LHC Group, Inc
Form 10-Q
November 14, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

þ **Quarterly report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**
For the quarterly period ended September 30, 2006

or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from__________ to __________

Commission file number: 0-8082
LHC GROUP, INC.
(Exact Name of Registrant as Specified in Charter)

Delaware	**71-0918189**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

420 West Pinhook Rd, Suite A
Lafayette, LA 70503
(Address of principal executive offices including zip code)
(337) 233-1307
(Registrant s telephone number, including area code)

Indicate by check mark whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated Filer o Non-accelerated filer þ

Indicate by check mark whether the registrant is a shell company (as defined in rule 12b-2 of the Exchange Act). Yes o No þ

Number of shares of common stock, par value $0.01, outstanding as of November 8, 2006: 17,827,704 shares

LHC GROUP, INC.
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PART I FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS.
LHC GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2006 (unaudited)	December 31, 2005
	(in thousands, except share data)	
ASSETS		
Current assets:		
Cash	$ 30,589	$ 17,398
Receivables:		
Patient accounts receivable, less allowance for uncollectible accounts of $4,381, and $2,544 at September 30, 2006 and December 31, 2005, respectively	47,091	34,810
Other receivables	2,429	3,365
Employee receivables	25	1,888
Amounts due from governmental entities	2,773	4,519
	52,318	44,582
Deferred income taxes	980	152
Income taxes recoverable		869
Prepaid expenses and other current assets	4,578	3,714
Assets held for sale	948	
Total current assets	89,413	66,715
Property, building, and equipment, net	11,396	10,224
Goodwill	38,540	26,103
Intangible assets, net	6,232	
Other assets	5,168	1,576
Total assets	$ 150,749	$ 104,618
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and other accrued liabilities	$ 5,161	$ 6,474
Salaries, wages, and benefits payable	10,251	6,124
Amounts due to governmental entities	3,045	3,080
Amounts payable under cooperative endeavor agreements	53	37
Income taxes payable	6,755	
Current portion of capital lease obligations	294	400
Current portion of long-term debt	426	1,406
Total current liabilities	25,985	17,521
Deferred income taxes, less current portion	1,974	1,573

Capital lease obligations, less current portion	126	347
Long-term debt, less current portion	3,841	3,274
Minority interests subject to exchange contracts and/or put options	540	1,511
Other minority interests	3,664	1,948
Stockholders equity:		
Common stock $0.01 par value: 40,000,000 shares authorized; 20,678,565 and 19,507,887 shares issued and 17,728,506 and 16,557,828 shares outstanding at September 30, 2006 and December 31, 2005, respectively	177	166
Treasury stock 2,950,059 shares at cost	(2,856)	(2,856)
Additional paid-in capital	80,156	58,596
Retained earnings	37,142	22,538
Total stockholders equity	114,619	78,444
Total liabilities and stockholders equity	$ 150,749	$ 104,618

See accompanying notes.

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LHC GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended September 30,		Nine months Ended September 30,	
	2006	2005	2006	2005
	(unaudited) (in thousands, except share and per share data)			
Net service revenue	$ 58,077	$ 38,611	$ 154,113	$ 110,037
Cost of service revenue	30,067	20,233	80,143	56,516
Gross margin	28,010	18,378	73,970	53,521
General and administrative expenses	18,817	11,792	50,496	32,207
Equity-based compensation expense[1]				3,856
Operating income	9,193	6,586	23,474	17,458
Interest expense	83	133	230	891
Non-operating income, including (gain) or loss on sales of assets	(364)	175	(645)	(389)
Income from continuing operations before income taxes and minority interest and cooperative endeavor allocations	9,474	6,278	23,889	16,956
Income tax expense	2,943	2,061	7,162	4,806
Minority interest and cooperative endeavor allocations	1,362	924	3,460	3,556
Income from continuing operations	5,169	3,293	13,267	8,594
Gain (Loss) from discontinued operations (net of income taxes (benefit) of $59 and $(328) in the three months ended September 30, 2006 and 2005, respectively, and $(147) and $(1,020) in the nine months ended September 30, 2006 and 2005, respectively)	102	(535)	(272)	(1,662)
Gain on sale of discontinued operations (net of income taxes of $390 for the nine months ended September 30, 2006)			667	
Net income	5,271	2,758	13,662	6,932
Redeemable minority interests	(72)	(404)	942	(1,743)
Net income available to common stockholders	$ 5,199	$ 2,354	$ 14,604	$ 5,189
Earnings per share basic:				
Income from continuing operations	$ 0.29	$ 0.20	$ 0.79	$ 0.62
	0.01	(0.03)	(0.02)	(0.12)

Gain (Loss) from discontinued operations, net								
Gain on sale of discontinued operations, net						0.04		
Net income		0.30		0.17		0.81		0.50
Redeemable minority interests				(0.03)		0.05		(0.13)
Net income available to common shareholders	$	0.30	$	0.14	$	0.86	$	0.37
Earnings per share diluted:								
Income from continuing operations	$	0.29	$	0.20	$	0.79	$	0.62
Gain (Loss) from discontinued operations, net		0.01		(0.03)		(0.02)		(0.12)
Gain on sale of discontinued operations, net						0.04		
Net income		0.30		0.17		0.81		0.50
Redeemable minority interests				(0.03)		0.05		(0.13)
Net income available to common shareholders	$	0.30	$	0.14	$	0.86	$	0.37
Weighted average shares outstanding:								
Basic		17,557,576		16,591,870		16,895,929		13,976,659
Diluted		17,574,541		16,594,774		16,907,787		14,049,940

(1) Equity-based compensation related to the KEEP units is allocated as follows, and does not include stock-based compensation related to FAS 123(R):

	Three Months Ended September 30,		Nine months Ended September 30,	
	(unaudited) (in thousands)			
	2006	2005	2006	2005
Cost of service revenue	$	$	$	$ 565
General and administrative expenses				3,291

Total equity-based compensation expense	$	$	$	$ 3,856

See accompanying notes.

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LHC GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine months Ended September 30,	
	2006	2005
	(unaudited) (in thousands)	
Operating activities		
Net income	$ 13,662	$ 6,932
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	1,742	1,237
Provision for bad debts	2,836	2,278
Equity-based compensation expense		3,856
Stock-based Compensation expense	536	98
Minority interest in earnings of subsidiaries	3,460	3,562
Deferred income taxes	(427)	1,202
Gain on divestitures and sale of assets	(667)	(205)
Changes in operating assets and liabilities, net of acquisitions:		
Receivables	(10,323)	(13,871)
Prepaid expenses, other assets	(3,652)	(1,188)
Accounts payable and accrued expenses	10,498	(5,191)
Net amounts due under cooperative endeavor agreements	16	181
Net amounts due governmental entities	1,711	1,551
Net cash provided by operating activities	19,392	442
Investing activities		
Purchases of property, building, and equipment	(2,702)	(1,568)
Proceeds from sale of entities	1,440	730
Cash paid for acquisitions, primarily goodwill	(21,060)	(2,076)
Net cash used in investing activities	(22,322)	(2,914)
Financing activities		
Issuance of common stock, net of underwriting discounts of $1,104 and $3,430 for the nine months ended September 30, 2006 and 2005 respectively	21,033	45,570
Dividends paid		(227)
Principal payments on debt	(1,163)	(2,295)
Payments on capital leases	(327)	(1,034)
Proceeds from issuance of debt		24
Net payments from lines of credit and revolving debt arrangements		(14,288)
Proceeds from exercise of options	135	
Proceeds from employee stock purchase plan	85	
Offering costs incurred	(250)	(1,816)
Minority interest distributions, net	(3,392)	(3,586)
Net cash provided by financing activities	16,121	22,348
Change in cash	13,191	19,876
Cash at beginning of period	17,398	2,911

Cash at end of period	$ 30,589	$ 22,787
Supplemental disclosures of cash flow information		
Interest paid	$ 230	$ 900
Income taxes paid	$ 120	$ 5,821

Supplemental disclosure of non-cash transactions:

The Company sold a clinic for promissory notes totaling $946,000 and recognized a loss on the sale of $28,000.

See accompanying notes.

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LHC GROUP, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Organization

LHC Group, Inc. (the Company) is a healthcare provider specializing in the post-acute continuum of care primarily for Medicare beneficiaries in rural markets in the southern United States. The Company provides home-based services, primarily through home nursing agencies and hospices, and facility-based services, primarily through long-term acute care hospitals and outpatient rehabilitation clinics. As of the date of this report, the Company, through its wholly and majority-owned subsidiaries, equity joint ventures, and controlled affiliates, operated in Louisiana, Alabama, Arkansas, Mississippi, Texas, West Virginia, Kentucky, and Florida.

The Company operated as Louisiana Health Care Group, Inc. (LHCG), until March 2001, when the shareholders of LHCG transferred to The Health Care Group, Inc. (THCG), all of the issued and outstanding shares of common stock of LHCG in exchange for shares in THCG. On January 1, 2003, the Company began operating as LHC Group, LLC, a Louisiana limited liability company. The THCG shareholders exchanged their shares for membership interests in the Company (units).

Prior to February 9, 2005, the Company operated under the terms of an operating agreement which provided that the Company had an infinite life and that the members personal liability was limited to his or her capital contribution. There was only one class of membership interest.

Plan of Merger and Recapitalization

In January 2005, LHC Group, LLC established a wholly-owned Delaware subsidiary, LHC Group, Inc. Effective February 9, 2005, LHC Group, LLC merged with and into LHC Group, Inc. In connection with the merger, each outstanding membership unit in LHC Group, LLC was converted into shares of the $0.01 par value common stock of LHC Group, Inc. based on an exchange ratio of three-for-two. LHC Group, Inc. has 40,000,000 shares of $0.01 par value common stock authorized and 5,000,000 shares of $0.01 par value preferred stock authorized. All references to common stock, share, and per share amounts have been retroactively restated to reflect the merger and recapitalization as if the merger and recapitalization had taken place as of the beginning of the earliest period presented.

