436	2,616
Tax benefit of stock option exercises	1,507	--	--	--

18. Subsequent Event

On February 1, 2008, Holdings and Select both filed a Form 15, to deregister Select's 7 ⅝ % senior subordinated notes and Holdings senior floating rate notes under section 15 of the Securities Exchange Act, thereby terminating their periodic reporting obligations with the U.S. Securities and Exchange Commission.

19. Financial Information for Subsidiary Guarantors and Non-Guarantor Subsidiaries under Select's 7 ⅝% Senior Subordinated Notes

Select's 7⅝% Senior Subordinated Notes are fully and unconditionally guaranteed on a senior subordinated basis by all of Select's wholly-owned subsidiaries (the "Subsidiary Guarantors"). Certain of Select's subsidiaries did not guarantee the 7⅝% Senior Subordinated Notes (the "Non-Guarantor Subsidiaries").

Select conducts a significant portion of its business through its subsidiaries. Presented below is condensed consolidating financial information for Select, the Subsidiary Guarantors and the Non-Guarantor Subsidiaries at December 31, 2006 and 2007 and for the period January 1, 2005 through February 24, 2005 (Predecessor), February 25, 2005 through December 31, 2005 (Successor), the year ended December 31, 2006 (Successor), and the year ended December 31, 2007 (Successor).

The equity method has been used by Select with respect to investments in subsidiaries. The equity method has been used by Subsidiary Guarantors with respect to investments in Non-Guarantor Subsidiaries. Separate financial statements for Subsidiary Guarantors are not presented.

The following table sets forth the Non-Guarantor Subsidiaries:

Caritas Rehab Services, LLC
Canadian Back Institute Limited and its subsidiaries (1)
Cupertino Medical Center, P.C. (2)
Elizabethtown Physical Therapy
Jeff Ayres, PT Therapy Center, Inc.
Jeffersontown Physical Therapy, LLC
Kentucky Orthopedic Rehabilitation, LLC
Kessler Core PT, OT and Speech Therapy at New York, LLC
Langhorne, P.C.
Lester OSM, P.C.
Louisville Physical Therapy, P.S.C.
Medical Information Management Systems, LLC (3)
Metropolitan West Physical Therapy and Sports Medicine Services Inc.
MKJ Physical Therapy, Inc.
New York Physician Services, P.C.
North Andover Physical Therapy, Inc.
OccuMed East, P.C.
Ohio Occupational Health, P.C., Inc.
Partners in Physical Therapy, PLLC
Penn State Hershey Rehabilitation, LLC
Philadelphia Occupational Health, P.C.
Rehabilitation Physician Services, P.C.
Robinson & Associates, P.C.
Select Physical Therapy of Las Vegas Limited Partnership
Select Specialty Hospital – Central Pennsylvania, L.P.
Select Specialty Hospital – Evansville, LLC
Select Specialty Hospital – Houston, L.P.
Select Specialty Hospital – Gulf Coast, Inc.
Sprint Physical Therapy, P.C.
Therex, P.C.
TJ Corporation I, LLC
U.S. Regional Occupational Health II, P.C.
U.S. Regional Occupational Health II of New Jersey, P.C.

(1) The operating results have been classified as discontinued operations and cash flows have been included with continuing operations for the period from January 1, 2005 through February 24, 2005 (Predecessor), the period from February 25, 2005 through December 31, 2005 (Successor) and for the year ended December 31, 2006. The operations were sold on March 1, 2006.

(2) In December 2006, the Company sold a group of legal entities that operated outpatient rehabilitation clinics. Cupertino Medical Center, P.C. was one of the legal entities sold.

(3) In February 2007, the Company sold Medical Information Management Systems, LLC.

Select Medical Corporation
Condensed Consolidating Balance Sheet
December 31, 2007
Successor

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations		Consolidated
			(in thousands)			
Assets						
Current Assets:						
Cash and cash equivalents	$ 161	$ 3,102	$ 1,266	$ -		$ 4,529
Accounts receivable, net	243	254,753	16,410	-		271,406
Current deferred tax asset	25,253	21,178	2,557	-		48,988
Prepaid income taxes	8,162	-	-			8,162
Other current assets	3,848	16,439	2,220	-		22,507
Total Current Assets	37,667	295,472	22,453	-		355,592
Property and equipment, net	9,412	443,176	34,438	-		487,026
Investment in affiliates	2,004,836	45,777	-	(2,050,613)	(a)(b)	-
Goodwill	-	1,499,485	-	-		1,499,485
Other identifiable intangibles	-	79,172	-	-		79,172
Assets held for sale	-	14,607	-			14,607
Other assets	33,147	19,581	2,167	-		54,895
Total Assets	$ 2,085,062	$ 2,397,270	$ 59,058	$ (2,050,613)		$ 2,490,777
Liabilities and Stockholders' Equity						
Current Liabilities:						
Bank overdrafts	$ 21,124	$ -	$ -	$ -		$ 21,124
Current portion of long-term debt and notes payable	6,920	819	10	-		7,749
Accounts payable	4,685	63,643	5,519	-		73,847
Intercompany accounts	275,918	(249,868)	(26,050)	-		-
Accrued payroll	953	58,320	210	-		59,483
Accrued vacation	2,629	27,799	2,652	-		33,080
Accrued interest	25,325	17	-	-		25,342
Accrued restructuring	-	15,484	-	-		15,484
Accrued other	33,921	58,918	2,403	-		95,242
Due to (from) third party payors	-	22,902	(7,830)	-		15,072
Total Current Liabilities	371,475	(1,966)	(23,086)	-		346,423
Long-term debt, net of current portion	1,042,809	370,323	25,644	-		1,438,776
Non-current deferred tax liability	(5,659)	26,355	2,684	-		23,380
Other non-current liabilities	52,266	-	-	-		52,266
Total Liabilities	1,460,891	394,712	5,242	-		1,860,845
Commitments and Contingencies						
Minority interest in consolidated subsidiary companies	-	-	5,761	-		5,761
Stockholders' Equity:						
Common stock	-	-	-	-		-
Capital in excess of par	478,911	-	-	-		478,911
Retained earnings	150,203	272,247	27,659	(299,906)	(b)	150,203
Subsidiary investment	-	1,730,311	20,396	(1,750,707)	(a)	-
Accumulated other comprehensive loss	(4,943)	-	-	-		(4,943)
Total Stockholders' Equity	624,171	2,002,558	48,055	(2,050,613)		624,171
Total Liabilities and Stockholders' Equity	$ 2,085,062	$ 2,397,270	$ 59,058	$ (2,050,613)		$ 2,490,777

(a) Elimination of investments in subsidiaries.
(b) Elimination of investments in subsidiaries' earnings.

Select Medical Corporation
Condensed Consolidating Statement of Operations
For the Year Ended December 31, 2007
Successor

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
			(in thousands)		
Net operating revenues	$ 1,663	$ 1,814,211	$ 175,792	$ -	$ 1,991,666
Costs and expenses:					
Cost of services	191	1,511,020	148,838	-	1,660,049
General and administrative	42,319	544	-	-	42,863
Bad debt expense	-	35,020	2,552	-	37,572
Depreciation and amortization	2,321	50,554	4,422	-	57,297
Total costs and expenses	44,831	1,597,138	155,812	-	1,797,781
Income (loss) from operations	(43,168)	217,073	19,980	-	193,885
Other income and expense:					
Intercompany interest and royalty fees	(60,969)	60,485	484	-	-
Intercompany management fees	189,796	(183,952)	(5,844)	-	-
Other income (expense)	(5,874)	1,380	-	-	(4,494)
Interest income	1,445	658	-	-	2,103
Interest expense	(79,900)	(23,487)	(2,110)	-	(105,497)
Income before minority interests and income taxes	1,330	72,157	12,510	-	85,997
Minority interest in consolidated subsidiary companies	-	-	1,537	-	1,537
Income from continuing operations before income taxes	1,330	72,157	10,973	-	84,460
Income tax expense (benefit)	(1,756)	30,521	550	-	29,315
Income from continuing operations	3,086	41,636	10,423	-	55,145
Equity in earnings of subsidiaries	52,059	9,330	-	(61,389)	-
Net income	$ 55,145	$ 50,966	$ 10,423	$ (61,389)	$ 55,145

Select Medical Corporation
Condensed Consolidating Statement of Cash Flows
For the Year Ended December 31, 2007
Successor

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
			(in thousands)		
Operating activities					
Net income	$ 55,145	$ 50,966	$ 10,423	$ (61,389) (a)	$ 55,145
Adjustments to reconcile net income to net cash provided by (used in) operating activities:					
Depreciation and amortization	2,321	50,554	4,422	-	57,297
Provision for bad debts	-	35,020	2,552	-	37,572
Gain from disposal of assets and sale of business units	287	2,468	(331)	-	2,424
Non-cash income from interest rate swaps	4,327	-	-	-	4,327
Non-cash stock compensation expense	3,746	-	-	-	3,746
Deferred income taxes	2,460	-	-	-	2,460
Minority interests	-	-	1,537	-	1,537
Changes in operating assets and liabilities, net of effects from acquisition of businesses:					
Equity in earnings of subsidiaries	(52,059)	(9,330)	-	61,389 (a)	-
Intercompany	(218,197)	224,902	(6,705)	-	-
Accounts receivable	(266)	(75,590)	316	-	(75,540)
Other current assets	(2,251)	4,409	(752)	-	1,406
Other assets	23,211	(15,946)	(1,625)	-	5,640
Accounts payable	802	(1,158)	244	-	(112)
Due to third-party payors	-	10,016	(7,830)	-	2,186
Accrued expenses	13,557	6,101	1,040	-	20,698
Net cash provided by (used in) operating activities	(166,917)	282,412	3,291	-	118,786
Investing activities					
Purchases of property and equipment	(4,395)	(158,610)	(3,069)	-	(166,074)
Proceeds from sale of business units	2,332	7,273	-	-	9,605
Proceeds from sale of property	-	6,438	-	-	6,438
Changes in restricted cash	4,335	-	-	-	4,335
Acquisition of businesses, net of cash acquired	-	(236,980)	-	-	(236,980)
Net cash provided by (used in) investing activities	2,272	(381,879)	(3,069)	-	(382,676)
Financing activities					
Borrowings on revolving credit facility	449,000	-	-	-	449,000
Payments on revolving credit facility	(329,000)	-	-	-	(329,000)
Credit facility term loan borrowing	100,000	-	-	-	100,000
Payments on credit facility term loan	(6,550)	-	-	-	(6,550)
Principal payments on seller and other debt	-	(1,323)	-	-	(1,323)
Intercompany debt reallocation	(92,279)	91,026	1,253	-	-
Proceeds from bank overdrafts	8,911	-	-	-	8,911
Dividends paid to Holdings	(32,787)	-	-	-	(32,787)
Equity investment by Holdings	266	-	-	-	266
Distributions to minority interests	-	-	(1,698)	-	(1,698)
Net cash provided by (used in) financing activities	97,561	89,703	(445)	-	186,819
Net decrease in cash and cash equivalents	(67,084)	(9,764)	(223)	-	(77,071)
Cash and cash equivalents at beginning of period	67,245	12,866	1,489	-	81,600
Cash and cash equivalents at end of period	$ 161	$ 3,102	$ 1,266	$ -	$ 4,529

(a) Elimination of equity in earnings of subsidiary.

Select Medical Corporation
Condensed Consolidating Balance Sheet
December 31, 2006
Successor

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
			(in thousands)		
Assets					
Current Assets:					
Cash and cash equivalents	$ 67,245	$ 12,866	$ 1,489	$ -	$ 81,600
Restricted cash	4,335	-	-	-	4,335
Accounts receivable, net	(23)	182,861	17,089	-	199,927
Current deferred tax asset	24,438	16,018	2,157	-	42,613
Other current assets	1,597	13,697	1,468	-	16,762
Total Current Assets	97,592	225,442	22,203	-	345,237
Property and equipment, net	10,979	315,141	30,216	-	356,336
Investment in affiliates	1,968,074	32,150	-	(2,000,224) (a)(b)	-
Goodwill	-	1,323,572	-	-	1,323,572
Other identifiable intangibles	-	79,230	- -	-	79,230
Assets held for sale	-	4,855	-	-	4,855
Other assets	56,358	11,512	542	-	68,412
Total Assets	$ 2,133,003	$ 1,991,902	$ 52,961	$ (2,000,224)	$ 2,177,642
Liabilities and Stockholders' Equity					
Current Liabilities:					
Bank overdrafts	$ 12,213	$ -	$ -	$ -	$ 12,213
Current portion of long-term debt and notes payable	5,921	288	-	-	6,209
Accounts payable	3,883	63,439	5,275	-	72,597
Intercompany accounts	489,795	(471,284)	(18,511)	-	-
Accrued payroll	730	54,098	256	-	55,084
Accrued vacation	2,902	22,292	2,166	-	27,360
Accrued interest	25,270	-	-	-	25,270
Accrued restructuring	-	225	-	-	225
Accrued other	36,206	22,473	1,820	-	60,499
Income taxes payable	(17,235)	20,202	(1,030)	-	1,937
Due to third party payors	-	12,523	363	-	12,886
Total Current Liabilities	559,685	(275,744)	(9,661)	-	274,280
Long-term debt, net of current portion	922,638	277,492	24,379	-	1,224,509
Non-current deferred tax liability	5,114	23,265	2,342	-	30,721
Other long-term liabilities	31,564	-	-	-	31,564
Total Liabilities	1,519,001	25,013	17,060	-	1,561,074
Commitments and Contingencies					
Minority interest in consolidated subsidiary companies	-	-	2,566	-	2,566
Stockholders' Equity:					
Common stock	-	-	-	-	-
Capital in excess of par	464,283	-	-	-	464,283
Retained earnings	146,774	221,281	17,323	(238,604) (b)	146,774
Subsidiary investment	-	1,745,608	16,012	(1,761,620) (a)	-
Accumulated other comprehensive income	2,945	-	-	-	2,945
Total Stockholders' Equity	614,002	1,966,889	33,335	(2,000,224)	614,002
Total Liabilities and Stockholders' Equity	$ 2,133,003	$ 1,991,902	$ 52,961	$ (2,000,224)	$ 2,177,642

(a) Elimination of investments in subsidiaries.
(b) Elimination of investments in subsidiaries' earnings.

Select Medical Corporation
Condensed Consolidating Statement of Operations
For the Year Ended December 31, 2006
Successor

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
			(in thousands)		
Net operating revenues	$ 493	$ 1,693,772	$ 157,233	$ -	$ 1,851,498
Costs and expenses:					
Cost of services	231	1,353,548	130,853	-	1,484,632
General and administrative	43,010	504	-	-	43,514
Bad debt expense	-	17,252	1,558	-	18,810
Depreciation and amortization	2,426	40,878	3,364	-	46,668
Total costs and expenses	45,667	1,412,182	135,775	-	1,593,624
Income (loss) from operations	(45,174)	281,590	21,458	-	257,874
Other income and expense:					
Intercompany interest and royalty fees	(64,387)	63,958	429	-	-
Intercompany management fees	176,833	(172,591)	(4,242)	-	-
Other income	1,366	-	-	-	1,366
Interest income	1,187	106	-	-	1,293
Interest expense	(73,963)	(21,722)	(1,603)	-	(97,288)
Income (loss) before minority interests and income taxes	(4,138)	151,341	16,042	-	163,245
Minority interest in consolidated subsidiary companies	-	-	1,414	-	1,414
Income (loss) from continuing operations before income taxes	(4,138)	151,341	14,628	-	161,831
Income tax expense	4,857	50,705	527	-	56,089
Income (loss) from continuing operations	(8,995)	100,636	14,101	-	105,742
Income from discontinued operations, net of tax	9,068	-	3,410	-	12,478
Equity in earnings of subsidiaries	118,147	14,185	-	(132,332)	-
Net income	$ 118,220	$ 114,821	$ 17,511	$ (132,332)	$ 118,220

Select Medical Corporation
Condensed Consolidating Statement of Cash Flows
For the Year Ended December 31, 2006
Successor

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
			(in thousands)		
Operating activities					
Net income	$ 118,220	$ 114,821	$ 17,511	$ (132,332) (a)	$ 118,220
Adjustments to reconcile net income to net cash provided by operating activities:					
Depreciation and amortization	2,426	40,878	3,540	-	46,844
Provision for bad debts	-	17,252	1,645	-	18,897
Loss (gain) from disposal of assets and sale of business units	(13,717)	2,074	136	-	(11,507)
Non-cash income from interest rate swaps	(1,366)	-	-	-	(1,366)
Non-cash stock compensation expense	3,782	-	-	-	3,782
Deferred income taxes	13,327	-	-	-	13,327
Minority interests	-	-	1,754	-	1,754
Changes in operating assets and liabilities, net of effects from acquisition of businesses:					
Equity in earnings of subsidiaries	(118,147)	(14,185)	-	132,332 (a)	-
Intercompany	75,688	(56,234)	(19,454)	-	-
Accounts receivable	23	36,652	(5,871)	-	30,804
Other current assets	314	(646)	2,347	-	2,015
Other assets	1,031	5,416	(140)	-	6,307
Accounts payable	1,892	10,690	(501)	-	12,081
Due to third-party payors	(6,099)	(1,630)	8,440	-	711
Accrued expenses	27,125	(8,243)	(561)	-	18,321
Net cash provided by operating activities	104,499	146,845	8,846	-	260,190
Investing activities					
Purchases of property and equipment	(2,159)	(127,042)	(25,895)	-	(155,096)
Proceeds from sale of business	74,966	-	-	-	74,966
Changes in restricted cash	2,010	-	-	-	2,010
Acquisition of businesses, net of cash acquired	-	(1,339)	(2,022)	-	(3,361)
Net cash provided by (used in) investing activities	74,817	(128,381)	(27,917)	-	(81,481)
Financing activities					
Borrowings on revolving credit facility	215,000	-	-	-	215,000
Payments on revolving credit facility	(300,000)	-	-	-	(300,000)
Payments on credit facility term loan	(5,800)	-	-	-	(5,800)
Principal payments on seller and other debt	-	(684)	(37)	-	(721)
Payment of bank overdrafts	(7,142)	-	-	-	(7,142)
Intercompany debt reallocation	1,678	(8,545)	6,867	-	-
Dividends paid to Holdings	(32,580)	-	-	-	(32,580)
Distributions to minority interests	-	-	(1,762)	-	(1,762)
Net cash provided by (used in) financing activities	(128,844)	(9,229)	5,068	-	(133,005)
Effect of exchange rate changes on cash and cash equivalents	35	-	-	-	35
Net increase (decrease) in cash and cash equivalents	50,507	9,235	(14,003)	-	45,739
Cash and cash equivalents at beginning of period	16,738	3,631	15,492	-	35,861
Cash and cash equivalents at end of period	$ 67,245	$ 12,866	$ 1,489	$ -	$ 81,600

(a) Elimination of equity in earnings of subsidiary.