As used herein, the Company includes LHC Group, Inc. and all predecessor entities.

Initial Public Offering

On June 9, 2005, the Company began its initial public offering of 4,800,000 shares of its common stock at a price of $14.00 per share. The Company offered 3,500,000 shares along with 1,300,000 shares that were sold by certain stockholders of LHC Group. The Company received no proceeds from the sale of the shares by the selling stockholders. The shares began trading on the NASDAQ National Market under the symbol LHCG on June 9, 2005. The initial public offering was completed on June 14, 2005. The underwriters exercised an option to purchase an additional 720,000 shares from certain stockholders solely to cover over-allotments. The Company received $45,570,000, net of underwriting discounts of $3,430,000 in proceeds from the offering. The Company incurred $3,963,000 in costs related to the initial public offering.

Unaudited Interim Financial Information

The condensed consolidated balance sheet as of September 30, 2006 and the related condensed consolidated statements of income and cash flows for the three and nine months ended September 30, 2006 and 2005 and related notes (interim financial information) have been prepared by LHC Group, Inc. and are unaudited. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation in accordance with accounting principles generally accepted in the United States have been included. Operating

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results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ended December 31, 2006.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted from the interim financial information presented. These consolidated financial statements should be read in conjunction with the notes to the consolidated financial statements included in the Company s Consolidated Financial Statements in the Company s Annual Report as filed with the Securities and Exchange Commission on Form 10-K for the year ended December 31, 2005, which includes information and disclosures not included herein.

2. Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 the reported revenue and expenses during the reported period. Actual results could differ from those estimates.

Critical Accounting Policies

The most critical accounting policies relate to the principles of consolidation, revenue recognition, accounts receivable and allowances for uncollectible accounts, and accounting for goodwill.

Principles of Consolidation

The consolidated financial statements include all subsidiaries and entities controlled by the Company. Control is generally defined by the Company as ownership of a majority of the voting interest of an entity. The consolidated financial statements include entities in which the Company absorbs a majority of the entity s expected losses, receives a majority of the entity s expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity.

All significant inter-company accounts and transactions have been eliminated in consolidation. Business combinations accounted for as purchases have been included in the consolidated financial statements from the respective dates of acquisition.

The following describes the Company s consolidation policy with respect to its various ventures excluding wholly-owned subsidiaries:

Equity Joint Ventures

The Company s joint ventures are structured as limited liability companies in which the Company typically owns a majority equity interest ranging from 51% to 98%. Each member of all but one of the Company s equity joint ventures participates in profits and losses in proportion to their equity interests. The Company has one joint venture partner whose participation in losses is limited. The Company consolidates these entities as the Company absorbs a majority of the entities expected losses, receives a majority of the entities expected residual returns and generally has voting control over the entity.

Cooperative Endeavors

The Company has arrangements with certain partners that involve the sharing of profits and losses. Unlike the equity joint ventures, the Company owns 100% of the equity in these cooperative endeavors. In these cooperative endeavors, the Company possesses interests in the net profits and losses ranging from 67% to 70%. The Company has one cooperative endeavor partner whose participation in losses is limited. The Company consolidates these

entities as the Company owns 100% of the outstanding equity and the Company absorbs a majority of the entities expected losses and receives a majority of the entities expected residual returns.

License Leasing Arrangements

The Company, through wholly-owned subsidiaries, leases home health licenses necessary to operate certain of its home nursing agencies. As with wholly-owned subsidiaries, the Company owns 100% of the equity of these entities and consolidates these entities due to such ownership, the Company s right to receive a majority of the entities expected residual returns and the Company s obligation to absorb a majority of the entities expected losses.

Management Services

The Company has various management services agreements under which the Company manages certain operations of agencies and facilities. The Company does not consolidate these agencies or facilities, as the Company does not have an ownership interest and does not have a right to receive a majority of the agencies or facilities expected residual returns or an obligation to absorb a majority of the agencies or facilities expected losses.

The following table summarizes the percentage of net service revenue earned by type of ownership or relationship the Company had with the operating entity:

	Three Months Ended September 30,		Nine months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Wholly-owned subsidiaries	40.4%	35.4%	37.6%	31.2%
Equity joint ventures	45.1	49.8	47.7	52.7
Cooperative endeavors	1.3	1.4	1.5	2.2
License leasing arrangements	10.6	10.9	11.1	11.0
Management services	2.6	2.5	2.1	2.9
	100.0%	100.0%	100.0%	100.0%

Revenue Recognition

The Company reports net service revenue at the estimated net realizable amount due from Medicare, Medicaid, commercial insurance, managed care payors, patients, and others for services rendered. Under Medicare, the Company s home nursing patients are classified into a group referred to as a home health resource group prior to the receipt of services. Based on this home health resource group, the Company is entitled to receive a prospective Medicare payment for delivering care over a 60-day period referred to as an episode. Medicare adjusts these prospective payments based on a variety of factors, such as low utilization, patient transfers, changes in condition and the level of services provided. In calculating the Company s reported net service revenue from home nursing services, the Company adjusts the prospective Medicare payments by an estimate of the adjustments. The Company calculates the adjustments based on a historical average of these types of adjustments. For home nursing services, the Company recognizes revenue based on the number of days elapsed during the episode of care.

For the Company s long-term acute care hospitals, revenue is recognized as services are provided. Under Medicare, patients in the Company s long-term acute care facilities are classified into long-term diagnosis-related groups. Based on this classification, the Company is then entitled to receive a fixed payment from Medicare. This fixed payment is also subject to adjustment by Medicare due to factors such as short stays. In calculating reported net service revenue for services provided in the Company s long-term acute care hospitals, the Company reduces the prospective payment amounts by an estimate of the adjustments. The Company calculates the adjustment based on a historical average of these types of adjustments for claims paid.

For hospice services, the Company is paid by Medicare under a per diem payment system. The Company receives one of four predetermined daily or hourly rates based upon the level of care the Company furnished. The Company records net service revenue from hospice services based on the daily or hourly rate. The Company recognizes revenue for hospice as services are provided.

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Under Medicare, the Company is reimbursed for rehabilitation services based on a fee schedule for services provided adjusted by the geographical area in which the facility is located. The Company recognizes revenue as these services are provided.

The Company s Medicaid reimbursement is based on a predetermined fee schedule applied to each service provided. Therefore, revenue is recognized for Medicaid services as services are provided based on this fee schedule. The Company s managed care payors reimburse the Company in a manner similar to either Medicare or Medicaid. Accordingly, the Company recognizes revenue from managed care payors in the same manner as the Company recognizes revenue from Medicare or Medicaid.

The Company records management services revenue as services are provided in accordance with the various management services agreements to which the Company is a party. The agreements generally call for the Company to provide billing, management, and other consulting services suited to and designed for the efficient operation of the applicable home nursing agency, hospice, or inpatient rehabilitation facility. The Company is responsible for the costs associated with the locations and personnel required for the provision of the services. The Company is generally compensated based on a percentage of net billings or an established base fee. In addition, for certain of the management agreements, the Company may earn incentive compensation.

Net service revenue was comprised of the following:

	Three Months Ended September 30,		**Nine months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Home-based services	78.1%	68.5%	74.4%	69.1%
Facility-based services	21.9	31.5	25.6	30.9
	100.0%	100.0%	100.0%	100.0%

The following table sets forth the percentage of net service revenue earned by category of payor:

	Three Months Ended September 30,		**Nine months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Payor:				
Medicare	80.9%	85.1%	82.9%	85.2%
Medicaid	4.1	5.0	4.3	4.6
Other	15.0	9.9	12.8	10.2
	100.0%	100.0%	100.0%	100.0%

Home-Based Services

Home Nursing Services. The Company receives a standard prospective Medicare payment for delivering care. The base payment, established through federal legislation, is a flat rate that is adjusted upward or downward based upon differences in the expected resource needs of individual patients as indicated by clinical severity, functional severity, and service utilization. The magnitude of the adjustment is determined by each patient s categorization into one of 80 payment groups, known as home health resource groups, and the costliness of care for patients in each group relative to the average patient. The Company s payment is also adjusted for differences in local prices using the hospital wage index. The Company performs payment variance analyses to verify the models utilized in projecting total net service revenue are accurately reflecting the payments to be received.

Medicare rates are subject to change. Due to the length of the Company s episodes of care, a situation may arise where Medicare rate changes affect a prior period s net service revenue. In the event that Medicare rates experience change, the net effect of that change will be reflected in the current reporting period.

Final payments from Medicare may reflect one of five retroactive adjustments to ensure the adequacy and effectiveness of the total reimbursement: (a) an outlier payment if the patient s care was unusually costly; (b) a low utilization adjustment if the number of visits was fewer than five; (c) a partial payment if the patient transferred to another provider before completing the episode; (d) a change-in-condition adjustment if the patient s medical status changes significantly, resulting in the need for more or less care; or (e) a payment adjustment based upon the level

of therapy services required in the population base. Management estimates the impact of these payment adjustments based on historical experience and records this estimate during the period the services are rendered.

Hospice Services. The Company s Medicare hospice reimbursement is based on an annually-updated prospective payment system. Hospice payments are also subject to two caps. One cap relates to individual programs receiving more than 20% of its total Medicare reimbursement from inpatient care services. The second cap relates to individual programs receiving reimbursements in excess of a cap amount, calculated by multiplying the number of beneficiaries during the period by a statutory amount that is indexed for inflation. The determination for each cap is made annually based on the 12-month period ending on October 31 of each year. This limit is computed on a program-by-program basis. None of the Company s hospices exceeded either cap during the nine months ended September 30, 2006 or 2005.

Facility-Based Services

Long-Term Acute Care Services. The Company is reimbursed by Medicare for services provided under the long-term acute care hospital prospective payment system, which was implemented on October 1, 2002. Each patient is assigned a long-term care diagnosis-related group. The Company is paid a predetermined fixed amount applicable to that particular group. This payment is intended to reflect the average cost of treating a Medicare patient classified in that particular long-term care diagnosis-related group. For selected patients, the amount may be further adjusted based on length of stay and facility-specific costs, as well as in instances where a patient is discharged and subsequently readmitted, among other factors. Similar to other Medicare prospective payment systems, the rate is also adjusted for geographic wage differences.

Outpatient Rehabilitation Services. Outpatient therapy services are reimbursed on a fee schedule, subject to annual limitations. Outpatient therapy providers receive a fixed fee for each procedure performed, adjusted by the geographical area in which the facility is located. The Company recognizes revenue as the services are provided. There are also annual per Medicare beneficiary caps that limit Medicare coverage for outpatient rehabilitation services.

Accounts Receivable and Allowances for Uncollectible Accounts

The Company reports accounts receivable net of estimated allowances for uncollectible accounts and adjustments. Accounts receivable are uncollateralized and primarily consist of amounts due from third-party payors and patients. To provide for accounts receivable that could become uncollectible in the future, the Company establishes an allowance for uncollectible accounts to reduce the carrying amount of such receivables to their estimated net realizable value. The credit risk for other concentrations of receivables is limited due to the significance of Medicare as the primary payor. The Company does not believe that there are any other significant concentrations of receivables from any particular payor that would subject it to any significant credit risk in the collection of accounts receivable.

The amount of the provision for bad debts is based upon the Company s assessment of historical and expected net collections, business and economic conditions, and trends in government reimbursement. Uncollectible accounts are written off when the Company has determined the account will not be collected.

A portion of the estimated Medicare prospective payment system reimbursement from each submitted home nursing episode is received in the form of a request for accelerated payment (RAP). The Company submits a RAP for 60% of the estimated reimbursement for the initial episode at the start of care. The full amount of the episode is billed after the episode has been completed. The RAP received for that particular episode is deducted from the final payment. If a final bill is not submitted within the greater of 120 days from the start of the episode, or 60 days from the date the RAP was paid, any RAPs received for that episode will be recouped by Medicare from any other claims in process for that particular provider. The RAP and final claim must then be re-submitted. For any subsequent episodes of care contiguous with the first episode for a particular patient, the Company submits a RAP for 50% instead of 60% of the estimated reimbursement. The Company has earned net service revenue in excess of billings rendered to Medicare. Only a nominal portion of the amounts due to the Medicare program represent cash collected in advance of providing services.

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Goodwill and Intangible Assets

Goodwill and other intangible assets with indefinite lives are reviewed annually, or more frequently if circumstances indicate impairment may have occurred.

The Company estimates the fair value of its identified reporting units and compares those estimates against the related carrying value. For each of the reporting units, the estimated fair value is determined based on a multiple of earnings before interest, taxes, depreciation, and amortization or on the estimated fair value of assets in situations when it is readily determinable.

The Company has concluded that licenses to operate home-based and/or facility-based services have indefinite lives, as management has determined that there are no legal, regulatory, contractual, economic or other factors that would limit the useful life of the licenses and the Company intends to renew and operate the licenses indefinitely. Accordingly, the Company has elected to recognize the fair value of these indefinite-lived licenses and goodwill as a single asset for financial reporting purposes. Intangible assets are assets acquired in business combinations that are separable from goodwill including trade names, licenses, and non-compete agreements.

Components of the Company s home nursing operating segment are generally represented by individual subsidiaries or joint ventures with individual licenses to conduct specific operations within geographic markets as limited by the terms of each license. Components of the Company s facility-based services are represented by individual operating entities. Effective January 1, 2004, management began aggregating the components of these two segments into two reporting units for purposes of evaluating impairment. Prior to January 1, 2004, management evaluated each operating entity separately for impairment. Modifications to the Company s management of the segments and reporting provided management with a basis to change the reporting unit structure.

Other Significant Accounting Policies

Due to/from Governmental Entities

The Company records revenue related to their critical access hospital at the lower of cost or charges, limited by cost caps depending on the payor. Final reimbursement is determined based on submission of annual cost reports and audits by the fiscal intermediary. Adjustments are accrued on an estimated basis in the period that the related services were rendered and further adjusted as final settlements are determined. These adjustments are accounted for as changes in estimates.

Also included in the due to/from governmental entities account are reimbursements that the Company is owed by the government as well as payments that are expected to be recouped by the government from the Company related to outlier payments for a long term acute care hospital.

Property, Building, and Equipment

Property, building, and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the individual assets, generally ranging from three to ten years and up to thirty-nine years on buildings. Depreciation expense for the three months ended September 30, 2006 and 2005 was $621,000 and $437,000, respectively and $1,742,000 and $1,162,000 for the nine months ended September 30, 2006 and 2005, respectively.

Capital leases are included in equipment. Capital leases are recorded at the present value of the future rentals at lease inception and are amortized over the shorter of the applicable lease term or the useful life of the equipment. Amortization of assets under the capital lease obligations is included in depreciation and amortization expense.

Long-Lived Assets

The Company reviews the recoverability of long-lived 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.

Income Taxes

The Company accounts for income taxes using the liability method. Under the liability method, deferred taxes are determined based on differences between the financial reporting and tax bases of assets and liabilities, and are measured using the enacted tax laws that will be in effect when the differences are expected to reverse. Management provides a valuation allowance for any net deferred tax assets when it is more likely than not that a portion of such net deferred tax assets will not be recovered.

Minority Interest and Cooperative Endeavor Agreements

The interest held by third parties in subsidiaries owned or controlled by the Company is reported on the consolidated balance sheets as minority interest. Minority interest reported in the consolidated statements of income reflects the respective interests in the income or loss of the subsidiaries attributable to the other parties, the effect of which is removed from the Company s consolidated results of operations.

Two of the Company s home health agencies have cooperative endeavor agreements with third parties that allow the third parties to be paid or recover a fee based on the profits or losses of the respective agencies. The Company accrues for the settlement of the third party s profits or losses during the period the amounts are earned. Under the agreements, the Company has incurred net amounts due to the third parties of $64,000 and $48,000 for the three months ended September 30, 2006 and 2005, respectively and $184,000 and $280,000 for the nine months ended September 30, 2006 and 2005, respectively. The cooperative endeavor agreements have terms expiring at the end of June 2008.

Agreements in which the third party is a healthcare institution typically require the Company to lease building and equipment and receive housekeeping and maintenance from the healthcare institutions. Ancillary services related to these arrangements are also typically provided by the healthcare institution.

Minority Interest Subject to Exchange Contracts and/or Put Options

During 2004, in conjunction with the acquisition/sale of joint venture interests, the Company entered into agreements with minority interest holders in three of its majority owned subsidiaries that allowed these minority interest holders to put their minority interests to the Company in the event the Company is sold, merged or otherwise acquired or completes an initial public offering (IPO). These put options were deemed to be part of the underlying minority interest shares, thus rendering the shares to be puttable shares. In September and November of 2004, the Company entered into forward exchange contracts with the minority interest holders in two of these subsidiaries, Acadian Home Health Care Services, LLC (Acadian) and Hebert, Thibodeaux, Albro and Touchet Therapy Group, Inc. (Hebert) which required the minority interest holders in these subsidiaries to sell their interests to the Company in the event of an IPO. In conjunction with the Company s IPO, the forward exchange contracts were consummated and the minority interest holders of Acadian and Hebert sold their minority interests to the Company in exchange for cash and shares of the Company s common stock. The Company had accrued the cash payment of approximately $2.2 million to be paid under these forward exchange contracts. This amount was paid in full in 2005.

In the third majority-owned subsidiary, St. Landry Extended Care Hospital, LLC (St. Landry), the put option allows the minority interest holders to convert their minority interests into shares of the Company based upon St. Landry s EBITDA for the prior fiscal year in relation to the Company s EBITDA over the same period. The put option became exercisable by the minority interest holders in St. Landry upon the completion of the IPO. However, due to applicable laws and regulations, the minority interest holders can not convert their minority interests in St. Landry unless certain conditions are met including, but not limited to, the Company having stockholders equity in excess of $75 million at the end of its most recent fiscal year or on average during the previous three fiscal years. If the St. Landry minority interest holders do not or are unable to convert their minority interests into shares of the Company, the minority interest holders shall have the option to redeem their minority interests at any time following 30 days after the IPO for cash consideration equal to the value of the shares the minority interest holders would have

received if they had converted their minority interests into shares of the Company multiplied by the average closing price of the Company s shares for the 30 days preceding the date of the minority interest holders exercise of the redemption option. As of December 31, 2005 and September 30, 2006, the Company had exceeded $75 million in stockholders equity. As of September 30, 2006, approximately 65% of the doctors have converted their minority interests to cash.