Select Medical Corporation
Condensed Consolidating Statement of Operations
For the Period February 25, 2005 through December 31, 2005
Successor

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
			(in thousands)		
Net operating revenues	$ 13	$ 1,432,620	$ 148,073	$ -	$ 1,580,706
Costs and expenses:					
Cost of services	178	1,122,278	121,905	-	1,244,361
General and administrative	58,209	1,285	-	-	59,494
Bad debt expense	-	18,448	(235)	-	18,213
Depreciation and amortization	5,472	29,605	2,845	-	37,922
Total costs and expenses	63,859	1,171,616	124,515	-	1,359,990
Income (loss) from operations	(63,846)	261,004	23,558	-	220,716
Other income and expense:					
Intercompany interest and royalty fees	(27,389)	27,073	316	-	-
Intercompany management fees	144,892	(141,877)	(3,015)	-	-
Other income	3,018	-	-		3,018
Interest income	694	71	2	-	767
Interest expense	(65,977)	(16,659)	(1,116)	-	(83,752)
Income (loss) before minority interests and income taxes	(8,608)	129,612	19,745	-	140,749
Minority interest in consolidated subsidiary companies	-	161	1,615	-	1,776
Income (loss) from continuing operations before income taxes	(8,608)	129,451	18,130	-	138,973
Income tax expense (benefit)	(95)	54,419	2,146		56,470
Income (loss) from continuing operations	(8,513)	75,032	15,984	-	82,503
Income from discontinued operations, net of tax	-	-	3,072	-	3,072
Equity in earnings of subsidiaries	94,088	15,878	-	(109,966) (a)	-
Net income	$ 85,575	$ 90,910	$ 19,056	$ (109,966)	$ 85,575

(a) Elimination of equity in net income (loss) from consolidated subsidiaries.

Select Medical Corporation
Condensed Consolidating Statement of Cash Flows
For the Period from February 25 through December 31, 2005
Successor

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
			(in thousands)		
Operating activities					
Net income	$ 85,575	$ 90,910	$ 19,056	$ (109,966) (a)	$ 85,575
Adjustments to reconcile net income to net cash provided by (used in) operating activities:					
Depreciation and amortization	5,472	29,605	3,983	-	39,060
Provision for bad debts	-	18,448	152	-	18,600
Loss from disposal of assets and sale of business units	-	810	-	-	810
Non-cash income from interest rate swaps	(1,926)	-	-	-	(1,926)
Non-cash stock compensation expense	10,312	-	-	-	10,312
Deferred income taxes	26,956	-	-	-	26,956
Minority interests	-	161	2,857	-	3,018
Changes in operating assets and liabilities, net of effects from acquisition of businesses:					
Equity in earnings of subsidiaries	(94,088)	(15,878)	-	109,966 (a)	-
Intercompany	(17,482)	29,077	(11,595)		-
Accounts receivable	162	(6,376)	3,306	-	(2,908)
Other current assets	(914)	1,129	97	-	312
Other assets	3,873	549	51	-	4,473
Accounts payable	641	2,713	(1,100)	-	2,254
Due to third-party payors	49	1,811	(3,617)	-	(1,757)
Accrued expenses	(37,745)	(108,387)	6,425	-	(139,707)
Net cash provided by (used in) operating activities	(19,115)	44,572	19,615	-	45,072
Investing activities					
Purchases of property and equipment	(2,784)	(95,882)	(8,694)	-	(107,360)
Changes in restricted cash	578	-	-	-	578
Acquisition of businesses, net of cash acquired	-	(2,255)	(1,017)	-	(3,272)
Net cash used in investing activities	(2,206)	(98,137)	(9,711)	-	(110,054)
Financing activities					
Borrowings on revolving credit facility	281,000	-	-	-	281,000
Payments on revolving credit facility	(196,000)	-	-	-	(196,000)
Credit facility term loan borrowing	580,000	-	-	-	580,000
Payments on credit facility term loan	(4,350)				(4,350)
Proceeds from senior subordinated notes	660,000	-	-	-	660,000
Repayment of senior subordinated notes	(350,000)	-	-	-	(350,000)
Payment of deferred financing costs	(57,198)	-	-	-	(57,198)
Principal payments on seller and other debt	(340)	(3,758)	(63)	-	(4,161)
Intercompany debt reallocation	(70,779)	70,958	(179)	-	-
Proceeds from bank overdrafts	19,355	-	-	-	19,355
Dividends paid to Holdings	(9,988)	-	-	-	(9,988)
Repurchases of common stock and options	(1,687,994)	-	-	-	(1,687,994)
Equity investment by Holdings	724,042	-	-	-	724,042
Costs associated with equity investment of Holdings	(8,686)	-	-	-	(8,686)
Distributions to minority interests	-	-	(1,541)	-	(1,541)
Net cash provided by (used in) financing activities	(120,938)	67,200	(1,783)	-	(55,521)
Effect of exchange rate changes on cash and cash equivalents	644	-	-		644
Net increase (decrease) in cash and cash equivalents	(141,615)	13,635	8,121	-	(119,859)
Cash and cash equivalents at beginning of period	158,353	(10,004)	7,371	-	155,720
Cash and cash equivalents at end of period	$ 16,738	$ 3,631	$ 15,492	$ -	$ 35,861

(a) Elimination of equity in earnings of subsidiary.

Select Medical Corporation
Condensed Consolidating Statement of Operations
For the Period January 1 through February 24, 2005
Predecessor

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
			(in thousands)		
Net operating revenues	$ 28	$ 248,857	$ 28,851	$ -	$ 277,736
Costs and expenses:					
Cost of services	27,188	193,323	23,810	-	244,321
General and administrative	121,956	553	-	-	122,509
Bad debt expense	-	6,223	365	-	6,588
Depreciation and amortization	371	5,025	537	-	5,933
Total costs and expenses	149,515	205,124	24,712	-	379,351
Income (loss) from operations	(149,487)	43,733	4,139	-	(101,615)
Other income and expense:					
Intercompany interest and royalty fees	(6,261)	6,221	40	-	-
Intercompany management fees	213,822	(213,436)	(386)	-	-
Loss on early retirement of debt	(42,736)	-	-	-	(42,736)
Merger related charges	(12,025)	-	-	-	(12,025)
Other income	267	-	-	-	267
Interest income	294	229	-	-	523
Interest expense	(1,433)	(2,953)	(265)	-	(4,651)
Income (loss) before minority interests and income taxes	2,441	(166,206)	3,528	-	(160,237)
Minority interest in consolidated subsidiary companies	-	7	323	-	330
Income (loss) from continuing operations before income taxes	2,441	(166,213)	3,205	-	(160,567)
Income tax expense (benefit)	130	(59,937)	13	-	(59,794)
Income (loss) from continuing operations	2,311	(106,276)	3,192	-	(100,773)
Income from discontinued operations, net of tax	-	-	522		522
Equity in earnings of subsidiaries	(102,562)	3,260	-	99,302 (a)	-
Net income (loss)	$ (100,251)	$ (103,016)	$ 3,714	$ 99,302	$ (100,251)

(a) Elimination of equity in net income (loss) from consolidated subsidiaries.

Select Medical Corporation
Condensed Consolidating Statement of Cash Flows
For the Period January 1 through February 24, 2005
Predecessor

	Select Medical Corporation (Parent Company Only)	Subsidiary Guarantors	Non-Guarantor Subsidiaries	Eliminations	Consolidated
			(in thousands)		
Operating activities					
Net income (loss)	$ (100,251)	$ (103,016)	$ 3,714	$ 99,302 (a)	$ (100,251)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:					
Depreciation and amortization	371	5,025	781	-	6,177
Provision for bad debts	-	6,223	438	-	6,661
Loss on early retirement of debt (non-cash)	7,977	-	-	-	7,977
Deferred income taxes	(63,863)	-	-	-	(63,863)
Minority interests	-	7	462	-	469
Changes in operating assets and liabilities, net of effects from acquisition of businesses:					
Equity in earnings of subsidiaries	102,562	(3,260)	-	(99,302) (a)	-
Intercompany	(9,581)	12,090	(2,509)	-	-
Accounts receivable	(133)	(47,567)	(1,276)	-	(48,976)
Other current assets	1,899	(374)	291	-	1,816
Other assets	8,375	(9,045)	48	-	(622)
Accounts payable	(296)	6,128	(582)	-	5,250
Due to third-party payors	-	3,953	(3,286)	-	667
Accrued expenses	51,876	152,793	(918)	-	203,751
Net cash provided by (used in) operating activities	(1,064)	22,957	(2,837)	-	19,056
Investing activities					
Purchases of property and equipment	(305)	(2,045)	(236)	-	(2,586)
Changes in restricted cash	108	-	-	-	108
Acquisition of businesses, net of cash acquired	-	(105,092)	(3,187)	-	(108,279)
Net cash used in investing activities	(197)	(107,137)	(3,423)	-	(110,757)
Financing activities					
Principal payments on seller and other debt	-	(528)	-	-	(528)
Intercompany debt reallocation	(2,964)	63	2,901	-	-
Proceeds from issuance of common stock	1,023	-	-	-	1,023
Distributions to minority interests	-	-	(401)	-	(401)
Net cash provided by (used in) financing activities	(1,941)	(465)	2,500	-	94
Effect of exchange rate changes on cash and cash equivalents	(149)	-	-	-	(149)
Net decrease in cash and cash equivalents	(3,351)	(84,645)	(3,760)	-	(91,756)
Cash and cash equivalents at beginning of period	161,704	74,641	11,131	-	247,476
Cash and cash equivalents at end of period	$ 158,353	$ (10,004)	$ 7,371	$ -	$ 155,720

(a) Elimination of equity in earnings of subsidiary.

20. Selected Quarterly Financial Data (Unaudited)

The table below sets forth selected unaudited financial data for each quarter of the last two years.

	Select Medical Holdings Corporation			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands)			
Year ended December 31, 2006				
Net revenues	$479,743	$482,141	$443,872	$445,742
Income from operations	66,451	77,993	54,313	59,117
Income from continuing operations	18,171	27,271	12,544	24,415
Income from discontinued operations, net of tax	10,018	---	---	2,460
Net income	$ 28,189	$ 27,271	$ 12,544	$ 26,875

	Select Medical Corporation			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands)			
Year ended December 31, 2006				
Net revenues	$479,743	$482,141	$443,872	$445,742
Income from operations	66,451	77,993	54,313	59,117
Income from continuing operations	25,349	33,937	16,139	30,317
Income from discontinued operations, net of tax	10,018	---	---	2,460
Net income	$ 35,367	$ 33,937	$ 16,139	$ 32,777

	Select Medical Holdings Corporation			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands)			
Year ended December 31, 2007				
Net revenues	$466,829	$506,484	$500,385	$517,968
Income from operations	60,325	60,576	31,292	41,692
Net income (loss)	$ 17,471	$ 14,315	$ (3,106)	$ 6,750

	Select Medical Corporation			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands)			
Year ended December 31, 2007				
Net revenues	$466,829	$506,484	$500,385	$517,968
Income from operations	60,325	60,576	31,292	41,692
Net income	$ 22,183	$ 21,037	$ 724	$ 11,201

Valuation and Qualifying Accounts
(In thousands)

Description	Balance at Beginning of Year	Charged to Cost and Expenses	Acquisitions (A)	Deductions (B)	Balance at End of Year
Year ended December 31, 2007 allowance for doubtful accounts	$ 55,306	$ 37,572	$ 9,061	$ (46,083)	$ 55,856
Year ended December 31, 2006 allowance for doubtful accounts	$ 74,891	$ 18,810	$ -	$ (38,395)	$ 55,306
Combined year ended December 31, 2005 allowance for doubtful accounts	$ 94,622	$ 24,801	$ 7,847	$ (52,379)	$ 74,891
Year ended December 31, 2007 income tax valuation allowance	$ 14,428	$ 2,507	$ -	$ (174)	$ 16,761
Year ended December 31, 2006 income tax valuation allowance	$ 11,961	$ 3,485	$ -	$ (1,018)	$ 14,428
Combined year ended December 31, 2005 income tax valuation allowance	$ 10,506	$ 2,322	$ 823	$ (1,690)	$ 11,961

(A) Represents opening balance sheet reserves resulting from purchase accounting entries.

(B) Allowance for doubtful accounts deductions represent write-offs against the reserve for 2006 and 2007. In 2005, allowance for doubtful accounts deductions represents: (1) write-offs against the reserve of $52.1 million and (2) $0.3 million reclassed to assets held for sale resulting from the sale of the Company's Canadian subsidiary. Income tax valuation allowance deductions primarily represent the disposition of certain subsidiaries.

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

You should read this discussion together with our audited consolidated financial statements and accompanying notes.

Forward Looking Statements

This discussion contains forward-looking statements relating to the financial condition, results of operations, plans, objectives, future performance and business of Select Medical Corporation and Select Medical Holdings Corporation. These statements include, without limitation, statements preceded by, followed by or that include the words "believes," "expects," "anticipates," "estimates" or similar expressions. These forward-looking statements involve risks and uncertainties. Actual results may differ materially from those contemplated by the forward-looking statements due to factors including the following:

- additional changes in government reimbursement for our services may result in increased costs and have an adverse effect on our future net operating revenues and profitability, such as the regulations released by the Centers for Medicare & Medicaid Services ("CMS") on May 2, 2006 and May 1, 2007;
- the failure of our long-term acute care hospitals, or LTCHs, to maintain their status as such may cause our net operating revenues and profitability to decline;
- the failure of our facilities operated as "hospitals within hospitals," or HIHs, to qualify as hospitals separate from their host hospitals may cause our net operating revenues and profitability to decline;
- implementation of modifications to the admissions policies for our inpatient rehabilitation facilities, as required to achieve compliance with Medicare guidelines, may result in a loss of patient volume at these hospitals and, as a result, may reduce our future net operating revenues and profitability;
- a government investigation or assertion that we have violated applicable regulations may result in sanctions or reputational harm and increased costs;
- integration of recently acquired operations (such as the outpatient rehabilitation division of HealthSouth Corporation) and future acquisitions may prove difficult or unsuccessful, use significant resources or expose us to unforeseen liabilities;
- private third-party payors for our services may undertake future cost containment initiatives that limit our future net operating revenues and profitability;
- the failure to maintain established relationships with the physicians in our markets could reduce our net operating revenues and profitability;
- shortages in qualified nurses or therapists could increase our operating costs significantly;
- competition may limit our ability to grow and result in a decrease in our net operating revenues and profitability;
- the loss of key members of our management team could significantly disrupt our operations; and
- the effect of claims asserted against us or lack of adequate available insurance could subject us to substantial uninsured liabilities;
- the ability to obtain any necessary or desired waiver or amendment from our existing lenders may be difficult due to the current uncertainty in the credit markets.

Overview

We are a leading operator of specialty hospitals and outpatient rehabilitation clinics in the United States. As of December 31, 2007, we operated 83 long-term acute care hospitals and four acute medical rehabilitation hospitals in 25 states, and 999 outpatient rehabilitation clinics in 37 states and the District of Columbia. We also provide medical rehabilitation services on a contracted basis to nursing homes, hospitals, assisted living and senior care centers, schools and work sites. We began operations in 1997 under the leadership of our current management team.

On February 24, 2005, Select merged with a wholly-owned subsidiary of Holdings pursuant to which Select became a wholly-owned subsidiary of Holdings. Holdings' primary asset is its investment in Select. Holdings is owned by an investor group that includes Welsh Carson, Thoma Cressey and members of our senior management. As a result of the Merger, Select's assets and liabilities have been adjusted to their fair value as of the closing. We have also experienced an increase in our aggregate outstanding indebtedness as a result of the financing transactions associated with the Merger. Accordingly, our amortization expense and interest expense are higher in periods following the Merger. The excess of the total purchase price over the fair value of our tangible and identifiable intangible assets of $1.4 billion has been allocated to goodwill, which is the subject of an annual impairment test. In determining the total economic consideration to use for financial accounting purposes, we have applied guidance found in Financial Accounting Standards Board Emerging Issues Task Force Issue No. 88-16 "Basis in Leveraged Buyout Transactions." This has resulted in a portion of the equity related to our continuing stockholders to be recorded at the stockholder's predecessor basis and a corresponding portion of the acquired assets to be recorded likewise.

Although the Predecessor and Successor results are not comparable by definition due to the Merger and the resulting change in basis, for ease of comparison in the following discussion and to assist the reader in understanding our operating performance and operating trends, the financial data for the period after the Merger, February 25, 2005 through December 31, 2005 (Successor period), has been added to the financial data for the period from January 1, 2005 through February 24, 2005 (Predecessor period), to arrive at the combined year ended December 31, 2005. The combined data is referred to herein as the combined year ended December 31, 2005. As a result of the Merger, interest expense, loss on early retirement of debt, merger related charges, stock compensation expense, long-term incentive compensation, depreciation and amortization have been impacted. We believe this combined presentation is a reasonable means of presenting our operating results.

We manage our Company through two business segments, our specialty hospital segment and our outpatient rehabilitation segment. We had net operating revenues of $1,991.7 million for the year ended December 31, 2007. Of this total, we earned approximately 70% of our net operating revenues from our specialty hospitals and approximately 30% from our outpatient rehabilitation business for the year ended December 31, 2007.

Our specialty hospital segment consists of hospitals designed to serve the needs of long-term stay acute patients and hospitals designed to serve patients that require intensive medical rehabilitation care. Patients in our long-term acute care hospitals typically suffer from serious and often complex medical conditions that require a high degree of care. Patients in our inpatient rehabilitation facilities typically suffer from debilitating injuries, including traumatic brain and spinal cord injuries, and require rehabilitation care in the form of physical and vocational rehabilitation services. Our outpatient rehabilitation business consists of clinics and contracted services that provide physical, occupational and speech rehabilitation services. Our outpatient rehabilitation patients are typically diagnosed with musculoskeletal impairments that restrict their ability to perform normal activities of daily living.

Recent Trends and Events

Acquisition of HealthSouth Corporation's Outpatient Rehabilitation Division

On May 1, 2007, Select completed the acquisition of substantially all of the outpatient rehabilitation division of HealthSouth Corporation. At the closing, Select acquired 540 outpatient rehabilitation clinics. The closing of the purchase of 29 additional outpatient rehabilitation clinics that was deferred pending certain state regulatory approvals was completed as of October 31, 2007 and resulted in the release of an additional $23.4 million of the purchase price. The aggregate purchase price of $245.0 million was reduced by approximately $7.0 million at closing for assumed indebtedness and other matters. The amount of the consideration was derived through arm's length negotiations. Select funded the acquisition through borrowings under its senior secured credit facility and cash on hand.

In conjunction with the acquisition, we have recorded an estimated liability of $18.7 million for restructuring costs associated with workforce reductions and lease termination costs resulting from our preliminary plans for integrating the acquired business. This estimated liability was accounted for as additional purchase price. We expect to pay the severance costs through 2008 and the lease termination costs through 2017.

Amendment to Credit Agreement

On March 19, 2007, Select entered into an Amendment No. 2 and Waiver to its senior secured credit facility and on March 28, 2007 Select entered into an Incremental Facility Amendment with a group of lenders and JPMorgan Chase Bank, N.A. as administrative agent. Amendment No. 2 increased the general exception to the prohibition on asset sales under Select's senior secured credit facility from $100.0 million to $200.0 million, relaxed certain financial covenants starting March 31, 2007 and waived Select's requirement to prepay certain term loan borrowings following its fiscal year ended December 31, 2006. The Incremental Facility Amendment provided to Select an incremental term loan of $100.0 million, the proceeds of which Select used to pay a portion of the purchase price for the HealthSouth transaction.

Year Ended December 31, 2007

For the year ended December 31, 2007, our net operating revenues increased 7.6% to $1,991.7 million compared to $1,851.5 million for the year ended December 31, 2006. This increase in net operating revenues resulted from a 0.6% increase in our specialty hospital net operating revenue and a 28.3% increase in our outpatient rehabilitation net operating revenue. The significant increase in our outpatient rehabilitation net operating revenue is primarily attributable to the net operating revenues generated by clinics acquired from HealthSouth Corporation on May 1, 2007. We had income from operations for the year ended December 31, 2007 of $193.9 million compared to $257.9 million for the year ended December 31, 2006. The decline in income from operations is principally related to a decline in the profitability of our specialty hospitals which resulted primarily from LTCH regulatory changes. Holdings' interest expense for the year ended December 31, 2007 was $140.2 million compared to $131.8 million for the year ended December 31, 2006. Select's interest expense for the year ended December 31, 2007 was $105.5 million compared to $97.3 million for the year ended December 31, 2006. The increase in interest expense for both Holdings and Select resulted from higher average debt levels resulting primarily from the outpatient rehabilitation clinics acquired from HealthSouth Corporation and higher interest rates experienced during the year ended December 31, 2007.

Cash flow from operations provided $86.0 million of cash for the year ended December 31, 2007 for Holdings and $118.8 million of cash for the year ended December 31, 2007 for Select.

Year Ended December 31, 2006

For the year ended December 31, 2006, our net operating revenues decreased 0.4% to $1,851.5 million compared to $1,858.4 million for the combined year ended December 31, 2005. This decrease in net operating revenues resulted from a 2.2% decrease in our outpatient rehabilitation net revenues offset by a

0.4% increase in our specialty hospital net operating revenue. The decline in our outpatient rehabilitation net revenues resulted from a decline in the number of clinics we operated and in the number of visits occurring at the operating clinics. We had income from operations for the year ended December 31, 2006 of $257.9 million compared to $119.1 million for the combined year ended December 31, 2005. For the combined year ended December 31, 2005, we incurred $152.5 million of stock compensation costs as a result of the Merger and a non-recurring long-term incentive compensation payment of $14.5 million in September 2005. Holdings' interest expense for the year ended December 31, 2006 was $131.8 million compared to $106.9 million for the combined year ended December 31, 2005. Select's interest expense for the year ended December 31, 2006 was $97.3 million compared to $88.4 million for the combined year ended December 31, 2005. The increase in interest expense for both Holdings and Select resulted from higher average debt levels and interest rates experienced during the year ended December 31, 2006.

Cash flow from operations provided $227.7 million of cash for the year ended December 31, 2006 for Holdings and $260.2 million of cash for the year ended December 31, 2006 for Select.

Regulatory Changes

The Medicare prospective payment system for long-term care hospitals or "LTCH-PPS" is the applicable Medicare reimbursement system for our long-term acute care hospitals or "LTCHs." Since the LTCH-PPS became effective for cost reporting periods beginning on or after October 1, 2002, Congress and CMS have adopted changes to the LTCH-PPS that affect our business. The following is a summary of significant changes to LTCH-PPS beginning in August 2004.

August 2004 Final Rule. On August 11, 2004, CMS published final regulations applicable to LTCHs that are operated as HIHs. Effective for hospital cost reporting periods beginning on or after October 1, 2004, subject to certain exceptions, the final regulations provide lower rates of reimbursement to HIHs for those Medicare patients admitted from their host hospitals that are in excess of a specified percentage threshold. For HIHs opened after October 1, 2004, the Medicare admissions threshold has been established at 25% except for HIHs located in rural hospitals, metropolitan statistical area ("MSA") dominant hospitals or single urban hospitals (as defined by the current regulation) where the percentage is no more than 50%, nor less than 25%.

For HIHs that meet specified criteria and were in existence as of October 1, 2004, including all but two of our then existing HIHs, the Medicare admissions thresholds are phased-in over a four-year period starting with hospital cost reporting periods that began on or after October 1, 2004. For discharges during the cost reporting period that began on or after October 1, 2005 and before October 1, 2006, the Medicare admissions threshold was the lesser of the Fiscal 2004 Percentage of Medicare discharges admitted from the host hospital or 75%. For discharges during the cost reporting period beginning on or after October 1, 2006 and before October 1, 2007, the Medicare admissions threshold was the lesser of the Fiscal 2004 Percentage of Medicare discharges admitted from the host hospital or 50%. For discharges during cost reporting periods beginning on or after October 1, 2007, the Medicare admissions threshold will be 25%, however; the Medicare, Medicaid and SCHIP Extension Act of 2007 (the "SCHIP Extension Act") generally limits the application of the Medicare admission threshold to no lower than 50% for a three year period to commence on an LTCHs first cost reporting period to begin on or after December 29, 2007. Under the SCHIP Extension Act, for HIHs and satellite facilities located in rural areas and those which receive referrals from MSA dominant hospitals or single urban hospitals (as defined by current regulations), the percentage threshold is no more than 75%, nor less than 50% during the three year cost reporting periods. As used above, "Fiscal 2004 Percentage" means, with respect to any HIH, the percentage of all Medicare patients discharged by such HIH during its cost reporting period beginning on or after October 1, 2003 and before October 1, 2004 who were admitted to such HIH from its host hospital, but in no event is the Fiscal 2004 Percentage less than 25%. The HIH regulations also established exceptions to the Medicare admissions thresholds with respect to patients who reach "outlier" status at the host hospital, HIHs located in "MSA-dominant hospitals" or HIHs located in rural areas.

Because these rules are complex and are based on the volume of Medicare admissions from our host hospitals as a percent of our overall Medicare admissions, we cannot predict with any certainty the impact on our future net operating revenues of compliance with these regulations. However, after the expiration of the three year moratorium provided by the SCHIP Extension Act, we expect the adverse financial impact to increase when the Medicare admissions thresholds decline to 25%. During the years ended December 31, 2007 and December 31, 2006, we recorded a reduction in our net operating revenues of approximately $5.9 million and $4.6 million, respectively. These reductions were due to estimated repayments to Medicare for host admissions exceeding an HIH hospital's applicable admission threshold.

August 2005 Final Rule. On August 12, 2005, CMS published the final rules for general acute care hospitals inpatient perspective payment system, or IPPS, for fiscal year 2006, which included an update of the LTC-DRG relative weights for fiscal year 2006. CMS estimated the changes to the relative weights would reduce LTCH Medicare payments-per-discharge by approximately 4.2 percent in its fiscal year 2006 which was the period from October 1, 2005 through September 30, 2006.

May 2006 Final Rule. On May 2, 2006, CMS released its final annual payment rate updates for the 2007 LTCH-PPS rate year (affecting discharges and cost reporting periods beginning on or after July 1, 2006 and before July 1, 2007 or "RY 2007"). The May 2006 final rule revised the payment adjustment formula for short stay outlier ("SSO") patients. For discharges occurring on or after July 1, 2006, the rule changed the payment methodology for Medicare patients with a length of stay less than or equal to five-sixths of the geometric average length of stay for each SSO case. Payment for these patients had been based on the lesser of (1) 120 percent of the cost of the case; (2) 120 percent of the LTC-DRG specific per diem amount multiplied by the patient's length of stay; or (3) the full LTC-DRG payment. The May 2006 final rule modified the limitation in clause (1) above to reduce payment for SSO cases to 100 percent (rather than 120 percent) of the cost of the case. The final rule also added a fourth limitation, capping payment for SSO cases at a per diem rate derived from blending 120 percent of the LTC-DRG specific per diem amount with a per diem rate based on the general acute care hospital IPPS. Under this methodology, as a patient's length of stay increases, the percentage of the per diem amount based upon the IPPS component will decrease and the percentage based on the LTC-DRG component will increase.

In addition, for discharges occurring on or after July 1, 2006, the May 2006 final rule provided for (i) a zero-percent update to the LTCH-PPS standard federal rate used as a basis for LTCH-PPS payments for the 2007 LTCH-PPS rate year; (ii) the elimination of the surgical case exception to the three-day or less interruption of stay policy, under which Medicare reimburses a general acute care hospital directly for surgical services furnished to a long-term acute care hospital patient during a brief interruption of stay from the long-term acute care hospital, rather than requiring the long-term acute care hospital to bear responsibility for such surgical services; and (iii) increasing the costs that a long-term acute care hospital must bear before Medicare will make additional payments for a case under its high-cost outlier policy for the 2007 LTCH-PPS rate year.

CMS estimated that the changes in the May 2006 final rule would result in an approximately 3.7 percent decrease in LTCH Medicare payments-per-discharge as compared to the 2006 rate year, largely attributable to the revised SSO payment methodology. We estimated that the May 2006 final rule reduced Medicare revenues associated with SSO cases and high-cost outlier cases to our long-term acute care hospitals by approximately $29.3 million for the 2006 rate year (July 1, 2006 to June 30, 2007). Of this amount, we estimated an effect of approximately $15.3 million on our Medicare payments for 2007 and $14.0 million on our Medicare payments for 2006.

Additionally, had CMS updated the LTCH-PPS standard federal rate by the 2007 estimated market basket index of 3.4 percent rather than applying the zero-percent update, we estimated that we would have received approximately $31.0 million in additional annual Medicare revenues, based on our historical Medicare patient volumes and revenues (such revenues would have been paid to our hospitals for discharges beginning on or after July 1, 2006).

August 2006 Final Rule. On August 18, 2006, CMS published the IPPS final rule for fiscal year 2007 which is the period from October 1, 2006 through September 30, 2007, which included an update of the LTC-DRG relative weights for fiscal year 2007. CMS estimated the changes to the relative weights would reduce LTCH Medicare payments-per-discharge by approximately 1.3 percent in fiscal year 2007. The

August 2006 final rule also included changes to the diagnosis related groups in IPPS that apply to LTCHs, as the LTC-DRGs are based on the IPPS DRGs. CMS created twenty new DRGs and modified thirty-two others, including LTC-DRGs. Prior to the August 2006 final rule, certain HIHs that were in existence on or before September 30, 1995, and certain satellite facilities that were in existence on or before September 30, 1999, referred to as "grandfathered" HIHs or satellites, were not subject to certain HIH "separateness and control" requirements as long as the "grandfathered" HIHs or satellites continued to operate under the same terms and conditions, including the number of beds and square footage, in effect on September 30, 2003 (for grandfathered HIHs) or September 30, 1999 (for grandfathered satellites). These grandfathered HIHs were also not subject to the payment adjustments for discharged Medicare patients admitted from their host hospitals in excess of the specified percentage threshold, as discussed in the August 2004 rule above. The August 2006 final rule revised the regulations to provide grandfathered HIHs and satellites more flexibility in adjusting square footage upward or downward, or decreasing the number of beds without being subject to the "separateness and control" requirements and payment adjustment provisions. As of December 31, 2007, we operated two grandfathered LTCH HIHs.

May 2007 Final Rule. On May 1, 2007, CMS published its annual payment rate update for the 2008 LTCH-PPS rate year ("RY 2008") (affecting discharges and cost reporting periods beginning on or after July 1, 2007 and before July 1, 2008). The May 2007 final rule makes several changes to LTCH-PPS payment methodologies and amounts during RY 2008, although, as described below, many of these changes have been postponed for a three year period by the SCHIP Extension Act.

For cost reporting periods beginning on or after July 1, 2007, the May 2007 final rule expanded the current Medicare HIH admissions threshold to apply to Medicare patients admitted from any individual hospital. Previously, the admissions threshold was applicable only to Medicare HIH admissions from hospitals co-located with a LTCH or satellite of an LTCH. Under the final rule, free-standing LTCHs and grandfathered LTCH HIHs are subject to the Medicare admission thresholds, as well as HIHs and satellites that admit Medicare patients from non-co-located hospitals. To the extent that any LTCH's or LTCH satellite facility's discharges that are admitted from an individual hospital (regardless of whether the referring hospital is co-located with the LTCH or LTCH satellite) exceed the applicable percentage threshold during a particular cost reporting period, the payment rate for those discharges would be subject to a downward payment adjustment. Cases admitted in excess of the applicable threshold will be reimbursed at a rate comparable to that under general acute care IPPS, which is generally lower than LTCH-PPS rates. Cases that reach outlier status in the discharging hospital would not count toward the limit and would be paid under LTCH-PPS. CMS estimated the impact of the expansion of the Medicare admission thresholds would result in a reduction of 2.2% of the aggregate payments to all LTCHs in RY 2008.

The applicable percentage threshold is generally 25% after the completion of the phase-in period described below. The percentage threshold for LTCH discharges from a referring hospital that is an "MSA-dominant" hospital or a single urban hospital is the percentage of total Medicare discharges in the MSA that are from the referring hospital, but no less than 25% nor more than 50%. For Medicare discharges from LTCHs or LTCH satellites located in rural areas, as defined by the Office of Management and Budget, the percentage threshold is 50% from any individual referring hospital. The expanded 25% rule is being phased in over a three year period. The three year transition period starts with cost reporting periods beginning on or after July 1, 2007 and before July 1, 2008, when the threshold is the lesser of 75% or the percentage of the LTCH's or LTCH satellite's admissions discharged from the referring hospital during its cost reporting period beginning on or after July 1, 2004 and before July 1, 2005 ("RY 2005"). For cost reporting periods beginning on or after July 1, 2008 and before July 1, 2009, the threshold will be the lesser of 50% or the percentage of the LTCH's or LTCH satellite's admissions from the referring hospital, during its RY 2005 cost reporting period. For cost reporting periods beginning on or after July 1, 2009, all LTCHs will be subject to the 25% threshold (or applicable threshold for rural, urban-single, or MSA-dominant hospitals). The SCHIP Extension Act postpones the application of the percentage threshold to all free-standing and grandfathered LTCH HIHs for a three year period commencing on an LTCH's first cost reporting period on or after December 29, 2007. However, the SCHIP Extension Act does not postpone the application of the percentage threshold, or the transition period stated above, to those Medicare patients discharged from an LTCH HIH or HIH satellite that were admitted from a non-co-located hospital. The SCHIP Extension Act only postpones the expansion of the admission threshold in the May 2007 final rule to free-standing LTCHs and grandfathered LTCH HIHs.

The May 2007 final rule further revised the payment adjustment for SSO cases. Beginning with discharges on or after July 1, 2007, for cases with a length of stay that is less than the average length of stay plus one standard deviation for the same DRG under IPPS (the so-called "IPPS comparable threshold"), the rule effectively lowers the LTCH payment to a rate based on the general acute care hospital IPPS. SSO cases with covered lengths of stay that exceed the IPPS comparable threshold would continue to be paid under the SSO payment policy described above under the May 2006 final rule. Cases with a covered length of stay less than or equal to the IPPS comparable threshold and less than five-sixths of the geometric average length of stay for that DRG will be paid at an amount comparable to the IPPS per diem. The SCHIP Extension Act also negates, for the three year period beginning on December 29, 2007, the SSO policy changes made in the May 2007 final rule.

The May 2007 final rule updated the standard federal rate by 0.71% for RY 2008. As a result, the federal rate for RY 2008 is equal to $38,356.45, as compared to $38,086.04 for RY 2007. The SCHIP Extension Act eliminates the update to the standard federal rate for the last quarter of RY 2007 (April 1, 2008-June 30, 2008). In a technical correction to the May 2007 final rule, CMS increased the fixed-loss amount for high cost outlier in RY 2008 to $20,738, compared to $14,887 in RY 2007. CMS projected an estimated 0.4% decrease in LTCH payments in RY 2008 due to this change in the fixed-loss amount.