The above put/redemption options and exchange agreements have been presented in the historical financial statements under the guidance in Accounting Series Release (ASR) No. 268 and Emerging Issues Task Force (EITF) Topic D-98, which generally require a public company s stock subject to redemption requirements that are outside the control of the issuer to be excluded from the caption stockholders equity and presented separately in the issuer s balance sheet. Under EITF Topic D-98, once it becomes probable that the minority interest would become redeemable, the minority interest should be adjusted to its current redemption amount. As noted above, the St. Landry put option allowed the minority interest holders in St. Landry to have their interests redeemed for cash upon the completion of the IPO and therefore the Company recorded an adjustment of approximately $1.5 million to minority interests subject to exchange contracts and/or put options and to retained earnings which represents the redemption value of St. Landry s interests at September 30, 2005. In September 2005, certain minority interest holders redeemed their interests in St. Landry. This resulted in a cash payment of approximately $214,000. In connection with the partial redemption of certain minority interests in September 2005, we decreased our minority interests by approximately $149,000 and increased our retained earnings by the same amount. Simultaneously, we recorded goodwill of $214,000 to represent the value of the minority interests redeemed. Also at the end of the third quarter of 2005, we recorded a mark-to-market charge of $404,000.

In November 2005, the agreement was amended to allow minority interest holders to redeem their minority interests based on the St. Landry s rolling twelve month EBITDA in relation to the Company s EBITDA over the same period. At December 31, 2005, the Company recorded an additional mark-to-market benefit of $266,000 to mark the liability to redemption value at the end of the quarter.

In connection with the partial redemption of certain minority interest in the nine months ended September 30, 2006, the Company decreased our minority interests by approximately $968,000 and increased our retained earnings by the same amount. Simultaneously, the Company recorded goodwill of $920,000 to represent the value of the minority interests redeemed. Also for the nine months ended September 30, 2006, the Company recorded a mark-to-market charge of $26,000.

Equity-Based Compensation Expense

During 2003, the Company began sponsoring a Key Employee Equity Participation Plan (KEEP Plan) whereby certain individuals are granted participation equity units (KEEP Units). The KEEP Plan was terminated in conjunction with the initial public offering when the outstanding units were converted to 481,680 shares of common stock. The KEEP Plan functioned as a stock appreciation rights plan whereby an individual was entitled to receive, on a per KEEP Unit basis, the increase in estimated fair value of the Company s common stock from the date of grant until the date that the employee dies, retires, or is terminated for other than cause. Accordingly, the KEEP Units were subject to variable accounting until such time as the obligation to the employee was settled. The Company had a call right, under which it could purchase all or portion of the KEEP Units. The individuals receiving KEEP Units vested in those rights in a graded manner over a five-year period and, accordingly, the Company recorded compensation expense for the vested portion of the KEEP Units. The KEEP Units had no exercise price.

Compensation expense, and a corresponding increase in paid-in capital, was also recognized each period for any change in value associated with certain KEEP Units that were held by an officer of the Company.

In conjunction with the initial public offering, the outstanding KEEP Units were converted to common stock. In conjunction with this conversion, the Company incurred a charge to equity based compensation of approximately $3.0 million. The Company did not incur any expenses relating to the KEEP Units in 2006.

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Stock-based Compensation

On January 20, 2005, the 2005 Long-Term Incentive Plan was adopted by the Company s board of directors. There are 1,000,000 shares available for issuance under this plan. The Plan went into effect at the close of the initial public offering. Also during 2005, stock options and restricted stock were granted to the independent members of our Board of Directors in accordance with the 2005 Director Compensation Plan. Both the shares and options were issued from the 1,000,000 shares reserved for issuance under the 2005 Long-Term Incentive Plan.

The Company previously accounted for these issuances of restricted stock and stock option grants in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations (APB 25). Accordingly, the Company did not recognize compensation cost in connection with the issuance of the stock options, as the options granted had an exercise price equal to the market value of LHC Group, Inc. common stock on the date of grant. The Company did recognize compensation cost in connection with the issuance of restricted stock.

The Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R) (revised 2004), *Share-Based Payment*, a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*, on January 1, 2006 using the modified prospective method. This method requires compensation cost to be recognized beginning with the effective date (a) based on the requirements of SFAS No. 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123(R) that remain unvested on the effective date.

SFAS 123(R) applies to new awards issued on or after January 1, 2006, as well as awards that were outstanding as of December 31, 2005. Prior periods were not restated to reflect the impact of adopting the new standard.

Stock Options

The Company uses the Black-Scholes option pricing model to estimate the fair value of stock-based awards with the following weighted-average assumptions.

	Nine months Ended September 30,	
	2006	**2005**
Risk free interest rate	5.03%	3.72%
Expected life (years)	5	5
Volatility	38.39	41.62
Expected annual dividend yield		

The following table represents stock options activity for the nine month period ended September 30, 2006:

	Number of Shares	**Weighted average exercise price**
Options outstanding at December 31, 2005	13,500	$ 14.45
Options granted	15,500	19.75
Options exercised	(8,000)	16.88
Options forfeited or expired		
Options outstanding at September 30, 2006	21,000	17.44
Options exercisable at September 30, 2006	21,000	17.44

The Company has recorded $134,000 in compensation expense related to stock option grants in the nine month period ended September 30, 2006. The proforma expense for the same period in 2005 was $45,000. No compensation expense related to stock option grants was recorded in the three month period ended September 30, 2006. There was no proforma expense for the same period in 2005.

Restricted Stock

During 2005, 24,500 shares of restricted stock were issued to our independent directors under the 2005 Director Compensation Plan. One third of these shares vested immediately, and the remaining will vest over a two year period. On January 3, 2006, the Company granted 76,114 shares of restricted stock to certain members of

management. These shares were granted pursuant to the 2005 Long-Term Incentive Plan. These shares vest over a five year period. During the three month period ended September 30, 2006, the Company has recorded $113,000 in compensation expense related to restricted stock grants. There were no awards or forfeitures of restricted stock in the three month period ended September 30, 2006.

As of January 1, 2006, there were 16,333 shares of restricted stock outstanding at an average market value at the date of award of $14.44. During the nine months ended September 30, 2006, the Company granted 89,614 shares of restricted stock at the fair value of $18.14. During the nine months ended September 30, 2006, 8,167 shares of restricted stock vested and 8,731 shares were forfeited.

The Company has recorded $336,000 in compensation expense related to restricted stock grants in the nine month period ended September 30, 2006.

The Company has a plan whereby eligible employees may purchase the Company s common stock at 95% of the market price on the last day of the calendar quarter. There are 250,000 shares reserved for the plan. The Company issued 4,511 shares of common stock under the plan at a per share price of $18.92 during the three months ended September 30, 2006, At September 30, 2006 there were 245,489 shares available for future issuance.

Earnings Per Share

Basic per share information is computed by dividing the item by the weighted-average number of shares outstanding during the period. Diluted per share information is computed by dividing the item by the weighted-average number of shares outstanding plus dilutive potential shares.

The following table sets forth shares used in the computation of basic and diluted per share information for the three and nine months ended September 30, 2006 and 2005.

	Three Months Ended September 30,		Nine months Ended September 30,	
	2006	2005	2006	2005
Weighted average number of shares outstanding for basic per share calculation	17,557,576	16,591,870	16,895,929	13,976,659
Effect of dilutive potential shares:				
Options	2,828	1,818	1,741	714
Restricted stock	14,137	1,086	10,117	566
KEEP Units				72,001
Adjusted weighted average shares for diluted per share calculation	17,574,541	16,594,774	16,907,787	14,049,940

Recently Issued Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48, Accounting for the Uncertainty in Income Taxes, (FIN 48). FIN 48 is an interpretation of FASB Statement No. 109, Accounting for Income Taxes, and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 requires expanded disclosure with respect to the uncertainty in income taxes and is effective as of the beginning of our 2007 fiscal year. The Company is currently evaluating the impact, if any, that FIN 48 will have on the financials statements.

3. Acquisitions and Divestitures

The following acquisitions were completed pursuant to the Company s strategy of becoming the leading provider of post-acute healthcare services to Medicare patients in selected rural markets in the southern United States. The purchase price of each acquisition was determined based on the Company s analysis of comparable acquisitions and target market s potential cash flows. Goodwill generated from the acquisitions was recognized based on the expected contributions of each acquisition to the overall corporate strategy. The Company expects the goodwill recognized in connection with the acquisition of existing operations to be fully tax deductible.

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2006 Acquisitions

During the nine month period ended September 30, 2006, the Company acquired the existing operations of four entities and the minority interest in one of its joint ventures for $4,950,000 in cash and $238,000 in acquisition costs. Goodwill of $3.9 million was assigned to the home based services segment.

During the three month period ended September 30, 2006, the Company acquired the assets of Lifeline Home Health Care, a privately-held company based in Somerset, Kentucky, for $14.7 million in cash and approximately $737,000 in acquisition costs. Goodwill of $9.1 million and other intangibles of $6.2 million were assigned to the home based services segment.

In conjunction with certain minority interest holders redeeming their interests in St. Landry, $920,000 of goodwill, which is deductible for income tax purposes, was recognized in the facility based services segment.

2006 Divestitures

The Company sold one of its long-term acute care hospitals during the nine month period ended September 30, 2006 for $1.2 million. The Company recognized a gain of $958,000 on the sale of this hospital. In conjunction with this transaction, the Company allocated and retired $155,000 of goodwill related to this hospital. The Company sold a clinic in the nine months ended September 30, 2006 for promissory notes totaling $946,000 and recognized a loss on the sale of $28,000. Goodwill of $891,000 was retired in conjunction with the sale of the clinic. Additionally, the Company closed one location of another clinic and terminated virtually all of its private duty business during the nine month period ended September 30, 2006. Finally, the Company sold one of its home health agencies during the nine month period ended September 30, 2006 for $250,000 and retired goodwill of $50,000. The Company recognized a gain of $98,000 on the sale of this agency. The Company has identified one long-term acute care hospital as held for sale as of September 30, 2006. Goodwill of $402,000 and other assets related to this hospital are classified as assets held for sale on the balance sheet.