In a technical correction to the May 2007 final rule published on July 5, 2007, CMS estimated the overall impact of the May 2007 final rule to be a 1.2% decrease in total estimated LTCH PPS payments for RY 2008.

The May 2007 final rule provides that beginning with the annual payment rate updates to the LTC-DRG classifications and relative weights for the fiscal year 2008 ("FY 2008") (affecting discharges beginning on or after October 1, 2007 and before September 30, 2008) that annual updates to the LTC-DRG classification and relative weights are to have a budget neutral impact. Under the May 2007 final rule, future LTC-DRG reclassification and recalibrations, by themselves, should neither increase nor decrease the estimated aggregated LTCH PPS payments.

The May 2007 final rules are complex and the SCHIP Extension Act has postponed the implementation of certain of the May 2007 final rules. While we cannot predict the ultimate long-term impact of LTCH-PPS because the payment system remains subject to significant change, if the May 2007 final rules become effective as currently written, after the expiration of the SCHIP Extension Act our future net operating revenues and profitability will be adversely affected.

August 2007 Final Rule. On August 1, 2007, CMS published the IPPS final rule for FY 2008, which created a new patient classification system, with categories referred to as MS-DRGs and MS-LTC-DRGs, respectively, for hospitals reimbursed under IPPS and LTCH PPS. Beginning with discharges on or after October 1, 2007, the new classification categories take into account the severity of the patient's condition. CMS assigned relative weights to each MS-DRG and MS-LTC-DRG to reflect their relative use of medical care resources. We believe that, because of the relative weights and length of stay assigned to the MS-LTC-DRGs for the patient populations served by our hospitals, our long-term acute care hospital payments may be adversely affected.

The August 2007 final rule published a budget neutral update to the MS-LTC-DRG classification and relative weights. In the preamble to the IPPS final rule for FY 2008, CMS restated that it intends to continue to update the LTC-DRG weights annually in the IPPS rulemaking and those weights would be modified by a budget neutrality adjustment factor to ensure that estimated aggregate LTCH payments after reweighting are equal to estimated aggregate LTCH payments before reweighting.

Medicare, Medicaid and SCHIP Extension Act of 2007. On December 29, 2007, the President signed into law the SCHIP Extension Act. Among other changes in the federal health care programs, the SCHIP

Extension Act makes significant changes to Medicare policy for LTCHs, including a new statutory definition of an LTCH, a report to Congress on new LTCH patient criteria, relief from certain LTCH-PPS payment policies for three years, a three-year moratorium on the development of new LTCHs and LTCH beds, elimination of the payment update for the last quarter of rate year 2008, and new medical necessity reviews by Medicare contractors through at least October 1, 2010.

Previously, the statutory definition of an LTCH focused on the facility having an average length of stay of greater than 25 days. The SCHIP Extension Act adds to the statutory requirements by defining an LTCH as a hospital primarily engaged in providing inpatient services to Medicare beneficiaries with medically complex conditions that require a long hospital stay. In addition, by definition, LTCHs must meet certain facility criteria, including (i) instituting a review process that screens patients for appropriateness of an admission and validates the patient criteria within 48 hours of each patient's subsequent admission, evaluates regularly their patients for continuation of care and assesses the available discharge options; (ii) having active physician involvement with patient care that includes a physician available on-site daily and additional consulting physicians on call; and (iii) having an interdisciplinary team of health care professionals "to prepare and carry out an individualized treatment plan for each patient." We do not expect that these changes will have any impact on the designation of our hospitals as LTCHs.

The SCHIP Extension Act requires the Secretary of the Department of Health and Human Services to conduct a study on the establishment of national LTCH facility and patient criteria for the purpose of determining medical necessity, appropriateness of admissions and continued stay at, and discharge from, LTCHs. The Secretary must submit a report on the results of this study to Congress within 18 months following enactment of the SCHIP Extension Act. Both the study and the report are required to consider recommendations on LTCH-specific facility and patient criteria contained in a June 2004 report to Congress by the Medicare Payment Advisory Commission.

As described above, the SCHIP Extension Act precludes the Secretary from implementing during a three year moratorium period the provisions added by the May 2007 final rule that extended the 25% rule to freestanding LTCHs, including grandfathered LTCHs. The SCHIP Extension Act also modifies, during the moratorium, the effect of the 25% rule for LTCHs that are co-located with other hospitals. For HIHs and satellite facilities, the applicable percentage threshold is set at 50% and not phased-in to the 25% level. For HIHs and satellite facilities located in rural areas and those which receive referrals from MSA dominant hospitals or single urban hospitals (as defined by current regulation), the percentage threshold is set at no more than 75%, nor less than 50%. These moratoria relating to LTCH admission thresholds extend for an LTCH's three cost reporting periods beginning on or after December 29, 2007.

The SCHIP Extension Act also precludes the Secretary from implementing, for the three year period beginning on December 29, 2007, a one-time adjustment to the LTCH standard federal rate. This rule, established in the original LTCH-PPS regulations, permits CMS to restate the standard federal rate to reflect the effect of changes in coding since the LTCH-PPS base year. In the preamble to the May 2007 final rule, CMS discussed making a one-time prospective adjustment to the LTCH-PPS rates for the 2009 rate year. In addition, the SCHIP Extension Act reduces the Medicare payment update for the portion of rate year 2008 from April 1, 2008 to June 30, 2008 to the same base rate applied to LTCH discharges during rate year 2007.

For the three years following December 29, 2007, the Secretary must impose a moratorium on the establishment and classification of new LTCHs, LTCH satellite facilities, and LTCH beds in existing LTCH or satellite facilities. This moratorium does not apply to LTCHs that, before the date of enactment, (a) began the qualifying period for payment under the LTCH-PPS, (b) have a written agreement with an unrelated party for the construction, renovation, lease or demolition for a LTCH and have expended at least 10% of the estimated cost of the project or $2,500,000, or (c) have obtained an approved certificate of need. Additionally, an LTCH located in a state with only two LTCHs, may request an increase in licensed beds following the closure or decrease in the number of licensed beds at the other LTCH located within the state. As a result of the SCHIP Extension Act's three year moratorium on the development of new LTCHs, we have stopped all LTCH development, except for five LTCHs currently under construction that are excluded from the moratorium.

Beginning with LTCH discharges on or after October 1, 2007 and through September 30, 2010 (unless extended by the Secretary), the SCHIP Extension Act also requires the Secretary to significantly expand medical necessity review for patients admitted to LTCHs by instituting a review of the medical necessity of continued stays of patients admitted to LTCHs. The medical necessity reviews must include a representative sample that results in a 95% confidence interval and guarantees that at least 75% of overpayments received by LTCHs for medically unnecessary admissions and continued stays are recovered and not counted toward an LTCH's Medicare average length of stay. The Secretary may use up to 40% of the recouped overpayments to compensate the fiscal intermediaries and Medicare administrative contractors for the costs of conducting medical necessity reviews.

January 2008 Proposed Rule. On January 22, 2008, CMS released a proposed rule for RY 2009 that includes a net update of 2.6% to the standard federal rate in effect during RY 2007. CMS is proposing to make the RY 2009 rates effective for a 15-month period, from July 1, 2008 through September 30, 2009, by moving the LTCH rule from a July-June update cycle to the same update cycle as the hospital inpatient rule (October – September). For RY 2009, CMS is proposing to increase the fixed-loss amount for high cost outlier cases to $21,199 from $20,738. The proposal also reviews the possible establishment of patient and facility-level criteria for LTCHs and the Technical Expert Panels that were held in January and November of 2007.

Medicare Reimbursement of Outpatient Rehabilitation Services.

Beginning on January 1, 1999, the Balanced Budget Act of 1997 (the "BBA") subjected certain outpatient therapy providers reimbursed under the Medicare physician fee schedule to annual limits for therapy expenses. Effective January 1, 2008, the annual limit on outpatient therapy services is $1,810 for combined physical and speech language pathology services and $1,810 for occupational therapy services. In the Deficit Reduction Act of 2005, Congress implemented an exceptions process to the annual limit for therapy expenses. Under this process, a Medicare enrollee (or person acting on behalf of the Medicare enrollee) is able to request an exception from the therapy caps if the provision of therapy services was deemed to be medically necessary. Therapy cap exceptions were available automatically for certain conditions and on a case-by-case basis upon submission of documentation of medical necessity. The SCHIP Extension Act extended the cap exceptions process through June 30, 2008. Prior to implementing the exceptions process to the therapy caps, only hospitals could bill for outpatient rehabilitation services that exceeded the annual caps. The exception process allows medically necessary outpatient services billed in any setting to exceed caps if they meet the criteria for exception. Through June 30, 2008, Medicare reimbursement to non-hospital providers for rehabilitation services is not limited by the therapy cap as long as the services are documented as medically necessary. Without further action, the therapy cap exception process will expire July 1, 2008. Elimination of the therapy cap exceptions may reduce our future net operating revenues and profitability.

Historically, outpatient rehabilitation services have been subject to scrutiny by the Medicare program for, among other things, medical necessity for services, appropriate documentation for services, supervision of therapy aides and students and billing for group therapy. CMS has issued guidance to clarify that services performed by a student are not reimbursed even if provided under "line of sight" supervision of the therapist. Likewise, CMS has reiterated that Medicare does not pay for services provided by aides regardless of the level of supervision. CMS also has issued instructions that outpatient physical and occupational therapy services provided simultaneously to two or more individuals by a practitioner should be billed as group therapy services.

Medicare Reimbursement of Inpatient Rehabilitation Facility Services.

Inpatient rehabilitation facilities are paid under a prospective payment system specifically applicable to this provider type, which is referred to as "IRF-PPS." Under the IRF-PPS, each patient discharged from an inpatient rehabilitation facility is assigned to a case mix group or "IRF-CMG" containing patients with similar clinical problems that are expected to require similar amounts of resources. An inpatient rehabilitation facility is generally paid a pre-determined fixed amount applicable to the assigned IRF-CMG (subject to applicable case adjustments related to length of stay and facility level adjustments for location and low income patients). The payment amount for each IRF-CMG is intended to reflect the average cost of treating a Medicare patient's condition in an inpatient rehabilitation facility relative to patients with conditions described by other IRF-CMGs. The IRF-PPS also includes special payment policies that adjust the payments for some patients based on the patient's length of stay, the facility's costs, whether the patient was discharged and readmitted and other factors. As required by Congress, IRF-CMG payments rates have been set to maintain budget neutrality with total expenditures that would have been made under the previous reasonable cost based system. The IRF-PPS was phased-in over a transition period in 2002. For cost reporting periods beginning on or after October 1, 2002, inpatient rehabilitation facilities are paid solely on the basis of the IRF-PPS payment rate.

Although the initial IRF-PPS regulations did not change the criteria that must be met in order for a hospital to be certified as an inpatient rehabilitation facility, CMS adopted a separate final rule on May 7, 2004 that made significant changes to those criteria. The new inpatient rehabilitation facility certification criteria became effective for cost reporting periods beginning on or after July 1, 2004. Under the historic IRF certification criteria that had been in effect since 1983, in order to qualify as an IRF, a hospital was required to satisfy certain operational criteria as well as demonstrate that, during its most recent 12-month cost reporting period, it served an inpatient population of whom at least 75% required intensive rehabilitation services for one or more of ten conditions specified in the regulation (referred to as the "75% test"). In 2002, CMS became aware that its various contractors were using inconsistent methods to assess compliance with the 75% test and that the percentage of inpatient rehabilitation facilities in compliance with the 75% test might be low. In response, in June 2002, CMS suspended enforcement of the 75% test and, on September 9, 2003, proposed modifications to the regulatory standards for certification as an inpatient rehabilitation facility. In addition, during 2003, several CMS contractors, promulgated draft local medical review policies that would change the guidelines used to determine the medical necessity for inpatient rehabilitation care.

CMS adopted four major changes to the 75% test in its May 7, 2004 final rule. First, CMS temporarily lowered the 75% compliance threshold, as follows: (i) 50% for cost reporting periods beginning on or after July 1, 2004 and before July 1, 2005; (ii) 60% for cost reporting periods beginning on or after July 1, 2005 and before July 1, 2006; (iii) 65% for cost reporting periods beginning on or after July 1, 2006 and before July 1, 2007; and (iv) 75% for cost reporting periods beginning on or after July 1, 2007. Second, CMS modified and expanded from 10 to 13 the medical conditions used to determine whether a hospital qualifies as an inpatient rehabilitation facility. Third, the agency finalized the conditions under which comorbidities can be used to verify compliance with the 75% test. Fourth, CMS changed the timeframe used to determine compliance with the 75% test from "the most recent 12-month cost reporting period" to "the most recent, consecutive, and appropriate 12-month period," with the result that a determination of non-compliance with the applicable compliance threshold will affect the facility's certification for its cost reporting period that begins immediately after the 12-month review period.

Congress temporarily suspended CMS enforcement of the 75% test under the Consolidated Appropriations Act, 2005, enacted on December 8, 2004. The Act required the Secretary to respond within 60 days to a study by the Government Accountability Office, or GAO, on the standards for defining inpatient rehabilitation services before the Secretary may use funds appropriated under the Act to redesignate as a general acute care hospital any hospital that was certified as an inpatient rehabilitation facility on or before June 30, 2004 as a result of the hospital's failure to meet the 75% test. The GAO issued its study on April 22, 2005, and recommended that CMS, based on further research, refine the 75% test to describe more thoroughly the subgroups of patients within the qualifying conditions that are appropriate for care in an inpatient rehabilitation facility. The Secretary issued a formal response to the

GAO study on June 24, 2005, in which it concluded that the revised inpatient rehabilitation facility certification standards, including the 75% test, were not inconsistent with the recommendations in the GAO report. In light of this determination, the Secretary announced that CMS would immediately begin enforcement of the revised certification standards.

Subsequently, under the Deficit Reduction Act of 2005, enacted on February 8, 2006, Congress extended the phase-in period for the 75% test by maintaining the compliance threshold at 60% (rather than increasing it to 65%) during the 12-month period beginning on July 1, 2006. The compliance threshold then increases to 65% for cost reporting periods beginning on or after July 1, 2007 and again to 75% for cost reporting periods beginning on or after July 1, 2008. The regulatory text was revised accordingly in the final rule updating the prospective payment rates for fiscal year 2007, as published by CMS on August 18, 2006. In the August 2006 final rule updating IRF-PPS, CMS also reduced the standard payment amount by 2.6% and updated the outlier threshold for fiscal year 2007 to $5,534. In the August 2007 final rule updating IRF-PPS, the compliance threshold increased to 65% for cost reporting periods beginning on or after July 1, 2007 and again to 75% for cost reporting periods beginning on or after July 1, 2008. As stipulated in the August 2007 final rule, for cost reporting periods beginning on or after July 1, 2008 comorbidities would not be used to determine whether an IRF meets the 75% test.

The SCHIP Extension Act includes a permanent freeze in the patient classification criteria compliance threshold at 60% (with comorbidities counting toward this threshold) and a payment freeze from April 1, 2008 through September 30, 2009. In order to comply with Medicare inpatient rehabilitation facility certification criteria, it may be necessary for our IRFs to implement restrictive admissions policies and not admit patients whose diagnoses fall outside the thirteen specified conditions. Such policies may result in reduced patient volumes, which could have a negative effect on financial performance.

In addition to meeting the compliance threshold, a hospital must meet other facility criteria to be classified as an IRF, including: (1) a provider agreement to participate as a hospital in Medicare; (2) a preadmission screening procedure; (3) ensuring that patients receive close medical supervision and furnish, through the use of qualified personnel, rehabilitation nursing, physical therapy, and occupational therapy, plus, as needed, speech therapy, social or psychological services, and orthotic and prosthetic services; (4) a full-time, qualified director of rehabilitation; (5) a plan of treatment for each inpatient that is established, reviewed, and revised as needed by a physician in consultation with other professional personnel who provide services to the patient; (6) a coordinated multidisciplinary team approach in the rehabilitation of each inpatient, as documented by periodic clinical entries made in the patient's medical record to note the patient's status in relationship to goal attainment, and that team conferences are held at least every two weeks to determine the appropriateness of treatment. Failure to comply with any of the classification criteria, including the compliance threshold, may cause a hospital to lose its exclusion from the prospective payment system that applies to general acute care hospitals and, as a result, no longer be eligible for payment at a higher rate.

The SCHIP Extension Act requires the Secretary, in consultation with providers, trade organizations and the Medicare Payment Advisory Commission, to prepare an analysis of the compliance threshold for the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate. Among other things, the analysis must include the potential effect of the 75% rule on access to care, alternatives to the 75% rule policy for certifying inpatient rehabilitation hospitals, and the appropriate setting of care for conditions of patients commonly admitted to IRFs that are not one the thirteen specified conditions. In requiring the Secretary to produce a recommendation for classifying IRFs, Congress used the term “75 percent rule” for the first time to describe the compliance threshold requirement, while at the same time freezing the threshold at 60%. The results of this analysis may impact future policies, regulations and statutes governing IRF-PPS.

Critical Accounting Matters

Sources of Revenue

Our net operating revenues are derived from a number of sources, including commercial, managed care, private and governmental payors. Our net operating revenues include amounts estimated by management to be reimbursable from each of the applicable payors and the federal Medicare program. Amounts we receive for treatment of patients are generally less than the standard billing rates. We account for the differences between the estimated reimbursement rates and the standard billing rates as contractual adjustments, which we deduct from gross revenues to arrive at net operating revenues.

Net operating revenues generated directly from the Medicare program from all segments represented approximately 48%, 53% and 56% of net operating revenues for the year ended December 31, 2007, the year ended December 31, 2006, and the combined year ended December 31, 2005, respectively. Approximately 65%, 69% and 73% of our specialty hospital revenues for the year ended December 31, 2007, the year ended December 31, 2006, and the combined year ended December 31, 2005, respectively, were received in respect of services provided to Medicare patients.