The following table summarizes the operating results of these divestitures which have been presented as loss from discontinued operations in the accompanying consolidated statements of income:

	Three Months Ended September 30,		**Nine months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Net service revenue	$ 1,736	$ 2,655	$ 6,078	$ 7,224
Costs, expenses and minority interest and cooperative endeavor allocations	1,575	3,518	6,497	9,906
Gain (Loss) from discontinued operations before income taxes	161	(863)	(419)	(2,682)
Income taxes (benefit)	59	(328)	(147)	(1,020)
Gain (Loss) from discontinued operations	$ 102	$ (535)	$ (272)	$ (1,662)

The changes in recorded goodwill by segment for the three month period ended September 30, 2006 were as follows:

	Nine months Ended September 30, 2006

	(in thousands)
Home-based services segment:	
Balance at December 31, 2005	$ 21,692
Goodwill acquired during the period from acquisitions	12,521
Goodwill retired during the period	(50)
Goodwill acquired during the period from purchase of minority interest	495
Balance at September 30, 2006	$ 34,658

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	Nine months Ended September 30, 2006 (in thousands)
Facility-based services segment:	
Balance at December 31, 2005	$ 4,411
Goodwill retired during the period from sale of business	(1,046)
Goodwill classified as held for sale during the period	(403)
Goodwill acquired during the period from redemption of minority interest	920
Balance at September 30, 2006	$ 3,882

The above transactions were considered to be immaterial individually and in the aggregate. Accordingly, no supplemental pro forma information is required.

4. Credit Arrangements

Long-Term Debt

Long-term debt consisted of the following:

	September 30, 2006	December 31, 2005
	(in thousands)	
Notes payable:		
Due in monthly installments of $143,000 through July 2006 at 5.5%	$	$ 842
Due in yearly installments of $50,000 through August 2010 at 6.5%	190	250
Due in monthly installments of $20,565 through October 2015 at LIBOR plus 225 basis points (7.55% at September 30, 2006)	2,904	2,929
Due in monthly installments of $48,500 through March 2006 at 5.7%		144
Due in monthly installments of $12,500 through November 2009 at 3.08%	423	515
Due in full February 1, 2008 at 7.25%	750	
	4,267	4,680
Less current portion of long-term debt	426	1,406
	$ 3,841	$ 3,274

In August 2005, the Company entered into a promissory note with Bancorp Equipment Finance, Inc. to purchase an airplane, for a principal amount of $2,975,000 with interest on any outstanding principal balance at the one month LIBOR rate plus 225 basis points. The note is collateralized by the airplane and is payable in 119 monthly installments of $20,565 followed by one balloon installment in the amount of $1,920,565.

In August 2005, the Company entered into a promissory note with the seller of A-1 Nursing Registry, Inc. (A-1) in conjunction with the purchase of the assets of A-1. The principal amount of the note is $250,000 and it bears interest at 6.5%.

In July 2006, the Company entered into a promissory note with the seller of Lifeline in conjunction with the purchase of the assets of Lifeline. The principle of the note is $750,000 and it bears interest at Wall Street Journal

prime rate minus 1.0%.

Certain of the Company s loan agreements contain certain restrictive covenants, including limitations on indebtedness and the maintenance of certain financial ratios. At September 30, 2006 and at December 31, 2005, the Company was in compliance with all covenants.

Other Credit Arrangements

The Company maintains a revolving-debt arrangement. Under the terms of this arrangement, the Company may be advanced funds up to a defined limit of eligible accounts receivable not to exceed the borrowing limit. At September 30, 2006 and December 31, 2005, the borrowing limit was $22,500,000, and no amounts were outstanding. Interest accrues on any outstanding amounts at a varying rate and is based on the Wells Fargo Bank, N.A. prime rate plus 1.5% (9.75% at September 30, 2006). The annual facility fee is 0.5% of the total availability. The agreement expires on April 15, 2010.

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5. Key Employee Equity Participation Plan

The Company had reserved up to 6.5% of the value of the Company s stock for issuance under the KEEP Plan. In conjunction with the initial public offering the 481,680 units became completely vested and were converted to common stock. During 2005, the Company incurred a charge to equity based compensation of $3.9 million. A summary of the changes in the KEEP Units outstanding is as follows:

	September 30, 2006	December 31, 2005
Outstanding at beginning of period		481,680
Granted		375,180
Exercised		
Converted		(481,680)
Outstanding at end of period		
Number of KEEP Units vested at end of period		

The KEEP Units were accounted for at their estimated fair value. Accordingly, no pro forma net income or per share information was required for prior periods.

6. Shareholders Equity

The following table summarizes the activity in stockholders equity for the nine month period ended September 30, 2006 (amounts in thousands, except per share data):

	Common Stock				Additional		
	Issued		Treasury		Paid-In	Retained	
	Amount	Shares	Amount	Shares	Capital	Earnings	Total
Balances at December 31, 2005	$ 166	19,507,887	$ (2,856)	2,950,059	$ 58,596	$ 22,538	$ 78,444
Net income						13,662	13,662
Sale of common stock	11	1,150,000			20,772		20,783
Compensation expense		8,167			395		395
Stock options issued					128		128
Stock options exercised		8,000			165		165
Issuance of stock under ESPP		4,511			100		100
Recording minority interest in joint venture at redemption value						942	942
Balances at September 30, 2006	$ 177	20,678,565	$ (2,856)	2,950,059	$ 80,156	$ 37,142	$ 114,619

7. Commitments and Contingencies

Contingent Convertible Minority Interests

During 2004, in conjunction with the acquisition/sale of joint venture interests, the Company entered into agreements with minority interest holders in three of its majority owned subsidiaries that allowed these minority interest holders to put their minority interests to the Company in the event the Company is sold, merged or otherwise acquired or completes an initial public offering (IPO). These put options were deemed to be part of the underlying minority interest shares, thus rendering the shares to be puttable shares. In September and November of 2004, the Company entered into forward exchange contracts with the minority interest holders in two of these subsidiaries, Acadian Home Health Care Services, LLC (Acadian) and Hebert, Thibodeaux, Albro and Touchet Therapy Group, Inc. (Hebert) which required the minority interest holders in these subsidiaries to sell their interests to the Company in the event of an IPO. In conjunction with the Company s IPO, the forward exchange contracts were consummated and the minority interest holders of Acadian and Hebert sold their minority interests to the Company in exchange for cash and shares of the Company s common stock. The Company had accrued the cash payment of approximately $2.2 million to be paid under these forward exchange contracts. This amount was paid in full in 2005.

In the third majority-owned subsidiary, St. Landry Extended Care Hospital, LLC (St. Landry), the put option allows the minority interest holders to convert their minority interests into shares of the Company based upon St. Landry s EBITDA for the prior fiscal year in relation to the Company s EBITDA over the same period. The put option became exercisable by the minority interest holders in St. Landry upon the completion of the IPO. However, due to applicable laws and regulations, the minority interest holders can not convert their minority interests in St. Landry unless certain conditions are met including, but not limited to, the Company having stockholders equity in excess of $75 million at the end of its most recent fiscal year or on average during the previous three fiscal years. If the St. Landry minority interest holders do not or are unable to convert their minority interests into shares of the Company, the minority interest holders shall have the option to redeem their minority interests at any time following 30 days after the IPO for cash consideration equal to the value of the shares the minority interest holders would have received if they had converted their minority interests into shares of the Company multiplied by the average closing price of the Company s shares for the 30 days preceding the date of the minority interest holders exercise of the redemption option. As of December 31, 2005 and September 30, 2006, the company had exceeded $75 million in stockholders equity. As of September 30, 2006, approximately 65% of the doctors have converted their minority interests to cash.

The above put/redemption options and exchange agreements have been presented in the historical financial statements under the guidance in Accounting Series Release (ASR) No. 268 and Emerging Issues Task Force (EITF) Topic D-98, which generally require a public company s stock subject to redemption requirements that are outside the control of the issuer to be excluded from the caption stockholders equity and presented separately in the issuer s balance sheet. Under EITF Topic D-98, once it becomes probable that the minority interest would become redeemable, the minority interest should be adjusted to its current redemption amount. As noted above, the St. Landry put option allowed the minority interest holders in St. Landry to have their interests redeemed for cash upon the completion of the IPO and therefore the Company recorded an adjustment of approximately $1.5 million to minority interests subject to exchange contracts and/or put options and to retained earnings which represents the redemption value of St. Landry s interests at September 30, 2005. In September 2005, certain minority interest holders redeemed their interests in St. Landry. This resulted in a cash payment of approximately $214,000. In connection with the partial redemption of certain minority interests in September 2005, we decreased our minority interests by approximately $149,000 and increased our retained earnings by the same amount. Simultaneously, we recorded goodwill of $214,000 to represent the value of the minority interests redeemed. Also at the end of the third quarter of 2005, we recorded a mark-to-market charge of $404,000.

In November 2005, the agreement was amended to allow minority interest holders to redeem their minority interests based on the St. Landry s rolling twelve month EBITDA in relation to the Company s EBITDA over the same period. At December 31, 2005, the Company recorded an additional mark-to-market benefit of $266,000 to mark the liability to redemption value at the end of the quarter.

In connection with the partial redemption of certain minority interest in the nine months ended September 30, 2006, we decreased our minority interests by approximately $968,000 and increased our retained earnings by the same amount. Simultaneously, we recorded goodwill of $920,000 to represent the value of the minority interests redeemed. Also for the nine months ended September 30, 2006, we recorded a mark-to-market charge of $26,000.

Contingencies

The terms of several joint venture operating agreements grant a buy/sell option that would require the Company to either purchase or sell the existing membership interest in the joint venture within 30 days of the receipt of the notice to exercise the provision. Either the Company or its joint venture partner has the right to exercise the buy/sell option. The party receiving the exercise notice has the right to either purchase the interests held by the other party or sell its interests to the other party. The purchase price formula for the interests is set forth in the joint venture agreement and is typically based on a multiple of the earnings before income taxes, depreciation and amortization of the joint venture. Total revenue earned by the Company from joint ventures subject to these arrangements was $3.4 million and $3.6 million for the three months ended September 30, 2006 and 2005, respectively and $10.6 million and $10.3 million for the nine months ended September 30, 2006 and 2005, respectively. The Company has not received notice from any joint venture partners of their intent to exercise the buy/sell option nor has the Company notified any joint venture partners of any intent to exercise the buy/sell option.

The Company is involved in various legal proceedings arising in the ordinary course of business. Although the results of litigation cannot be predicted with certainty, management believes the outcome of pending litigation will not have a material adverse effect, after considering the effect of the Company s insurance coverage, on the Company s consolidated financial statements.

Compliance

The laws and regulations governing the Company s operations, along with the terms of participation in various government programs, regulate how the Company does business, the services offered, and interactions with patients and the public. These laws and regulations, and their interpretations, are subject to frequent change. Changes in existing laws or regulations, or their interpretations, or the enactment of new laws or regulations could materially and adversely affect the Company s operations and financial condition.

The Company is subject to various routine and non-routine governmental reviews, audits, and investigations. In recent years, federal and state civil and criminal enforcement agencies have heightened and coordinated their oversight efforts related to the healthcare industry, including with respect to referral practices, cost reporting, billing practices, joint ventures, and other financial relationships among healthcare providers. Violation of the laws governing the Company s operations, or changes in the interpretation of those laws, could result in the imposition of fines, civil or criminal penalties, the termination of the Company s rights to participate in federal and state-sponsored programs, and the suspension or revocation of the Company s licenses.

If the Company s long-term acute care hospitals fail to meet or maintain the standards for Medicare certification as long-term acute care hospitals, such as average minimum length of patient stay, they will receive payments under the prospective payment system applicable to general acute care hospitals rather than payment under the system applicable to long-term acute care hospitals. Payments at rates applicable to general acute care hospitals would likely result in the Company receiving less Medicare reimbursement than currently received for patient services. Moreover, all of the Company s long-term acute care hospitals are subject to additional Medicare criteria because they operate as separate hospitals located in space leased from, and located in, a general acute care hospital, known as a host hospital. This is known as a hospital within a hospital model. These additional criteria include requirements concerning financial and operational separateness from the host hospital.

The Company anticipates there may be changes to the standard episode-of-care payment from Medicare in the future. Due to the uncertainty of the revised payment amount, the Company cannot estimate the impact that changes in the payment rate, if any, will have on its future financial statements. In August 2004, the Centers for Medicare and Medicaid Services, or CMS, adopted new regulations that implement significant changes affecting long-term acute care hospitals. Among other things, these new regulations, which became effective in October 2004, implemented new rules that provide long-term acute care hospitals operating in the hospital within a hospital model with lower rates of reimbursement for Medicare admissions from their host hospitals that are in excess of specified percentages.

These new rules also reclassified certain long-term acute care hospital diagnosis related groups, which could result in a decrease in reimbursement rates. Further, the new rules kept in place the financial penalties associated with the failure to limit to 5% the total number of Medicare patients discharged to the host hospital and subsequently readmitted to a long-term acute care hospital located within the host hospital.

The Company believes that it is in material compliance with all applicable laws and regulations and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing. While no such regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action, including fines, penalties, and exclusion from the Medicare program.

7. Segment Information

The Company s segments consist of (a) home-based services and (b) facility-based services. Home-based services include home nursing services and hospice services. Facility-based services include long-term acute care

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services and outpatient rehabilitation services. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

	Three Months Ended September 30, 2006		
	Home-Based Services	Facility-Based Services	Total
		(in thousands)	
Net service revenue	$ 45,348	$ 12,729	$ 58,077
Cost of service revenue	21,773	8,294	30,067
General and administrative expenses	15,104	3,713	18,817
Operating income	8,471	722	9,193
Interest expense	53	30	83
Non-operating income, including gain on sale of assets	(251)	(113)	(364)
Income from continuing operations before income taxes and minority interest and cooperative endeavor allocations	8,669	805	9,474
Minority interest and cooperative endeavor allocations	916	446	1,362
Income from continuing operations before income taxes	7,753	359	8,112
Total assets	$113,529	$ 37,220	$150,749

	Three Months Ended September 30, 2005		
	Home-Based Services	Facility-Based Services	Total
		(in thousands)	
Net service revenue	$26,434	$ 12,177	$ 38,611
Cost of service revenue	12,349	7,884	20,233
General and administrative expenses	8,851	2,941	11,792
Operating income	5,234	1,352	6,586
Interest expense	85	48	133
Non-operating income, including gain on sale of assets	22	153	175
Income from continuing operations before income taxes and minority interest and cooperative endeavor allocations	5,127	1,151	6,278
Minority interest and cooperative endeavor allocations	537	387	924
Income from continuing operations before income taxes	4,590	764	5,354
Total assets	$54,468	$ 47,189	$101,657

	Nine months Ended September 30, 2006		
	Home-Based Services	Facility-Based Services	Total
		(in thousands)	
Net service revenue	$ 114,601	$ 39,512	$ 154,113
Cost of service revenue	55,553	24,590	80,143
General and administrative expenses	39,249	11,247	50,496
Operating income	19,799	3,675	23,474
Interest expense	149	81	230
Non-operating income, including gain on sale of assets	(440)	(205)	(645)
Income from continuing operations before income taxes and minority interest and cooperative endeavor allocations	20,090	3,799	23,889
Minority interest and cooperative endeavor allocations	2,153	1,307	3,460
Income from continuing operations before income taxes	17,937	2,492	20,429

Total assets	$ 113,529	$ 37,220	$ 150,749

	Nine months Ended September 30, 2005		
	Home-Based Services	**Facility-Based Services**	**Total**
		(in thousands)	
Net service revenue	$75,984	$ 34,053	$110,037
Cost of service revenue	35,617	20,899	56,516
General and administrative expenses	23,750	8,457	32,207
Equity-based compensation expense	2,699	1,157	3,856
Operating income	13,918	3,540	17,458
Interest expense	588	303	891
Non-operating gain, including gain on sale of assets	(9)	(380)	(389)

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	Nine months Ended September 30, 2005		
	Home-Based Services	Facility-Based Services	Total
		(in thousands)	
Income from continuing operations before income taxes and minority interest and cooperative endeavor allocations	13,339	3,617	16,956
Minority interest and cooperative endeavor allocations	2,593	963	3,556
Income from continuing operations before income taxes	10,746	2,654	13,400
Total assets	$54,468	$ 47,189	$101,657

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

CAUTIONARY NOTICE REGARDING FORWARD-LOOKING STATEMENTS

This Management s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements. Forward-looking statements relate to expectations, beliefs, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts or that necessarily depend upon future events. In some cases, you can identify forward-looking statements by terms such as may, will, should, could, would, expect, plan, anticipate, believe, estimate, project, predict, potential, anc
Specifically, this report contains, among others, forward-looking statements about:

- our expectations regarding financial condition or results of operations for periods after September 30, 2006;
- our future sources of and needs for liquidity and capital resources;
- our expectations regarding the size and growth of the market for our services;
- our business strategies and our ability to grow our business;
- the implementation or interpretation of current or future regulations and legislation;
- the reimbursement levels of third-party payors;
- possible changes in legislation and/or government regulations that would affect our business;
- the impact of interest rates on our business; and
- our discussion of our critical accounting policies.

The forward-looking statements contained in this report reflect our current views about future events, are based on assumptions and are subject to known and unknown risks and uncertainties. Many important factors could cause actual results or achievements to differ materially from any future results or achievements expressed in or implied by our forward-looking statements. Many of the factors that will determine future events or achievements are beyond our ability to control or predict. Important factors that could cause actual results or achievements to differ materially from the results or achievements reflected in our forward-looking statements include, among other things, the factors discussed in the Part II, Item 1A Risk Factors, included in this report and in other of our filings with the SEC, including our annual report on Form 10-K for the year ended December 31, 2005. This report should be read in conjunction with that annual report on Form 10-K, and all our other filings, including quarterly reports on Form 10-Q and current reports on Form 8-K, made with the SEC through the date of this report.

You should read this report, the information incorporated by reference into this report and the documents filed as exhibits to this report completely and with the understanding that our actual future results or achievements may be materially different from what we expect or anticipate.

The forward-looking statements contained in this report reflect our views and assumptions only as of the date this report is signed. Except as required by law, we assume no responsibility for updating any forward-looking statements.

We qualify all of our forward-looking statements by these cautionary statements. In addition, with respect to all of our forward-looking statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

Unless the context otherwise requires, we, us, our, and the Company refer to LHC Group, Inc. and its consolidate subsidiaries.

Overview

We provide post-acute healthcare services primarily to Medicare beneficiaries in rural markets in the southern United States. We provide these post-acute healthcare services through our home nursing agencies, hospices, long-term acute care hospitals and outpatient rehabilitation clinics. Since our founders began operations in 1994 with one home nursing agency in Palmetto, Louisiana, we have grown to 128 locations in Louisiana, Alabama, Arkansas, Mississippi, Texas, West Virginia, Kentucky, and Florida as of September 30, 2006.

Segments

We operate in two segments for financial reporting purposes: home-based services and facility-based services. We derived 78.1% and 68.5% of our net service revenue during the three months ended September 30, 2006 and 2005, respectively, and 74.4% and 69.1% of our net service revenue during the nine months ended September 30, 2006 and 2005, respectively, from our home-based services segment and derived the balance of our net service revenue from our facility-based services segment.