Most of our specialty hospitals receive bi-weekly periodic interim payments ("PIP") from Medicare instead of being paid on an individual claim basis. Under a PIP payment methodology, Medicare estimates a hospital's claim volume based on historical trends and periodically reconciles the differences between the actual claim data and the estimated payments. At each balance sheet date, we record the difference between our actual claims and the PIP payments as a receivable or payable from third-party payors on our balance sheet.

Contractual Adjustments

Net operating revenues include amounts estimated by us to be reimbursable by Medicare and Medicaid under prospective payment systems and provisions of cost-reimbursement and other payment methods. In addition, we are reimbursed by non-governmental payors using a variety of payment methodologies. Amounts we receive for treatment of patients covered by these programs are generally less than the standard billing rates. Contractual allowances are calculated and recorded through our internally developed systems. Within our hospital segment our billing system automatically calculates estimated Medicare reimbursement and associated contractual allowances. For non-governmental payors, we manually calculate the contractual allowance for each patient based upon the contractual provisions associated with the specific payor. In our outpatient segment, we perform provision testing, using internally developed systems, whereby we monitor a payors' historical paid claims data and compare it against the associated gross charges. This difference is determined as a percentage of gross charges and is applied against gross billing revenue to determine the contractual allowances for the period. Additionally, these contractual percentages are applied against the gross receivables on the balance sheet to determine that adequate contractual reserves are maintained for the gross accounts receivables reported on the balance sheet. We account for any difference as additional contractual adjustments deducted from gross revenues to arrive at net operating revenues in the period that the difference is determined. The estimation processes described above and used in recording our contractual adjustments have historically yielded consistent and reliable results.

Allowance for Doubtful Accounts

Substantially all of our accounts receivable are related to providing healthcare services to patients. Collection of these accounts receivable is our primary source of cash and is critical to our operating performance. Our primary collection risks relate to non-governmental payors who insure these patients, and deductibles, co-payments and self-insured amounts owed by the patient. Deductible, co-payments and self-insured amounts are an immaterial portion of our net accounts receivable balance. At December 31, 2007, deductible, co-payments and self-insured amounts owed by the patient accounted for approximately 0.3% of our net accounts receivable balance before doubtful accounts. Our general policy is to verify insurance coverage prior to the date of admission for a patient admitted to our hospitals or in the case of our outpatient rehabilitation clinics, we verify insurance coverage prior to their first therapy visit. Our estimate for the allowance for doubtful accounts is calculated by generally reserving as uncollectible all governmental accounts over 365 days and non-governmental accounts over 180 days from discharge. This method is monitored based on our historical cash collections experience. Collections are impacted by the effectiveness of our collection efforts with non-governmental payors and regulatory or administrative disruptions with the fiscal intermediaries that pay our governmental receivables.

We estimate bad debts for total accounts receivable within each of our operating units. We believe our policies have resulted in reasonable estimates determined on a consistent basis. We believe that we collect substantially all of our third-party insured receivables (net of contractual allowances) which includes receivables from governmental agencies. We review our overall reserve adequacy by monitoring historical cash collections as a percentage of net revenue less the provision for bad debts.

Uncollected accounts are written off the balance sheet when they are turned over to an outside collection agency, or when management determines that the balance is uncollectible, whichever occurs first.

The following table is an aging of our net (after allowances for contractual adjustments but before doubtful accounts) accounts receivable (in thousands):

	Balance as of December 31,			
	2006		2007	
	0-90 Days	Over 90 Days	0-90 Days	Over 90 Days
Medicare and Medicaid	$ 56,558	$ 15,216	$ 76,927	$ 15,131
Commercial insurance, and other	116,552	66,907	175,152	60,052
Total net accounts receivable	$ 173,110	$ 82,123	$ 252,079	$ 75,183

The approximate percentage of total net accounts receivable (after allowance for contractual adjustments but before doubtful accounts) summarized by aging categories is as follows:

	As of December 31,	
	2006	2007
0 to 90 days	67.8%	77.0%
91 to 180 days	10.8%	10.0%
181 to 365 days	8.4%	6.0%
Over 365 days	13.0%	7.0%
Total	100.0%	100.0%

The approximate percentage of total net accounts receivable (after allowance for contractual adjustments but before doubtful accounts) summarized by payor is as follows:

	As of December 31,	
	2006	2007
Insured receivables	99.1%	99.7%
Self-pay receivables (including deductible and copayments)	0.9%	0.3%
Total	100.0%	100.0%

Insurance

Under a number of our insurance programs, which include our employee health insurance program, our workers' compensation, our professional liability insurance programs and certain components under our property and casualty insurance program, we are liable for a portion of our losses. In these cases we accrue for our losses under an occurrence based principle whereby we estimate the losses that will be incurred by us in a given accounting period and accrue that estimated liability. Where we have substantial exposure, we utilize actuarial methods in estimating the losses. In cases where we have minimal exposure, we will estimate our losses by analyzing historical trends. We monitor these programs quarterly and revise our estimates as necessary to take into account additional information. At December 31, 2007 and December

31, 2006, we have recorded a liability of $58.9 million and $60.0 million, respectively, for our estimated losses under these insurance programs.

Related Party Transactions

We are party to various rental and other agreements with companies affiliated with us through common ownership. Our payments to these related parties amounted to $2.3 million for both the year ended December 31, 2007 and December 31, 2006. Our future commitments are related to commercial office space we lease for our corporate headquarters in Mechanicsburg, Pennsylvania. These future commitments amount to $35.9 million through 2023. These transactions and commitments are described more fully in the notes to our consolidated financial statements included herein.

Consideration of Impairment Related to Goodwill and Other Intangible Assets

Goodwill and certain other indefinite-lived intangible assets are no longer amortized, but instead are subject to periodic impairment evaluations under Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets." Our most recent impairment assessment was completed during the fourth quarter of 2007, which indicated that there was no impairment with respect to goodwill or other recorded intangible assets. The majority of our goodwill resides in our Specialty Hospital reporting unit. In performing periodic impairment tests, the fair value of the reporting unit is compared to the carrying value, including goodwill and other intangible assets. If the carrying value exceeds the fair value, an impairment condition exists, which results in an impairment loss equal to the excess carrying value. Impairment tests are required to be conducted at least annually, or when events or conditions occur that might suggest a possible impairment. These events or conditions include, but are not limited to, a significant adverse change in the business environment, regulatory environment or legal factors; a current period operating or cash flow loss combined with a history of such losses or a projection of continuing losses; or a sale or disposition of a significant portion of a reporting unit. The occurrence of one of these events or conditions could significantly impact an impairment assessment, necessitating an impairment charge and adversely affecting our results of operations. For purposes of goodwill impairment assessment, we have defined our reporting units as specialty hospitals, outpatient rehabilitation clinics and contract therapy with goodwill having been allocated among reporting units based on the relative fair value of those divisions when the Merger occurred in 2005 and based on subsequent acquisitions.

To determine the fair value of our reporting units, we use a discounted cash flow approach. Included in this analysis are assumptions regarding revenue growth rates, internal development of specialty hospitals and rehabilitation clinics, future EBITDA margin estimates, future selling, general and administrative expense rates and the industry's weighted average cost of capital. We also must estimate residual values at the end of the forecast period and future capital expenditure requirements. Each of these assumptions requires us to use our knowledge of (1) our industry, (2) our recent transactions, and (3) reasonable performance expectations for our operations. If any one of the above assumptions changes or fails to materialize, the resulting decline in our estimated fair value could result in a material impairment charge to the goodwill associated with any one of the reporting units.

Realization of Deferred Tax Assets

We account for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes" ("SFAS No. 109") which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS No. 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax asset will not be realized. As part of the process of preparing our consolidated financial statements, we estimate our income taxes based on our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. We also recognize as deferred tax assets the future tax benefits from net operating loss carryforwards. We evaluate the realizability of these deferred tax assets by assessing their valuation allowances and by adjusting the amount of such allowances, if necessary. Among the factors used to assess the likelihood of realization are our projections of future taxable income streams, the expected timing of the reversals of existing temporary differences, and the impact of tax planning strategies that could be implemented to avoid the potential loss of future tax benefits. However, changes in tax codes, statutory tax rates or future taxable income levels could materially impact our valuation of tax accruals and assets and could cause our provision for income taxes to vary significantly from period to period.

At December 31, 2007, we had deferred tax assets in excess of deferred tax liabilities of approximately $26.0 million and $25.6 million for Holdings and Select, respectively. This amount is net of approximately $16.8 million of valuation reserves related to state tax net operating losses that may not be realized.

Uncertain Tax Positions

We record and review quarterly our uncertain tax positions. Reserves for uncertain tax positions are established for exposure items related to various federal and state tax matters. Income tax reserves are recorded when an exposure is identified and when, in the opinion of management, it is more likely than not that a tax position will not be sustained and the amount of the liability can be estimated. While we believe that our reserves for uncertain tax positions are adequate, the settlement of any such exposures at amounts that differ from current reserves may require us to materially increase or decrease our reserves for uncertain tax positions.

Operating Statistics

The following table sets forth operating statistics for our specialty hospitals and our outpatient rehabilitation clinics for each of the periods presented. The data in the table reflect the changes in the number of specialty hospitals and outpatient rehabilitation clinics we operate that resulted from acquisitions, start-up activities, closures and consolidations. The operating statistics reflect data for the period of time these operations were managed by us.

	Combined Year Ended December 31, 2005	Year Ended December 31, 2006	Year Ended December 31, 2007
Specialty hospital data(1):			
Number of hospitals — start of period	86	101	96
Number of hospital start-ups	—	3	3
Number of hospitals acquired	17	—	—
Number of hospitals closed	(2)	(4)	(8)
Number of hospitals consolidated	—	(4)	(4)
Number of hospitals — end of period	101	96	87
Available licensed beds	3,829	3,867	3,819
Admissions	39,963	39,668	40,008
Patient days	985,025	969,590	987,624
Average length of stay (days)	25	24	25
Net revenue per patient day(2)	$ 1,370	$ 1,392	$ 1,378
Occupancy rate	70%	69%	69%
Percent patient days — Medicare	75%	73%	69%
Outpatient rehabilitation data (3):			
Number of clinics owned — start of period	589	553	477
Number of clinics acquired	—	—	570
Number of clinic start-ups	22	12	15
Number of clinics closed/sold(4)	(58)	(88)	(144)
Number of clinics owned — end of period	553	477	918
Number of clinics managed — end of period	55	67	81
Total number of clinics (all) — end of period	608	544	999
Number of visits	3,308,620	2,972,243	4,032,197
Net revenue per visit(5)	$ 89	$ 94	$ 100

(1) Specialty hospitals consist of long-term acute care hospitals and inpatient rehabilitation facilities.

(2) Net revenue per patient day is calculated by dividing specialty hospital inpatient service revenues by the total number of patient days.

(3) Clinic data excludes clinics operated by CBIL. CBIL was sold March 31, 2006 and is being reported as a discontinued operation in 2005 and 2006.

(4) The number of clinics closed/sold for the year ended December 31, 2007 relate primarily to clinics closed in connection with the restructuring plan for integrating the acquisition of HealthSouth Corporation's outpatient rehabilitation division.

(5) Net revenue per visit is calculated by dividing outpatient rehabilitation clinic revenue by the total number of visits. For purposes of this computation, outpatient rehabilitation clinic revenue does not include contract services revenue.

Results of Operations

The following tables present the combined consolidated statement of operations for the combined year ended December 31, 2005. This data was derived by adding the financial data for the period after the Merger, February 25, 2005 through December 31, 2005 (Successor Period) to the financial data for the period from January 1, 2005 through February 24, 2005 (Predecessor Period).

	Select Medical Holdings Corporation		
	Predecessor	Successor	Combined
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	Year Ended December 31, 2005
		(in thousands)	
Net operating revenues	$ 277,736	$ 1,580,706	$ 1,858,442
Costs and expenses:			
Cost of services	244,321	1,244,361	1,488,682
General and administrative	122,509	59,494	182,003
Bad debt expense	6,588	18,213	24,801
Depreciation and amortization	5,933	37,922	43,855
Total costs and expenses	379,351	1,359,990	1,739,341
Income (loss) from operations	(101,615)	220,716	119,101
Other income and expense:			
Loss on early retirement of debt	(42,736)	—	(42,736)
Merger related charges	(12,025)	—	(12,025)
Other income	267	1,092	1,359
Interest income	523	767	1,290
Interest expense	(4,651)	(102,208)	(106,859)
Income (loss) from continuing operations before minority interests and income taxes	(160,237)	120,367	(39,870)
Minority interest in consolidated subsidiary companies	330	1,776	2,106
Income (loss) from continuing operations before income taxes	(160,567)	118,591	(41,976)
Income tax expense (benefit)	(59,794)	49,336	(10,458)
Income (loss) from continuing operations	(100,773)	69,255	(31,518)
Income from discontinued operations, net of tax	522	3,072	3,594
Net income (loss)	$ (100,251)	$ 72,327	$ (27,924)

	Select Medical Corporation		
	Predecessor	Successor	Combined
	Period from January 1 through February 24, 2005	Period from February 25 through December 31, 2005	Year Ended December 31, 2005
		(in thousands)	
Net operating revenues	$ 277,736	$ 1,580,706	$ 1,858,442
Costs and expenses:			
Cost of services	244,321	1,244,361	1,488,682
General and administrative	122,509	59,494	182,003
Bad debt expense	6,588	18,213	24,801
Depreciation and amortization	5,933	37,922	43,855
Total costs and expenses	379,351	1,359,990	1,739,341
Income (loss) from operations	(101,615)	220,716	119,101
Other income and expense:			
Loss on early retirement of debt	(42,736)	—	(42,736)
Merger related charges	(12,025)	—	(12,025)
Other income	267	3,018	3,285
Interest income	523	767	1,290
Interest expense	(4,651)	(83,752)	(88,403)
Income (loss) from continuing operations before minority interests and income taxes	(160,237)	140,749	(19,488)
Minority interest in consolidated subsidiary companies	330	1,776	2,106
Income (loss) from continuing operations before income taxes	(160,567)	138,973	(21,594)
Income tax expense (benefit)	(59,794)	56,470	(3,324)
Income (loss) from continuing operations	(100,773)	82,503	(18,270)
Income from discontinued operations, net of tax	522	3,072	3,594
Net income (loss)	$ (100,251)	$ 85,575	$ (14,676)

The following tables outline, for the periods indicated, selected operating data as a percentage of net operating revenues:

	Select Medical Holdings Corporation		
	Combined Year Ended December 31, 2005 (1)	Year Ended December 31, 2006	Year Ended December 31, 2007
Net operating revenues	100.0%	100.0%	100.0%
Cost of services (2)	80.1	80.2	83.3
General and administrative	9.8	2.4	2.2
Bad debt expense	1.3	1.0	1.9
Depreciation and amortization	2.4	2.5	2.9
Income from operations	6.4	13.9	9.7
Loss on early retirement of debt	(2.3)	—	—
Merger related charges	(0.7)	—	—
Other income	0.1	—	—
Interest expense, net	(5.7)	(7.1)	(6.9)
Income (loss) from continuing operations before minority interests and income taxes	(2.2)	6.8	2.8
Minority interests	0.1	0.1	0.1
Income (loss) from continuing operations before income taxes	(2.3)	6.7	2.7
Income tax expense (benefit)	(0.6)	2.4	0.9
Income (loss) from continuing operations	(1.7)	4.3	1.8
Income from discontinued operations, net of tax	0.2	0.7	—
Net income (loss)	(1.5)%	5.0%	1.8%

	Select Medical Corporation		
	Combined Year Ended December 31, 2005 (1)	Year Ended December 31, 2006	Year Ended December 31, 2007
Net operating revenues	100.0%	100.0%	100.0%
Cost of services (2)	80.1	80.2	83.3
General and administrative	9.8	2.4	2.2
Bad debt expense	1.3	1.0	1.9
Depreciation and amortization	2.4	2.5	2.9
Income from operations	6.4	13.9	9.7
Loss on early retirement of debt	(2.3)	—	—
Merger related charges	(0.7)	—	—
Other income (expense)	0.2	0.1	(0.2)
Interest expense, net	(4.7)	(5.2)	(5.2)
Income (loss) from continuing operations before minority interests and income taxes	(1.1)	8.8	4.3
Minority interests	0.1	0.1	0.1
Income (loss) from continuing operations before income taxes	(1.2)	8.7	4.2
Income tax expense (benefit)	(0.2)	3.0	1.4
Income (loss) from continuing operations	(1.0)	5.7	2.8
Income from discontinued operations, net of tax	0.2	0.7	—
Net income (loss)	(0.8)%	6.4%	2.8%

The following table summarizes selected financial data by business segment, for the periods indicated:

	Select Medical Holdings Corporation				
	Combined Year Ended December 31, 2005 (1)	**Year Ended December 31, 2006**	**Year Ended December 31, 2007**	**% Change 2005-2006**	**% Change 2006-2007**
	(in thousands)				
Net operating revenues:					
Specialty hospitals	$1,372,483	$ 1,378,543	$ 1,386,410	0.4%	0.6%
Outpatient rehabilitation	480,711	470,339	603,413	(2.2)	28.3
Other (4)	5,248	2,616	1,843	(50.2)	(29.5)
Total company	$1,858,442	$ 1,851,498	$ 1,991,666	(0.4)%	7.6%
Income (loss) from operations:					
Specialty hospitals	$ 280,789	$ 252,539	$ 180,090	(10.1)%	(28.7)%
Outpatient rehabilitation	56,052	51,859	57,979	(7.5)	11.8
Other (4)	(217,740)	(46,524)	(44,184)	78.6	5.0
Total company	$ 119,101	$ 257,874	$ 193,885	116.5%	(24.8)%
Adjusted EBITDA: (3)					
Specialty hospitals	$ 308,144	$ 283,270	$ 217,175	(8.1)%	(23.3)%
Outpatient rehabilitation	65,957	64,823	75,437	(1.7)	16.4
Other (4)	(44,167)	(39,769)	(37,684)	10.0	5.2
Adjusted EBITDA margins: (3)					
Specialty hospitals	22.5%	20.5%	15.7%	(8.9)%	(23.4)%
Outpatient rehabilitation	13.7	13.8	12.5	0.7	(9.4)
Other (4) :	N/M	N/M	N/M	N/M	N/M
Total assets:					
Specialty hospitals	$1,656,224	$ 1,742,803	$ 1,882,476		
Outpatient rehabilitation	293,720	258,773	513,397		
Other	218,441	180,948	99,173		
Total company (4)	$2,168,385	$ 2,182,524	$ 2,495,046		
Purchases of property and equipment, net:					
Specialty hospitals	$ 102,323	$ 146,291	$ 146,901		
Outpatient rehabilitation	3,750	6,527	14,737		
Other (4)	3,873	2,278	4,436		
Total company	$ 109,946	$ 155,096	$ 166,074		

	Select Medical Corporation				
	Combined Year Ended December 31, 2005 (1)	Year Ended December 31, 2006	Year Ended December 31, 2007	% Change 2005-2006	% Change 2006-2007
			(in thousands)		
Net operating revenues:					
Specialty hospitals	$1,372,483	$ 1,378,543	$ 1,386,410	0.4%	0.6%
Outpatient rehabilitation	480,711	470,339	603,413	(2.2)	28.3
Other (4)	5,248	2,616	1,843	(50.2)	(29.5)
Total company	$1,858,442	$ 1,851,498	$ 1,991,666	(0.4)%	7.6%
Income (loss) from operations:					
Specialty hospitals	$ 280,789	$ 252,539	$ 180,090	(10.1)%	(28.7)%
Outpatient rehabilitation	56,052	51,859	57,979	(7.5)	11.8
Other (4)	(217,740)	(46,524)	(44,184)	78.6	5.0
Total company	$ 119,101	$ 257,874	$ 193,885	116.5%	(24.8)%
Adjusted EBITDA: (3)					
Specialty hospitals	$ 308,144	$ 283,270	$ 217,175	(8.1)%	(23.3)%
Outpatient rehabilitation	65,957	64,823	75,437	(1.7)	16.4
Other (4)	(44,167)	(39,769)	(37,684)	10.0	5.2
Adjusted EBITDA margins: (3)					
Specialty hospitals	22.5%	20.5%	15.7%	(8.9)%	(23.4)%
Outpatient rehabilitation	13.7	13.8	12.5	0.7	(9.4)
Other (4) :	N/M	N/M	N/M	N/M	N/M
Total assets:					
Specialty hospitals	$1,656,224	$ 1,742,803	$ 1,882,476		
Outpatient rehabilitation	293,720	258,773	513,397		
Other	213,425	176,066	94,904		
Total company (4)	$2,163,369	$ 2,177,642	$ 2,490,777		
Purchases of property and equipment, net:					
Specialty hospitals	$ 102,323	$ 146,291	$ 146,901		
Outpatient rehabilitation	3,750	6,527	14,737		
Other (4)	3,873	2,278	4,436		
Total company	$ 109,946	$ 155,096	$ 166,074		

The following tables reconcile same hospitals information:

	Select Medical Holdings Corporation Year Ended December 31, 2005 (1)	Select Medical Holdings Corporation Year Ended December 31, 2006	Select Medical Corporation Year Ended December 31, 2005 (1)	Select Medical Corporation Year Ended December 31, 2006
	(in thousands)		(in thousands)	
Net operating revenue				
Specialty hospitals net operating revenue	$ 1,372,483	$ 1,378,543	$ 1,372,483	$ 1,378,543
Less: Specialty hospitals in development, opened or closed after 1/1/05	49,046	23,764	49,046	23,764
Specialty hospitals same store net operating revenue	$ 1,323,437	$ 1,354,779	$ 1,323,437	$ 1,354,779
Adjusted EBITDA (3)				
Specialty hospitals Adjusted EBITDA (3)	$ 308,144	$ 283,270	$ 308,144	$ 283,270
Less: Specialty hospitals in development, opened or closed after 1/1/05	5,404	(9,344)	5,404	(9,344)
Specialty hospitals same store Adjusted EBITDA (3)	$ 302,740	$ 292,614	$ 302,740	$ 292,614
All specialty hospitals Adjusted EBITDA margin (3)	22.5%	20.5%	22.5%	20.5%
Specialty hospitals same store Adjusted EBITDA margin (3)	22.9%	21.6%	22.9%	21.6%

	Select Medical Holdings Corporation Year Ended December 31, 2006	Select Medical Holdings Corporation Year Ended December 31, 2007	Select Medical Corporation Year Ended December 31, 2006	Select Medical Corporation Year Ended December 31, 2007
	(in thousands)		(in thousands)	
Net operating revenue				
Specialty hospitals net operating revenue	$ 1,378,543	$ 1,386,410	$ 1,378,543	$ 1,386,410
Less: Specialty hospitals in development, opened or closed after 1/1/06	106,940	81,514	106,940	81,514
Specialty hospitals same store net operating revenue	$ 1,271,603	$ 1,304,896	$ 1,271,603	$ 1,304,896
Adjusted EBITDA (3)				
Specialty hospitals Adjusted EBITDA (3)	$ 283,270	$ 217,175	$ 283,270	$ 217,175
Less: Specialty hospitals in development, opened or closed after 1/1/06	5,867	(13,524)	5,867	(13,524)
Specialty hospitals same store Adjusted EBITDA (3)	$ 277,403	$ 230,699	$ 277,403	$ 230,699
All specialty hospitals Adjusted EBITDA margin (3)	20.5%	15.7%	20.5%	15.7%
Specialty hospitals same store Adjusted EBITDA margin (3)	21.8%	17.7%	21.8%	17.7%

N/M — Not Meaningful.

(1) The financial data for the period after the Merger, February 25, 2005 through December 31, 2005 (Successor period), has been added to the financial data for the period from January 1, 2005 through February 24, 2005 (Predecessor period), to arrive at the combined year ended December 31, 2005.

(2) Cost of services includes salaries, wages and benefits, operating supplies, lease and rent expense and other operating costs.

(3) We define Adjusted EBITDA as net income before interest, income taxes, depreciation and amortization, income from discontinued operations, loss on early retirement of debt, merger related charges, stock compensation expense, long-term incentive compensation, other income (expense) and minority interest. We believe that the presentation of Adjusted EBITDA is important to investors because Adjusted EBITDA is commonly used as an analytical indicator of performance by investors within the healthcare industry. Adjusted EBITDA is used by management to evaluate financial performance and determine resource allocation for each of our operating units. Adjusted EBITDA is

not a measure of financial performance under generally accepted accounting principles. Items excluded from Adjusted EBITDA are significant components in understanding and assessing financial performance. Adjusted EBITDA should not be considered in isolation or as an alternative to, or substitute for, net income, cash flows generated by operations, investing or financing activities, or other financial statement data presented in the consolidated financial statements as indicators of financial performance or liquidity. Because Adjusted EBITDA is not a measurement determined in accordance with generally accepted accounting principles and is thus susceptible to varying calculations, Adjusted EBITDA as presented may not be comparable to other similarly titled measures of other companies. See Note 13 to our audited consolidated financial statements for a reconciliation of net income to Adjusted EBITDA as utilized by us in reporting our segment performance in accordance with SFAS No. 131.

(4) Other includes our general and administrative services, as well as businesses associated with the sale of home medical equipment, infusion/intravenous services and non-healthcare services.

Year Ended December 31, 2007 Compared to Year Ended December 31, 2006

In the following discussion, we address the results of operations of Select and Holdings. With the exception of incremental interest expense and income taxes, the results of operations of Holdings are identical to those of Select. Therefore, the discussion related to net operating revenue, operating expenses, Adjusted EBITDA, income from operations, minority interest and income from discontinued operations is identical for Holdings and Select.

Net Operating Revenues

Our net operating revenues increased by 7.6% to $1,991.7 million for the year ended December 31, 2007 compared to $1,851.5 million for the year ended December 31, 2006.

Specialty Hospitals. Our specialty hospital net operating revenues increased 0.6% to $1,386.4 million for the year ended December 31, 2007 compared to $1,378.5 million for the year ended December 31, 2006. Net operating revenues for the specialty hospitals opened before January 1, 2006 and operated by us throughout both years increased 2.6% to $1,304.9 million for the year ended December 31, 2007 from $1,271.6 million for the year ended December 31, 2006. This increase was offset by the effect of closed hospitals, which accounted for $57.2 million of net revenue for the year ended December 31, 2006. Hospitals opened in 2006 and 2007 increased net operating revenues by $31.8 million. The increase in same store hospitals net operating revenues resulted from an increase in our patient days. Our patient days for these same store hospitals increased 4.0% and our occupancy percentage remained constant at 71% for both the year ended December 31, 2007 and the year ended December 31, 2006. The $33.3 million increase in our same store specialty hospitals net operating revenue was the result of a $63.7 million increase in our non-Medicare net operating revenues that was offset by a reduction in our Medicare net operating revenues of $30.4 million. The reduction in Medicare net operating revenues has resulted from LTACH regulatory changes that have reduced the payment rates for Medicare cases and a reduction in our Medicare volume.

Outpatient Rehabilitation. Our outpatient rehabilitation net operating revenues increased 28.3% to $603.4 million for the year ended December 31, 2007 compared to $470.3 million for the year ended December 31, 2006. The number of patient visits in our outpatient rehabilitation clinics increased 35.7% for the year ended December 31, 2007 to 4,032,197 visits compared to 2,972,243 visits for the year ended December 31, 2006. Substantially all of the increase in net operating revenues and patient visits was related to the outpatient rehabilitation clinics acquired from HealthSouth Corporation, offset in part by a decrease in net operating revenues due to the sale of a group of clinics at the end of 2006. Net revenue per visit in our clinics was $100 for the year ended December 31, 2007 compared to $94 for the year ended December 31, 2006.

Other. Our other revenues were $1.8 million for the year ended December 31, 2007 compared to $2.6 million for the year ended December 31, 2006. These revenues are generated from non-healthcare related services.

Operating Expenses

Our operating expenses increased by 12.5% to $1,740.5 million for the year ended December 31, 2007 compared to $1,547.0 million for the year ended December 31, 2006. Our operating expenses include our cost of services, general and administrative expense and bad debt expense. The increase in operating expenses was principally related to the outpatient rehabilitation clinics acquired from HealthSouth Corporation.

As a percentage of our net operating revenues, our operating expenses were 87.4% for the year ended December 31, 2007 compared to 83.6% for the year ended December 31, 2006. Cost of services as a percentage of operating revenues was 83.3% for the year ended December 31, 2007 compared to 80.2% for the year ended December 31, 2006. This increase in the relative percentage for cost of services is principally due to the significant decline in our specialty hospital Medicare revenue and an increase in labor costs at our specialty hospitals. We also experienced a higher relative labor component in the outpatient operations acquired from HeathSouth Corporation. Another component of cost of services is facility rent expense, which was $98.5 million for the year ended December 31, 2007 compared to $84.0 million for the year ended December 31, 2006. The increase in rent expense was principally related to the facility rent expense for the outpatient rehabilitation clinics acquired from HealthSouth Corporation. During the same period general and administrative expense decreased as a percentage of net operating revenue to 2.2% compared to 2.4% for the year ended December 31, 2006, principally due to the increase in our net operating revenues. Our bad debt expense as a percentage of net operating revenues was 1.9% for the year ended December 31, 2007 compared to 1.0% for the year ended December 31, 2006. This increase occurred across both business segments. In our specialty hospital segment we have experienced an increase in our bad debts associated with the write-off of uncollectible Medicare co-payments and deductibles. In our outpatient segment we have experienced an aging of our accounts receivable which has generated higher reserve requirements and an increase in bad debt expense under our reserve methodology.

Adjusted EBITDA

Specialty Hospitals. Adjusted EBITDA decreased by 23.3% to $217.2 million for the year ended December 31, 2007 compared to $283.3 million for the year ended December 31, 2006. Our Adjusted EBITDA margins decreased to 15.7% for the year ended December 31, 2007 from 20.5% for the year ended December 31, 2006. The hospitals opened before January 1, 2006 and operated throughout both years had Adjusted EBITDA of $230.7 million, a decrease of 16.8% over the Adjusted EBITDA of these hospitals in 2006. Our Adjusted EBITDA margin in these same store hospitals decreased to 17.7% for the year ended December 31, 2007 from 21.8% for the year ended December 31, 2006. The decrease in our Adjusted EBITDA is principally due to a $16.6 million decline in our Medicare net operating revenues resulting from LTCH regulatory changes that reduced our payment rates for Medicare cases without any corresponding reduction in the cost of services associated with those cases. We also experienced a decline in our non-Medicare rate per patient day and an increase in our labor, bad debt and facility costs that contributed to the decrease in our Adjusted EBITDA. These contributors to the decline in our Adjusted EBITDA were offset by an increase in Adjusted EBITDA resulting from an increase in our non-Medicare volume.

Outpatient Rehabilitation. Adjusted EBITDA increased by 16.4% to $75.4 million for the year ended December 31, 2007 compared to $64.8 million for the year ended December 31, 2006. Our Adjusted EBITDA margins decreased to 12.5% for the year ended December 31, 2007 from 13.8% for the year ended December 31, 2006. The increase in Adjusted EBITDA was the result of Adjusted EBITDA contributed by the outpatient rehabilitation clinics acquired from HealthSouth Corporation and an increase in the net revenue per visit at our existing clinics, offset in part by a reduction in Adjusted EBITDA due to the sale of a group of clinics at the end of 2006. Our Adjusted EBITDA margins decreased due to lower margins generated by the outpatient rehabilitation clinics acquired from HealthSouth Corporation.

Other. The Adjusted EBITDA loss, which primarily includes our general and administrative expenses, was $37.7 million for the year ended December 31, 2007 compared to a loss of $39.8 million for the year ended December 31, 2006.

Income from Operations

For the year ended December 31, 2007, we experienced income from operations of $193.9 million compared to income from operations of $257.9 million for the year ended December 31, 2006. The decrease in income from operations resulted from the Adjusted EBITDA changes described above and an increase in depreciation and amortization expense. The increase in depreciation and amortization expense resulted primarily from increased depreciation expense associated with free-standing hospitals we have placed in service and an increase in depreciation and amortization expense related to the outpatient rehabilitation clinics acquired from HealthSouth Corporation.

Interest Expense

Select Medical Corporation. Interest expense was $105.5 million for the year ended December 31, 2007 compared to $97.3 million for the year ended December 31, 2006. The increase in interest expense is related to higher outstanding debt balances and slightly higher interest rates under Select's senior secured credit facility. The increase in outstanding debt is principally related to the borrowings used to fund the acquisition of the outpatient rehabilitation division of HealthSouth Corporation.

Select Medical Holdings Corporation. Interest expense was $140.2 million for the year ended December 31, 2007 compared to $131.8 million for the year ended December 31, 2006. The increase in interest expense is related to higher outstanding debt balances and slightly higher interest rates under Select's senior secured credit facility. The increase in outstanding debt is principally related to the borrowings used to fund the acquisition of the outpatient rehabilitation division of HealthSouth Corporation.

Minority Interests

Minority interests in consolidated earnings was $1.5 million for the year ended December 31, 2007 compared to $1.4 million for the year ended December 31, 2006.

Income Taxes

Select Medical Corporation. We recorded income tax expense of $29.3 million, representing an effective tax rate of 34.7%, for the year ended December 31, 2007. For the year ended December 31, 2006, we recorded income tax expense of $56.1 million, representing an effective tax rate of 34.7%. In both the years ended December 31, 2007 and December 31, 2006 we experienced an effective tax rate that was lower than our expected blended federal and state tax rate. For the year ended December 31, 2007 we recognized a lower effective tax rate as a result of greater than expected tax benefits generated on the sale of equipment and subsidiaries. For the year ended December 31, 2006 we recognized a lower effective tax rate as a result of a significant tax loss we recognized on the sale of a group of legal entities that operated outpatient rehabilitation clinics. These legal entities were sold at an amount that approximated their GAAP book value. However, the stock of these legal entities that were originally acquired as part of our acquisition of the NovaCare Physical Rehabilitation and Occupational Health Group in 1999 had a substantial tax basis.

*Select Medical Holdings Corporation***.** We recorded income tax expense of $18.7 million for the year ended December 31, 2007. This expense represented an effective tax rate of 34.5%. For the year ended December 31, 2006, we recorded income tax expense of $43.5 million. This expense represented an effective tax rate of 34.6%. In both the years ended December 31, 2007 and December 31, 2006 we experienced an effective tax rate that was lower than our expected blended federal and state tax rate. For the year ended December 31, 2007 we recognized a lower effective tax rate as a result of greater than expected tax benefits generated on the sale of equipment and subsidiaries. For the year ended December 31, 2006 we recognized a lower effective tax rate as a result of a significant tax loss we recognized on the sale of a group of legal entities that operated outpatient rehabilitation clinics. These legal entities were sold at an amount that approximated their GAAP book value. However, the stock of these legal entities that were originally acquired as part of our acquisition of the NovaCare Physical Rehabilitation and Occupational Health Group in 1999 had a substantial tax basis.

Income from Discontinued Operations, Net of Tax

On March 1, 2006, we sold our wholly-owned subsidiary, Canadian Back Institute Limited ("CBIL"), for approximately C$89.8 million in cash (US$79.0 million). We conducted all of our Canadian operations through CBIL. The financial results of CBIL have been reclassified as discontinued operations for all periods presented in this report. We recognized a gain on sale (net of tax) of $9.1 million in the quarter ended March 31, 2006.