Through our home-based services segment we offer a wide range of services, including skilled nursing, private duty nursing, physical, occupational, and speech therapy, medically-oriented social services, and hospice care. As of September 30, 2006, we owned and operated 98 Medicare-certified home nursing locations and five Medicare-certified hospices. Of these 103 home-based services locations, 58 are wholly-owned by us and 45 are majority-owned or controlled by us through joint ventures. We also manage the operations of 10 home nursing agencies and one hospice in which we have no ownership interest. We intend to increase the number of home nursing agencies that we operate through continued acquisition and development, primarily in underserved rural markets, as we implement our growth strategy. As we acquire and develop home nursing agencies, we anticipate the percentage of our net service revenue and operating income derived from our home-based services segment will increase.

We provide facility-based services principally through our long-term acute care hospitals and outpatient rehabilitation clinics. As of September 30, 2006, we owned and operated four long-term acute care hospitals with seven locations, six of these located within host hospitals. We also owned and operated one critical access hospital, two outpatient rehabilitation clinics and provided contract rehabilitation services to third parties. Of these 10 facility-based services locations, three are wholly-owned by us and seven are majority-owned or controlled by us through joint ventures. We also manage the operations of one inpatient rehabilitation facility in which we have no ownership interest. Because of the recent changes in the regulations applicable to long-term acute care hospitals operated as hospitals within hospitals, we do not intend to expand the number of hospital within a hospital long-term acute care hospitals that we operate. Due to our emphasis on expansion through the acquisition and development of home nursing agencies, we anticipate that the percentage of our net service revenue and operating income derived from our facility-based segment will decline.

Recent Developments

Medicare

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Home-Based Services. The current base payment rate for Medicare home nursing is $2,264. Since the inception of the prospective payment system in October 2000, the base episode rate payment has varied due to both the impact of annual market basket based increases and Medicare-related legislation.

Home health payment rates are updated annually by either the full home health market basket percentage, or by the home health market basket percentage as adjusted by Congress. The Centers for Medicare and Medicaid Services, or (CMS), establishes the home health market basket index, which measures inflation in the prices of an appropriate mix of goods and services included in home health services.

On November 1, 2006, the Centers for Medicare and Medicaid Services (CMS) released the final rule updating the home health perspective payment systems for calendar year 2007. The rule finalizes the market basket increase of 3.3%, a 0.2% increase over the proposed rule. This equates to a 3.1% update for urban HHAs and a 3.6% update for rural HHAs after accounting for changes in the wage index. The update increases the national 60-day episode payment rate for urban home health agencies from the current level of $2,264.38 to $2,339.00. Under the final rule, HHAs will get the full home health market basket as long as they submit required quality data using the Outcome and Assessment Information Set (OASIS). With some limited exceptions, if an HHA does not provide this data, then its home health market basket update of 3.3% will be reduced by two percentage points. The final rule discontinues the temporary 5% add-on payment for rural HHAs in 2007, except for episodes that begin before January 1, 2007. The final rule does not modify the current case-mix methodology for 2007

In August 2006, CMS announced the payment rates for hospice care furnished from October 1, 2006 through September 30, 2007. These rates are 3.4% higher more than the rates for the previous year. In addition, CMS announced that the hospice cap amount for the year ending October 31, 2006 is $20,585.

Facility-Based Services. Under the long-term acute care hospital prospective payment system implemented on October 1, 2002, each patient discharged from our long-term acute care hospitals is assigned a long-term care diagnosis-related group. CMS establishes these long-term care diagnosis-related groups by categorizing diseases by diagnosis, reflecting the amount of resources needed to treat a given disease. For each patient, we are paid a pre-determined fixed amount applicable to the particular long-term care diagnosis-related group to which that patient is assigned. Effective for discharges on or after October 1, 2005, CMS has published the new relative weights applicable to the long-term care diagnosis-related group system. The updated regulations provide for a 3.4% increase in the standard federal rate, a budget neutrality factor of 0, which became effective July 1, 2005, and a decrease in the high cost outlier fixed loss threshold to $10,501. In addition, on May 6, 2005 CMS published a final rule increasing the Medicare payment rates for long-term acute care hospitals by 3.4% for patient discharges taking place on or after July 1, 2005 through September 30, 2006.

CMS has also stated its intention to develop long-term acute care hospital patient-specific criteria to refine the definition of such facilities. Comments included in the May 6, 2005 rule indicate that CMS has awarded a contract to Research Triangle Institute for the purpose of evaluating patient and facility level characteristics for long-term care hospitals in order to differentiate the role of long-term acute care hospitals from general acute care hospitals. This evaluation is in response to the June 2004 MedPAC Report recommending that CMS examine defining long-term acute care hospitals by facility and patient criteria. CMS has also charged Research Triangle Institute with examining the present role of Quality Improvement organizations with regard to long-term care acute hospitals.

On May 2, 2006, CMS issued a rule under the long-term care hospital prospective payment system for the 2007 rate year starting July 1, 2006. The rule provides for no increase in the Medicare payment rates to long-term acute care hospitals for discharges taking place on or after July 1, 2006 through September 30, 2007. Therefore, CMS has ruled that the long-term care hospital prospective payment system federal rate will remain at $38,086.04 for the 2007 rate year. In addition, CMS adopted the Rehabilitation, Psychiatric and Long-Term Care market basket to replace the excluded hospital with capital market basket that is currently used as the measure of inflation for calculating the annual update to the long-term care hospital prospective payment system federal rate. The rule also revised the payment adjustment formula for short-stay outlier cases, which overall comprise 37% of long-term care hospital prospective payment system discharges. These are cases where a patient is discharged early and the hospital s costs are significantly below average. The rule made a number of other regulatory changes aimed at curbing the long-term care hospital Medicare margin growth that has occurred since implementation of the prospective payment system in 2002

(growth CMS says will reach 7.8% in 2006). CMS also contends that long-term

care hospital Medicare margins increased from 7.8% in fiscal year 2003 to 12.7% in fiscal year 2004. The high cost outlier will increase for the rate year 2007 to $14,887.

Under Medicare, we are reimbursed for rehabilitation services based on a fee schedule for services provided adjusted by the geographical area in which the facility is located. Outpatient therapy services are subject to an annual cap of $1,750 per beneficiary effective January 1, 2006. The Deficit Reduction Act of 2005 included a medical review policy to the statutory therapy cap that allows claims over the cap to be approved on a case-by-case basis on the basis of medical necessity. This exceptions process is in effect for only for one year; it ends on December 31, 2006. We are unable to predict whether Congress will renew the exceptions process this year before it adjourns.

Components of Expenses

Cost of Service Revenue

Our cost of service revenue consists primarily of the following expenses incurred by our clinical and clerical personnel in our agencies and facilities:

- salaries and related benefits;
- transportation, primarily mileage reimbursement; and
- supplies and services, including payments to contract therapists.

General and Administrative Expenses

Our general and administrative expenses consist primarily of the following expenses incurred by our home office and administrative field personnel:

- Home office
  - salaries and related benefits;
  - insurance;
  - costs associated with advertising and other marketing activities; and
  - rent and utilities;
- Supplies and services
  - accounting, legal and other professional services; and
  - office supplies;
- Depreciation; and
- Provision for bad debts.

Equity-Based Compensation Expense

Under our KEEP Plan certain of our employees were granted KEEP Units. The KEEP Units, which have no exercise price, vested over a five-year period. The KEEP Units functioned as stock appreciation rights whereby an individual is entitled to receive, on a per unit basis, the increase in estimated fair value, as determined by us, of our units from the date of grant until the date upon which the employee dies, retires or is terminated for any reason other than cause. Accordingly, the KEEP Units were subject to variable accounting until such time as the obligation to the employee was settled. At the initial public offering price of $14.00 per share, upon the completion of the offering all obligations relating to our KEEP Units were settled by conversion into shares of our common stock and we incurred a final, non-recurring equity-based compensation charge in the amount of approximately $3.0 million (net of taxes of $1.7 million).

Our equity-based compensation expense was allocated to our home-based and facility-based services segments in accordance with our home office allocation, which is calculated based on the percentage of our net service revenue contributed by each segment during the applicable period.

Results of Operations

Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005

Net Service Revenue

Net service revenue for the three months ended September 30, 2006 was $58.1 million, an increase of $19.5 million, or 50.4%, from $38.6 million in 2005. For the three months ended September 30, 2006 and 2005, 80.9% and 85.1%, respectively, of our net service revenue was derived from Medicare.

Home-Based Services.

Net service revenue for the three months ended September 30, 2006 was $45.3 million, an increase of 71.6%, from $26.4 million for the three months ended September 30, 2005. Organic growth in this service sector was approximately $10.5 million, or 43.3%. Total admissions were 7,377 during the period, versus 4,220 for the same period in 2005, a 74.8% increase. Organic growth in admissions was 26.2%. The Company also monitors patient census as a key performance indicator within its home based services. LHC Group s average home based patient census for the three months ended September 30, 2006 was 13,524 patients, an increase of 81.0% as compared to 7,471 patients for the three months ended September 30, 2005. Organic growth in home-based patient census was 26.0%. Organic growth includes growth on same store locations (owned for greater than 12 months), and growth from de novo locations. Growth from acquired locations owned less than 13 months is not included.

	2005 Revenue	2006 Revenue	% Growth	2005 Admissions	2006 Admissions	% Growth	2005 Census	2006 Census	% Growth
Organic	$24,340	$34,868	43.3%	3,805	4,803	26.2%	6,985	8,801	26.0%
Acquired	$ 2,093	$10,480	400.7%	415	2,574	520.2%	486	4,723	871.8%
Total	$26,433	$45,348	71.6%	4,220	7,377	74.8%	7,471	13,524	81.0%

Facility-Based Services.