Year Ended December 31, 2006 Compared to Combined Year Ended December 31, 2005

Net Operating Revenues

Our net operating revenues decreased by 0.4% to $1,851.5 million for the year ended December 31, 2006 compared to $1,858.4 million for the combined year ended December 31, 2005.

Specialty Hospitals. Our specialty hospital net operating revenues increased 0.4% to $1,378.5 million for the year ended December 31, 2006 compared to $1,372.5 million for the combined year ended December 31, 2005. Net operating revenues for the specialty hospitals opened before January 1, 2005 and operated by us throughout both years increased 2.4% to $1,354.8 million for the year ended December 31, 2006 from $1,323.4 million for the combined year ended December 31, 2005. This increase was offset by the effect of closed hospitals, which accounted for $28.0 million of net revenue for the combined year ended December 31, 2005. Hospitals opened in 2006 increased net operating revenues by $2.6 million. The increase in same store hospitals net operating revenues resulted from both an increase in our patient days and higher net revenue per patient day. Our patient days for these same store hospitals increased 0.3% and our occupancy percentage remained constant at 70% for both the year ended December 31, 2006 and the combined year ended December 31, 2005. Although we experienced a small increase in our same store specialty hospitals net operating revenue, we experienced a reduction in our Medicare net operating revenues of $21.4 million that was offset by a $52.8 million increase in our non-Medicare net operating revenues. The reduction in Medicare net operating revenues has resulted from LTACH regulatory changes that have reduced the payment rates for Medicare cases.

Outpatient Rehabilitation. Our outpatient rehabilitation net operating revenues declined 2.2% to $470.3 million for the year ended December 31, 2006 compared to $480.7 million for the combined year ended December 31, 2005. The number of patient visits in our outpatient rehabilitation clinics declined 10.2% for the year ended December 31, 2006 to 2,972,243 visits compared to 3,308,620 visits for the combined year ended December 31, 2005. The decrease in net operating revenues and patient visits was principally related to a decline in the volume of visits per clinic and in the number of clinics we own. Net revenue per visit in these clinics was $94 for the year ended December 31, 2006 compared to $89 for the combined year ended December 31, 2005.

Other. Our other revenues were $2.6 million for the year ended December 31, 2006 compared to $5.2 million for the combined year ended December 31, 2005. These revenues are principally related to the sales of home medical equipment, infusion/intravenous services, and non-healthcare services. In May 2005, we sold the assets of our home medical equipment and infusion/intravenous service business, which resulted in the reduction in our other revenues.

Operating Expenses

Our operating expenses decreased by 8.8% to $1,547.0 million for the year ended December 31, 2006 compared to $1,695.5 million for the combined year ended December 31, 2005. Our operating expenses include our cost of services, general and administrative expense and bad debt expense. The principal reason for the decline in our operating expenses resulted from a significant decline in our general and administrative expenses. There were three significant categories of expenses incurred during the combined year ended December 31, 2005 that did not exist for the year ended December 31, 2006. First, we granted restricted stock awards in connection with the Merger to certain key management employees. These awards generally vest over five years. Effective at the time of the Merger, we also granted stock options to certain other key employees that vest over five years. The fair value of restricted stock awards and stock options vesting and expensed during the Successor period of February 25, 2005 through December 31, 2005 was $10.3 million. Of this amount, $10.1 million was included in general and administrative expense and $0.2 million was included in cost of services. Second, during the Predecessor period of January 1, 2005 through February 24, 2005, all of our then outstanding stock options were cancelled and cashed-out in accordance with the Merger agreement. This resulted in a charge of $142.2 million of which $115.0 million is included in general and administrative expense and $27.2 million is included in cost of services. And third, as a result of the special dividend of $175.0 million paid to our preferred stockholders on September 29, 2005, we incurred $14.5 million of expense in connection with a payment to certain members of management under the terms of our long-term incentive compensation plan that is included in general and administrative expense. Our general and administrative cost for the combined year ended December 31, 2005 also contained costs associated with the SemperCare corporate office which were not eliminated until the second quarter of 2005.

During the year ended December 31, 2006, we recorded expense related to the vesting of restricted stock and stock options in the amount of $3.8 million. Of this amount, $3.6 million is included in general and administrative expense and $0.2 million is included in cost of services.

As a percentage of our net operating revenues, our operating expenses were 83.6% for the year ended December 31, 2006 compared to 91.2% for the combined year ended December 31, 2005. Cost of services as a percentage of operating revenues was 80.2% for the year ended December 31, 2006 compared to 80.1% for the combined year ended December 31, 2005. These costs primarily reflect our labor expenses. Another component of cost of services is facility rent expense, which was $84.0 million for the year ended December 31, 2006 compared to $81.6 million for the combined year ended December 31, 2005. Our bad debt expense as a percentage of net operating revenues was 1.0% for the year ended December 31, 2006 compared to 1.3% for the combined year ended December 31, 2005. This decrease in bad debt expense resulted from continued improvement in the aging composition of our accounts receivable measured in absolute dollars which has resulted in a lower bad debt requirement and expense.

Adjusted EBITDA

Specialty Hospitals. Adjusted EBITDA decreased by 8.1% to $283.3 million for the year ended December 31, 2006 compared to $308.1 million for the combined year ended December 31, 2005. Our Adjusted EBITDA margins decreased to 20.5% for the year ended December 31, 2006 from 22.5% for the combined year ended December 31, 2005. The hospitals opened before January 1, 2005 and operated throughout both years had Adjusted EBITDA of $292.6 million, a decrease of 3.3% over the Adjusted EBITDA of these hospitals in 2005. The decrease in same store hospitals' Adjusted EBITDA resulted primarily from the reduction in our Medicare net operating revenues resulting from LTACH regulatory changes that have reduced our payment rates for Medicare cases. Additionally, during 2005 we recorded a one-time benefit of $3.8 million due to the reversal of an accrued patient care liability as a result of the termination of this obligation. Our Adjusted EBITDA margin in these same store hospitals decreased to 21.6% for the year ended December 31, 2006 from 22.9% for the combined year ended December 31, 2005.

Outpatient Rehabilitation. Adjusted EBITDA decreased by 1.7% to $64.8 million for the year ended December 31, 2006 compared to $66.0 million for the combined year ended December 31, 2005. Our

Adjusted EBITDA margins increased to 13.8% for the year ended December 31, 2006 from 13.7% for the combined year ended December 31, 2005. The decline in Adjusted EBITDA was the result of the decline in clinic visit volumes, described under "— Net Operating Revenue — Outpatient Rehabilitation" above.

Other. The Adjusted EBITDA loss, which primarily includes our general and administrative expenses, was $39.8 million for the year ended December 31, 2006 compared to a loss of $44.2 million for the combined year ended December 31, 2005. This reduction in the Adjusted EBITDA loss was primarily the result of the decline in our general and administrative expenses associated with the SemperCare corporate office which were eliminated in the second quarter of 2005 and losses incurred during 2005 related to our home medical equipment and infusion/intravenous service business which was sold in May 2005.

Income from Operations

For the year ended December 31, 2006, we experienced income from operations of $257.9 million compared to income from operations of $119.1 million for the combined year ended December 31, 2005. The increase in income from operations experienced for the year ended December 31, 2006 resulted from the higher expenses incurred during the combined year ended December 31, 2005 related to significant stock compensation costs associated with the Merger of $152.5 million and the payment of $14.5 million under the terms of our long-term incentive compensation plan offset by an increase in depreciation and amortization of $2.8 million, and the Adjusted EBITDA decreases described above. The stock compensation expense was comprised of $142.2 million related to the redemption of all vested and unvested outstanding stock options in accordance with the terms of the Merger agreement in the Predecessor period of January 1, 2005 through February 24, 2005 and an additional $10.3 million of stock compensation expense related to shares of restricted stock that were issued in the Successor period of February 25, 2005 through December 31, 2005.

Loss on Early Retirement of Debt

In connection with the Merger, Select commenced tender offers to acquire all of its $9^1/_2$% senior subordinated notes due 2009 and all of its $7^1/_2$% senior subordinated notes due 2013. Upon completion of the tender offers on February 24, 2005, all $175.0 million of the $7^1/_2$% senior subordinated notes were tendered and $169.3 million of the $175.0 million of $9^1/_2$% notes were tendered. The loss consists of the tender premium cost of $34.8 million and the remaining unamortized deferred financing costs of $7.9 million.

Merger Related Charges

As a result of the Merger, we incurred costs of $12.0 million in the Predecessor period of January 1, 2005 through February 24, 2005 directly related to the Merger. This included the fees of the investment advisor hired by the special committee of Select's board of directors to evaluate the Merger, legal and accounting fees, costs associated with the Hart-Scott-Rodino filing related to the Merger, cost associated with purchasing a six-year extended reporting period under our directors and officers liability insurance policy and other associated expenses.

Interest Expense

Select Medical Corporation. Interest expense increased by $8.9 million to $97.3 million for the year ended December 31, 2006 from $88.4 million for the combined year ended December 31, 2005. The increase in interest expense is due to higher average debt levels and interest rates experienced during the year ended December 31, 2006.

Select Medical Holdings Corporation. Interest expense increased by $24.9 million to $131.8 million for the year ended December 31, 2006 from $106.9 million for the combined year ended December 31, 2005. The increase in interest expense is due to higher average debt levels and interest rates experienced during the year ended December 31, 2006.

Minority Interests

Minority interests in consolidated earnings was $1.4 million for the year ended December 31, 2006 compared to $2.1 million for the combined year ended December 31, 2005.

Income Taxes

Select Medical Corporation. For the year ended December 31, 2006, we recorded income tax expense of $56.1 million. This expense represented an effective tax rate of 34.7%. We recognized a lower effective tax for the year ended December 31, 2006 as a result of a significant tax loss we recognized on the sale of a group of legal entities that operated outpatient rehabilitation clinics. These legal entities were sold at an amount that approximated their GAAP book value. However, the stock of these legal entities that were originally acquired as part of our acquisition of the NovaCare Physical Rehabilitation and Occupational Health Group in 1999 had a substantial tax basis. We recorded an income tax benefit of $59.8 million for the Predecessor period of January 1, 2005 through February 24, 2005. The tax benefit represented an effective tax benefit rate of 37.2%. This effective tax benefit rate consisted of the statutory federal rate of 35% and a state rate of 2.2%. The federal tax benefit was carried forward and used to offset our federal tax throughout the remainder of 2005. Because of the differing state tax rules related to net operating losses, a portion of these state net operating losses were assigned valuation allowances. We recorded an income tax expense of $56.5 million for the Successor period of February 25, 2005 through December 31, 2005. The expense represented an effective tax rate of 40.6%.

Select Medical Holdings Corporation. For the year ended December 31, 2006, we recorded income tax expense of $43.5 million. This expense represented an effective tax rate of 34.6%. We recognized a lower effective tax for the year ended December 31, 2006 as a result of a significant tax loss we recognized on the sale of a group of legal entities that operated outpatient rehabilitation clinics. These legal entities were sold at an amount that approximated their GAAP book value. However, the stock of these legal entities that were originally acquired as part of our acquisition of the NovaCare Physical Rehabilitation and Occupational Health Group in 1999 had a substantial tax basis. We recorded an income tax benefit of $59.8 million for the Predecessor period of January 1, 2005 through February 24, 2005. The tax benefit represented an effective tax benefit rate of 37.2%. This effective tax benefit rate consisted of the statutory federal rate of 35% and a state rate of 2.2%. The federal tax benefit was carried forward and used to offset our federal tax throughout the remainder of 2005. Because of the differing state tax rules related to net operating losses, a portion of these state net operating losses were assigned valuation allowances. We recorded an income tax expense of $49.3 million for the Successor period of February 25, 2005 through December 31, 2005. The expense represented an effective tax rate of 41.6%.

Income from Discontinued Operations, Net of Tax

On March 1, 2006, we sold our wholly-owned subsidiary, CBIL, for approximately C$89.8 million in cash (US$79.0 million). We conducted all of our Canadian operations through CBIL. The financial results of CBIL have been reclassified as discontinued operations for all periods presented in this report. We recognized a gain on sale (net of tax) of $9.1 million in the quarter ended March 31, 2006.

Liquidity and Capital Resources

Year Ended December 31, 2007, Year Ended December 31, 2006, and Combined Year Ended December 31, 2005

	Select Medical Holdings Corporation			Select Medical Corporation		
	Year Ended December 31,			Year Ended December 31,		
	2005	2006	2007	2005	2006	2007
	(in thousands)			(in thousands)		
Cash flows provided by operating activities	$ 57,211	$227,651	$ 86,013	$64,128	$260,190	$118,786
Cash flows used in investing activities	(220,811)	(81,481)	(382,676)	(220,811)	(81,481)	(382,676)
Cash flows provided by (used in) financing activities	(48,510)	(100,466)	219,592	(55,427)	(133,005)	186,819
Effect of exchange rate changes on cash and cash equivalents	495	35	-	495	35	-
Net increase (decrease) in cash and cash equivalents	(211,615)	45,739	(77,071)	(211,615)	45,739	(77,071)
Cash and cash equivalents at beginning of period	247,476	35,861	81,600	247,476	35,861	81,600
Cash and cash equivalents at end of period	$ 35,861	$ 81,600	$ 4,529	$ 35,861	$ 81,600	$ 4,529

*Select Medical Corporation**.*** Operating activities generated $118.8 million in cash during the year ended December 31, 2007. Our days sales outstanding were 48 days at December 31, 2007 compared to 41 days at December 31, 2006. Our operating cash flow was negatively affected by a reduction in our operating earnings, an increase in interest expense and an increase in our accounts receivable.

Operating activities generated $260.2 million in cash during the year ended December 31, 2006. Our operating cash flow was positively affected by a reduction in our accounts receivable and tax benefits we realized by changing our tax accounting method used for deducting bad debts. The tax accounting change had the effect of accelerating the tax deduction for bad debt reserves. Our days sales outstanding were 41 days at December 31, 2006 compared to 52 days at December 31, 2005. The significant reduction in days sales outstanding was the result of several factors. The timing of our Periodic Interim Payments from Medicare received by our Specialty Hospitals resulted in a seven day decline in the days sales outstanding. The remaining decline was the result of improved cash collections.

For the combined year ended December 31, 2005, operating activities generated $64.1 million of cash. Our operating cash flow includes $186.0 million in cash expenses related to the Merger. Our days sales outstanding were 52 days at December 31, 2005 compared to 48 days at December 31, 2004. The increase in days sales outstanding is primarily the result of a change in the way Medicare calculated our Periodic Interim Payments in our Specialty Hospitals. Medicare changed from a per day based calculation to a discharged based calculation to better align the Periodic Interim Payment methodology with the current discharge based reimbursement system. As a result, we are no longer receiving a periodic payment for those patients that have not yet been discharged.

The operating cash flow of Select exceeds the operating cash flow of Holdings by $32.8 million, $32.5 million and $6.9 million for the years ended December 31, 2007 and 2006 and for the combined year ended December 31, 2005, respectively. The difference primarily relates to interest payments related to Holdings senior subordinated notes and senior floating rate notes.

Investing activities used $382.7 million, $81.5 million, and $220.8 million of cash flow for the year ended December 31, 2007, the year ended December 31, 2006, and the combined year ended December 31, 2005, respectively. Of this amount, we incurred earnout and acquisition related payments of $237.0 million,

$3.4 million, and $111.6 million, respectively in 2007, 2006, and 2005. In 2007, the acquisition of the outpatient division of HealthSouth Corporation accounted for the $236.9 million in acquisition payments. In 2005, the SemperCare acquisition accounted for $105.1 million of the $111.6 million in acquisition payments. The remaining acquisition payments relate primarily to small acquisitions of outpatient businesses. The earnout payments related principally to obligations we assumed as part of our 1999 NovaCare acquisition. Investing activities also used cash for the purchases of property and equipment of $166.1 million, $155.1 million, and $109.9 million in 2007, 2006, and 2005, respectively, which was related principally to construction and relocation of existing hospitals. During 2005 and 2006 we purchased properties that have been used to relocate existing hospitals and develop new free-standing hospitals. Each of these properties required additional improvements to be made before they become operational. Additionally during 2005 and 2006 we made major improvements and expanded our rehabilitation hospital in West Orange, New Jersey. During 2007 we sold business units and real property which generated $16.0 million in cash. During 2006, we sold all of our Canadian operations and a group of outpatient rehabilitation clinics. The cash flow from these transactions, net of operating cash transferred with the businesses, was $75.0 million.

Financing activities provided $186.8 million of cash for the year ended December 31, 2007. The cash resulted primarily from borrowings, net of repayments on our credit facility of $213.5 million, dividends paid to Holdings of $32.8 million and proceeds from bank overdrafts of $8.9 million. Approximately $203.0 million of the borrowings from our credit facility were used to fund the acquisition of the outpatient division of HealthSouth Corporation. The remaining borrowings were used to fund our normal operations including our hospital construction activities.

Financing activities used $133.0 million of cash for the year ended December 31, 2006. The cash usage resulted primarily from repayments, net of borrowings, on our credit facility of $90.8 million, dividends paid to Holdings of $32.6 million and repayment of bank overdrafts of $7.1 million.

Financing activities used $55.4 million of cash for the combined year ended December 31, 2005. The principal financing activities were related to the Merger financing discussed below. The excess proceeds from the transactions were used to pay Merger related costs, which include the cancellation of outstanding stock options. Additionally, during 2005 we repaid $115.0 million of debt under our revolving loans and $4.4 million of our term loans. During 2005, we paid dividends of $10.0 million to Holdings which it used to fund interest payments on its debt. Bank overdrafts of $19.4 million also provided additional financing cash.

The difference in cash flows provided by (used in) financing activities of Holdings compared to Select of $32.8 million, $32.5 million and $6.9 million for the years ended December 31, 2007 and 2006 and the combined year ended December 31, 2005 relates to dividends paid by Select to Holdings to service Holdings' interest obligations related to its senior subordinated notes and senior floating rate notes.

Capital Resources

Select Medical Corporation. Select had net working capital of $9.2 million at December 31, 2007 compared to net working capital of $71.0 million at December 31, 2006. This reduction in working capital was principally related to an increase in our accrued restructuring liability that resulted from our acquisition of the outpatient division of HealthSouth Corporation, a decrease in the market value of our interest rate swap instruments and the declared dividend to Holdings.

Select Medical Holdings Corporation. Holdings had net working capital of $14.7 million at December 31, 2007 compared to net working capital of $59.4 million at December 31, 2006. This reduction in working capital was principally related to an increase in our accrued restructuring liability that resulted from our acquisition of the outpatient division of HealthSouth Corporation and a decrease in the market value of our interest rate swap instruments.

In connection with the Merger, on February 24, 2005, Select borrowed $780.0 million under an $880.0 million senior secured credit facility and issued $660.0 million $7^5/_8$% senior subordinated notes. As a result, our liquidity requirements are significantly higher than they were before the Merger due to our increased debt service obligations.

On March 19, 2007, Select entered into an Amendment No. 2 and Waiver to its senior secured credit facility and on March 28, 2007 Select entered into an Incremental Facility Amendment with a group of lenders and JPMorgan Chase Bank, N.A. as administrative agent. Amendment No. 2 and Waiver increased the general exception to the prohibition on asset sales under Select's senior secured credit facility from $100.0 million to $200.0 million, relaxed certain financial covenants starting March 31, 2007 and waived Select's requirement to prepay certain term loan borrowings following its fiscal year ended December 31, 2006. The Incremental Facility Amendment provided to us an incremental term loan of $100.0 million, the proceeds of which we used to pay a portion of the purchase price for the HealthSouth transaction.

After giving effect to the Incremental Facility Amendment, Select's senior secured credit facility provides for senior secured financing of up to $980.0 million, consisting of:

- a $300.0 million revolving loan facility that will terminate on February 24, 2011, including both a letter of credit sub-facility and a swingline loan sub-facility, and

- a $680.0 million term loan facility that matures on February 24, 2012.

The interest rates per annum applicable to loans, other than swingline loans, under Select's senior secured credit facility are, at its option, equal to either an alternate base rate or an adjusted LIBOR rate for a one, two, three or six month interest period, or a nine or twelve month period if available, in each case, plus an applicable margin percentage. The alternate base rate is the greater of (1) JPMorgan Chase Bank, N.A.'s prime rate and (2) one-half of 1% over the weighted average of rates on overnight Federal funds as published by the Federal Reserve Bank of New York. The adjusted LIBOR rate is determined by reference to settlement rates established for deposits in dollars in the London interbank market for a period equal to the interest period of the loan and the maximum reserve percentages established by the Board of Governors of the United States Federal Reserve to which our lenders are subject. The applicable margin percentage for borrowings under our revolving loans is subject to change based upon the ratio of our total indebtedness to our consolidated EBITDA (as defined in the credit agreement). The applicable margin percentage for revolving loans is currently (1) 1.50% for alternate base rate loans and (2) 2.50% for adjusted LIBOR loans. The applicable margin percentages for the term loans are (1) 1.00% for alternate base rate loans and (2) 2.00% for adjusted LIBOR loans.

On June 13, 2005, Select entered into a five year interest rate swap transaction with an effective date of August 22, 2005. On March 8, 2007 and November 23, 2007, Select entered into two additional interest rate swap transactions for three years with effective dates of May 22, 2007 and November 23, 2007, respectively. The swaps are designated as a cash flow hedge of forecasted LIBOR-based variable rate interest payments. The underlying variable rate debt is $500.0 million.

On February 24, 2005, EGL Acquisition Corp. issued and sold $660.0 million in aggregate principal amount of $7^5/_8$% senior subordinated notes due 2015, which Select assumed in connection with the Merger. The net proceeds of the offering were used to finance a portion of the funds needed to consummate the Merger with EGL Acquisition Corp. The notes were issued under an indenture between EGL Acquisition Corp. and U.S. Bank Trust National Association, as trustee. Interest on the notes is payable semi-annually in arrears on February 1 and August 1 of each year. The notes are guaranteed by all of our wholly-owned subsidiaries, subject to certain exceptions. On or after February 1, 2010, the notes may be redeemed at our option, in whole or in part, at redemption prices that decline annually to 100% on and after February 1, 2013, plus accrued and unpaid interest.

Upon a change of control of Holdings, each holder of notes may require us to repurchase all or any portion of the holder's notes at a purchase price equal to 101% of the principal amount plus accrued and unpaid interest to the date of purchase.

On September 29, 2005, Holdings sold $175.0 million of senior floating rate notes due 2015, which bear interest at a rate per annum, reset semi-annually, equal to the 6-month LIBOR plus 5.75%. Interest is payable semi-annually in arrears on March 15 and September 15 of each year, with the principal due in full on September 15, 2015. The senior floating rate notes are general unsecured obligations of Holdings and are not guaranteed by us or any of our subsidiaries. In connection with the issuance of the senior floating rate notes, we entered into an interest rate swap transaction. The notional amount of the interest rate swap is $175.0 million. The variable interest rate of the debt was 11.3% and the fixed rate after the swap was 10.2% at December 31, 2007. The net proceeds of the issuance of the senior floating rate notes, together with cash was used to reduce the amount of our preferred stock, to make a payment to participants in our long-term incentive plan and to pay related fees and expenses.

In connection with the issuance of the senior floating rate notes by Holdings, Select entered into an amendment to its senior secured credit facility. This amendment, among other things, permitted Holdings to incur this indebtedness and permits Select to make distributions to Holdings to service its indebtedness. The amendment also permitted Holdings to use the net proceeds of the offering to make the $175.0 million special dividend to its preferred stockholders and to incur $14.5 million of expense in connection with a payment to certain members of management under the terms of Holdings' long-term incentive compensation plan that is included in general and administrative expense.

We believe internally generated cash flows and borrowings of revolving loans under our senior secured credit facility will be sufficient to finance operations for at least the next twelve months.

Following the adoption of the August 2004 final rule with respect to HIH admissions, we developed a business plan and strategy to adapt to the HIH admission regulations. Our plan included managing admissions at existing HIHs, relocating certain HIHs to leased spaces in smaller host hospitals in the same markets, consolidating HIHs in certain of our markets, relocating certain of our facilities to alternative settings, building or buying free-standing facilities and closing some of our facilities. We relocated one of our HIH hospitals to a free-standing building in the fourth quarter of 2005. During 2006, we relocated 11 of our HIH hospitals into seven free-standing buildings. Additionally, during 2006 we opened two new hospitals in free-standing buildings and one new hospital as an HIH. We closed four HIH hospitals during 2006. During 2007, we relocated nine of our HIH hospitals into two free-standing buildings and four new HIH hospitals. Additionally, we opened two free-standing hospitals, closed seven HIH hospitals and sold one HIH hospital.

As a result of the SCHIP Extension Act which has a three year moratorium on the development of new LTCHs, we have stopped all LTCH development, except for five LTCHs currently under construction that are excluded from the moratorium. However, we continue to evaluate opportunities to develop rehabilitation hospitals. We also intend to open new outpatient rehabilitation clinics in our current markets where we can benefit from existing referral relationships and brand awareness to produce incremental growth.

We periodically investigate strategic acquisitions that could increase our market share in one or both of our business segments. We cannot predict the likelihood that any of these business acquisitions will be consummated nor can we predict the cost of this type of acquisition.

Commitments and Contingencies

The following tables summarize contractual obligations at December 31, 2007, and the effect such obligations are expected to have on liquidity and cash flow in future periods. Reserves for uncertain tax positions of $21.4 million have been excluded from the tables below as the Company cannot reasonably estimate the amounts or periods in which these liabilities will be paid.

Select Medical Holdings Corporation:

Contractual Obligations	Payments Due by Year Total	2008	2009-2011	2012-2013	After 2013
			(in thousands)		
$7^5/_8$% senior subordinated notes	$ 660,000	$ —	$ —	$ —	$ 660,000
Senior secured credit facility	783,300	6,800	615,775	160,725	—
10% senior subordinated notes (1)	134,110	—	—	—	134,110
Senior floating rate notes	175,000	—	—	—	175,000
Seller notes	633	233	400	—	—
Capital lease obligations	2,286	635	1,651	—	—
Other debt obligations	306	81	225	—	—
Total debt	1,755,635	7,749	618,051	160,725	969,110
Interest (2)	805,678	137,812	386,410	166,245	115,211
Letters of credit outstanding	29,706	—	29,706	—	—
Purchase obligations	6,244	3,903	2,169	172	—
Construction contracts	8,689	8,689	—	—	—
Naming, promotional and sponsorship agreement	56,382	2,559	8,040	5,676	40,107
Operating leases	473,348	100,215	171,536	46,937	154,660
Related party operating leases	35,918	3,069	9,237	6,433	17,179
Total contractual cash obligations	$ 3,171,600	$ 263,996	$1,225,149	$ 386,188	$ 1,296,267

Select Medical Corporation:

Contractual Obligations	Payments Due by Year Total	2008	2009-2011	2012-2013	After 2013
			(in thousands)		
$7^5/_8$% senior subordinated notes	$ 660,000	$ —	$ —	$ —	$ 660,000
Senior secured credit facility	783,300	6,800	615,775	160,725	—
Seller notes	633	233	400	—	—
Capital lease obligations	2,286	635	1,651	—	—
Other debt obligations	306	81	225	—	—
Total debt	1,446,525	7,749	618,051	160,725	660,000
Interest (2)	548,341	105,015	288,017	100,650	54,659
Letters of credit outstanding	29,706	—	29,706	—	—
Purchase obligations	6,244	3,903	2,169	172	—
Construction contracts	8,689	8,689	—	—	—
Naming, promotional and sponsorship agreement	56,382	2,559	8,040	5,676	40,107
Operating leases	473,348	100,215	171,536	46,937	154,660
Related party operating leases	35,918	3,069	9,237	6,433	17,179
Total contractual cash obligations	$ 2,605,153	$ 231,199	$1,126,756	$ 320,593	$ 926,605

(1) Reflects the balance sheet liability of Holdings' senior subordinated notes calculated in accordance with GAAP. The balance sheet liability so reflected is less than the $150.0 million aggregate principal amount of such notes that were issued with an original issued discount totaling $17.2 million. Interest on the senior subordinated notes accrued on the full principal amount thereof and Holdings will be obligated to repay the full principal thereof at maturity or upon any mandatory or voluntary prepayment thereof.

(2) The interest obligation was calculated using the average interest rate at December 31, 2007 of 6.8% for the senior secured credit facility, the stated interest rate for the $7^5/_8$% senior subordinated notes and the 10% senior subordinated notes, 10.2% for the senior floating rate notes and 6.0% for seller notes, capital lease obligations and other debt obligations.

Inflation

The healthcare industry is labor intensive. Wages and other expenses increase during periods of inflation and when labor shortages occur in the marketplace. In addition, suppliers pass along rising costs to us in the form of higher prices. We have implemented cost control measures, including our case and resource management program, to curtail increases in operating costs and expenses. We cannot predict our ability to offset future cost increases through increases in our charges for healthcare services.

Recent Accounting Pronouncements

In December 2007, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141 (Revised 2007), "Business Combinations" which replaces SFAS No. 141. SFAS No. 141R retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value and requires the expensing of acquisition-related costs as incurred. SFAS No. 141R is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. This statement will be applied prospectively and will not result in any changes to our historical financial statements.

In December 2007, FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB 51." SFAS No. 160 changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent's equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement and upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in earnings. SFAS No. 160 is effective for financial statements issued for years beginning after December 15, 2008, except for the presentation and disclosure requirements, which will apply retrospectively. Our adoption of this statement will result in changes related to presentation and disclosure of our minority interest and will not affect our results of operations.

In February 2007, the FASB Issued SFAS No. 159, "Establishing the Fair Value Option for Financial Assets and Liabilities ("SFAS No. 159"). SFAS No. 159 was to permit all entities to choose to elect, at specified election dates, to measure eligible financial instruments at fair value. An entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date, and recognize upfront costs and fees related to those items in earnings as incurred and not deferred. SFAS No. 159 applies to fiscal years beginning after November 15, 2007, with early adoption permitted for an entity that has also elected to apply the provisions of SFAS No. 157, "Fair Value Measurements." An entity is prohibited from retrospectively applying SFAS No. 159, unless it chooses early adoption. SFAS No. 159 also applies to eligible items existing at November 15, 2007 (or early adoption date). We do not believe that the adoption of SFAS No. 159 will materially impact our consolidated financial statements.

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, "Fair Value Measurements" ("SFAS No. 157"). SFAS No. 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. The changes to current practice resulting from the application of SFAS No. 157 relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. . In February 2008, the FASB issued FASB Staff Position (FSP) 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13" (FSP 157-1) and FSP 157-2, "Effective Date of FASB Statement No. 157" (FSP 157-2). FSP 157-1 amends SFAS No. 157 to remove certain leasing transactions from its scope. FSP 157-2 delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of fiscal 2009. We do not believe that the adoption of SFAS No. 157 will materially impact our consolidated financial statements.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are subject to interest rate risk in connection with our long-term indebtedness. Our principal interest rate exposure relates to the loans outstanding under Select's senior secured credit facility and Holdings' senior floating rate notes. As of December 31, 2007, Select had $783.3 million in term and revolving loans outstanding under its senior secured credit facility, which bear interest at variable rates. On June 13, 2005, Select entered into a five year interest rate swap transaction with an effective date of August 22, 2005. On March 8, 2007 and November 16, 2007, Select entered into two additional interest rate swap transactions for three years with effective dates of May 22, 2007 and November 23, 2007, respectively. Select entered into the swap transactions to mitigate the risks of future variable rate interest payments. The notional amount of the interest rate swaps are $500.0 million and the underlying variable rate debt is associated with the senior secured credit facility. Each eighth point change in interest rates on the variable rate portion of our long-term indebtedness would result in a $0.4 million change in interest expense on our term loans.

In conjunction with the issuance of the Holdings' senior floating rate notes, on September 29, 2005 we entered into a swap transaction to mitigate the risks of future variable rate interest payments associated with this debt. The notional amount of the interest rate swap is $175.0 million and the swap is for a period of five years.

Select Medical Holdings Corporation
Ratio of Earnings to Fixed Charges
(in thousands)

	Predecessor			Successor		
	For the Year Ended December 31,		Period from January 1 through February 24,	Period from February 25 through December 31,	For the Year Ended December 31,	
	2003	2004	2005	2005	2006	2007
Pre-tax income (loss) from continuing operations before adjustments for minority interests in consolidated subsidiaries or income or loss from equity investees	$ 117,681	$ 192,885	$ (160,237)	$ 120,367	$ 127,336	$ 55,666
Fixed charges:						
Interest expense and amortization of debt discount and premium on all indebtedness	25,435	33,299	4,651	102,208	131,831	140,155
Capitalized interest	-	-	-	1,394	2,016	3,757
Interest related to discontinued operations	905	335	83	-	-	-
Rentals:						
Buildings - 33% (A)	23,237	25,039	4,169	22,871	27,736	32,490
Office and other equipment - 33% (A)	6,761	8,691	1,771	9,054	11,337	11,023
Preferred stock dividend requirements of consolidated subsidiaries	-	-	-	40,272	34,632	36,374
Total fixed charges	$ 56,338	$ 67,364	$ 10,674	$ 175,799	$ 207,552	$ 223,799
Pre-tax income (loss) from continuing operations before adjustment for minority interests in consolidated subsidiaries or income or loss from equity investees plus fixed charges, less preferred stock dividend requirements of consolidated subsidiaries less capitalized interest	$ 173,114	$ 259,914	$ (149,646)	$ 294,772	$ 332,872	$ 275,708
Ratio of earnings to fixed charges	3.0728	3.8584	(B)	1.6768	1.6038	1.2319

(A) The Company uses 33% to estimate the interest on its rentals. This percentage is a reasonable approximation of the interest factor.

(B) In the predecessor period of January 1, 2005 to February 24, 2005 the ratio coverage was less than 1.1. The Company would have had to generate additional earnings of approximately $160.3 million to achieve a coverage ratio of 1:1.

Select Medical Corporation
Ratio of Earnings to Fixed Charges
(in thousands)

	Predecessor			Successor		
	For the Year Ended December 31,		Period from January 1 through February 24,	Period from February 25 through December 31,	For the Year Ended December 31,	
	2003	2004	2005	2005	2006	2007
Pre-tax income (loss) from continuing operations before adjustments for minority interests in consolidated subsidiaries or income or loss from equity investees	$ 117,681	$ 192,885	$ (160,237)	$ 140,749	$ 163,245	$ 85,997
Fixed charges:						
Interest expense and amortization of debt discount and premium on all indebtedness	25,435	33,299	4,651	83,752	97,288	105,497
Capitalized interest	-	-	-	1,394	2,016	3,757
Interest related to discontinued operations	905	335	83	-	-	-
Rentals:						
Buildings - 33% (A)	23,237	25,039	4,169	22,871	27,736	32,490
Office and other equipment - 33% (A)	6,761	8,691	1,771	9,054	11,337	11,023
Total fixed charges	$ 56,338	$ 67,364	$ 10,674	$ 117,071	$ 138,377	$ 152,767
Pre-tax income (loss) from continuing operations before adjustment for minority interests in consolidated subsidiaries or income or loss from equity investees plus fixed charges, less preferred stock dividend requirements of consolidated subsidiaries, less capitalized interest	$ 173,114	$ 259,914	$ (149,646)	$ 256,426	$ 299,606	$ 235,007
Ratio of earnings to fixed charges	3.0728	3.8584	(B)	2.1903	2.1651	1.5383

(A) The Company uses 33% to estimate the interest on its rentals. This percentage is a reasonable approximation of the interest factor.

(B) In the predecessor period of January 1, 2005 to February 24, 2005 the ratio coverage was less than 1.1. The Company would have had to generate additional earnings of approximately $160.3 million to achieve a coverage ratio of 1:1.