Net service revenue for the three months ended September 30, 2006 was $12.7 million, an increase of $0.5 million, or 4.5%, from $12.2 million for the three months ended September 30, 2005. Organic growth in this service sector made up the entire growth during the period. The increase in net service revenue resulted in part due to an increase in patient days of 2.1% to 11,674 in the three months ended September 30, 2006 from 11,437 in the three months ended September 30, 2005. Outpatient visits decreased to 4,287 at September 30, 2006, a 56.1% decrease as compared to 9,768 for the three months ended September 30, 2005 due to the sale of one of our clinics and the closing of one location of another clinic.

	2005 Revenue	2006 Revenue	% Growth	2005 Patient Days	2006 Patient Days	% Growth	2005 Discharges	2006 Discharges	% Growth
Organic	$12,177	$12,729	4.5%	11,437	11,674	2.1%	402	441	9.7%
Acquired			0.0%			0.0%			0.0%
Total	$12,177	$12,729	4.5%	11,437	11,674	2.1%	402	441	6.2%

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Cost of Service Revenue

Cost of service revenue for the three months ended September 30, 2006 was $30.1 million, an increase of $9.9 million, or 48.6%, from $20.2 million for the three months ended September 30, 2005. Cost of service revenue represented approximately 51.8% and 52.4% of our net service revenue for the three months ended September 30, 2006 and 2005, respectively.

Home-Based Services. Cost of service revenue for the three months ended September 30, 2006 was $21.8 million, an increase of $9.5 million, or 76.3%, from $12.3 million for the three months ended September 30, 2005. Approximately $7.5 million of this increase resulted from an increase in salaries and benefits. Approximately $7.1 million of the increase in salaries and benefits expense was due to acquisitions. The remaining increase in salaries and benefits expense of approximately $0.4 million was primarily attributable to internal growth. The remaining increase in cost of service revenue was attributable to increases in supplies and services expense and transportation expense of $1.4 million and $500,000, respectively. Approximately $900,000 of the increase in supplies and services expense was due to acquisitions while the entire increase in transportation was due to acquisitions.

Facility-Based Services. Cost of service revenue for the three months ended September 30, 2006 was $8.3 million, an increase of $0.4 million or 5.2%, from $7.9 million for the three months ended September 30, 2005. The entire increase resulted from an increase in salaries and benefits from internal growth.

General and Administrative Expenses

General and administrative expenses for the three months ended September 30, 2006 was $18.8 million, an increase of $7.0 million, or 59.6%, from $11.8 million for the three months ended September 30, 2005. Approximately $4.7 million was incurred as a result of acquisition or development activity. Public company costs of SEC filings and Sarbanes-Oxley compliance totaled $0.5 million during the period. The remaining $1.8 million is due to internal growth. General and administrative expenses represented approximately 32.4% and 30.5% of our net service revenue for the three months ended September 30, 2006 and 2005, respectively.

Home-Based Services. General and administrative expenses for the three months ended September 30, 2006 was $15.1 million, an increase of $6.2 million, or 70.6%, from $8.9 million for the three months ended September 30, 2005. Approximately $1.5 million of this increase resulted from internal growth and $4.7 million was incurred as a result of acquisition or development activity.

Facility-Based Services. General and administrative expenses for the three months ended September 30, 2006 were $3.7 million, an increase of $0.6 million, or 26.2%, from $2.9 million for the same period in 2005. The entire growth was attributable to internal growth.

Income Tax Expense

The effective tax rates for the three months ended September 30, 2006 and 2005 were 36.3% and 38.6%, respectively. The effective tax rate decrease in the three months ended September 30, 2006 is primarily due to the Company recording tax credits of $235,000 related to the Gulf Opportunity Zone Act of 2005.

Minority Interest and Cooperative Endeavor Allocations

The minority interest and cooperative endeavor allocations expense for the three months ended September 30, 2006 was $1.4 million, compared to $0.9 million for the same period in 2005.

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Discontinued Operations

Revenue from discontinued operations for the three months ended September 30, 2006 and 2005 was $1.7 million and $2.7 million, respectively. Costs, expenses, and minority interest and cooperative endeavor allocations were $1.6 million and $3.5 million, respectively, for the three months ended September 30, 2006 and 2005. For the three months ended September 30, 2006, income from discontinued operations was $102,000, as compared to a loss from discontinued operations of $535,000 for the same period in 2005.

Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005

Net Service Revenue

Net service revenue for the nine months ended September 30, 2006 was $154.1 million, an increase of $44.1 million, or 40.1%, from $110.0 million in 2005. For the nine months ended September 30, 2006 and 2005, 82.9% and 85.2% respectively, of our net service revenue was derived from Medicare.

Home-Based Services.

Net service revenue for the nine months ended September 30, 2006 was $114.6 million, an increase of 50.8%, from $76.0 million for the nine months ended September 30, 2005. Organic growth in this service sector was approximately $24.1 million, or 33.5%. Total admissions were 18,799 during the period, versus 12,377 for the same period in 2005, a 51.9% increase. Organic growth in admissions was 18.5%. LHC Group s average home based patient census for the nine months ended September 30, 2006 was 13,306 patients, an increase of 83.1% as compared to 7,267 patients for the nine months ended September 30, 2005. Organic growth in home-based patient census was 26.5%.

	2005 Revenue	2006 Revenue	% Growth	2005 Admissions	2006 Admissions	% Growth	2005 Census	2006 Census	% Growth
Organic	$71,860	$ 95,932	33.5%	11,368	13,468	18.5%	6,846	8,660	24.7%
Acquired	$ 4,124	$ 18,669	352.8%	1,009	5,331	428.3%	421	4,646	1,041.5%
Total	$75,984	$114,601	50.8%	12,377	18,799	51.9%	7,267	13,306	81.1%

Facility-Based Services.

Net service revenue for the nine months ended September 30, 2006 was $39.5 million, an increase of $5.4 million, or 16.0%, from $34.1 million for the nine months ended September 30, 2005. Organic growth in this service sector was approximately $5.5 million which made up the entire growth during the period. The increase in net service revenue resulted in part due to an increase in patient days of 6.7% to 34,483 in the nine months ended September 30, 2006 from 32,332 in the nine months ended September 30, 2005. Outpatient visits decreased to 18,219 at September 30, 2006, a 44.6% decrease as compared to 32,892 for the nine months ended September 30, 2005 due to the sale of one of our clinics and the closing of one location of another clinic.

	2005 Revenue	2006 Revenue	% Growth	2005 Patient Days	2006 Patient Days	% Growth	2005 Discharges	2006 Discharges	% Growth
Organic	$34,053	$39,512	16.0%	32,332	34,483	6.7%	1,164	1,324	13.7%
Acquired			0.0%			0.0%			0.0%
Total	$34,053	$39,512	16.0%	32,332	34,483	6.7%	1,164	1,324	6.2%

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Cost of Service Revenue

Cost of service revenue for the nine months ended September 30, 2006 was $80.1 million, an increase of $23.6 million, or 41.8%, from $56.5 million for the nine months ended September 30, 2005. Cost of service revenue represented approximately 52.0% and 51.4% of our net service revenue for the nine months ended September 30, 2006 and 2005, respectively.

Home-Based Services. Cost of service revenue for the nine months ended September 30, 2006 was $55.6 million, an increase of $20.0 million, or 56.0%, from $35.6 million for the nine months ended September 30, 2005. Approximately $13.7 million of this increase resulted from an increase in salaries and benefits due to acquisition or development activity. The increase in salaries and benefits expense due to internal growth accounted for approximately $2.1 million of the increase in this category. Supplies and services expense and transportation expense contributed approximately $2.8 million and $1.3 million, respectively, to the increase in cost of service revenue. Acquisition or development activity accounted for $2.0 of the supplies and service expense increase and the entire increase in transportation.

Facility-Based Services. Cost of service revenue for the nine months ended September 30, 2006 was $24.6 million, an increase of $3.7 million, or 17.7%, from $20.9 million for the nine months ended September 30, 2005. Approximately $3.1 million of this increase resulted from an increase in salaries and benefits related to internal growth. Supplies and services expense contributed approximately $600,000 of the increase in cost of service revenue. Transportation expense increased approximately $100,000 over this same period.

General and Administrative Expenses

General and administrative expenses for the nine months ended September 30, 2006 were $50.5 million, an increase of $18.3 million, or 56.8%, from $32.2 million for the nine months ended September 30, 2005. Approximately $10.4 million of this increase was attributable to acquisition or internal development activity. Public company costs of SEC filings and Sarbanes-Oxley compliance totaled $1.3 million during the period. The remaining $6.6 million increase was attributable to the Company s growth.

Home-Based Services. General and administrative expenses for the nine months ended September 30, 2006 were $39.2 million, an increase of $15.4 million, or 65.3%, from $23.8 million for the nine months ended September 30, 2005. Approximately $10.4 million of this increase was attributable to acquisition or internal development activity. Internal growth accounted for approximately $5.0 million.

Facility-Based Services. General and administrative expenses for the nine months ended September 30, 2006 were $11.2 million, an increase of $2.7 million, or 33.0%, from $8.5 million for the nine months ended September 30, 2005. The entire increase is due to internal growth.

Equity-Based Compensation Expense

There was no equity-based compensation expense for the nine months ended September 30, 2006, which was a decrease of $3.9 million from the same period in 2005. Equity-based compensation expense related to the KEEP Units was zero in the nine months ended September 30, 2006 due to the conversion of all of the KEEP units to common stock in connection with the initial public offering in the second quarter of 2005.

Income Tax Expense

The effective tax rates for the nine months ended September 30, 2006 and 2005 were 35.1% and 35.3%, respectively.

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Minority Interest and Cooperative Endeavor Allocations

The minority interest and cooperative endeavor allocations expense for the nine months ended September 30, 2006 was $3.5 million, a decrease of approximately $100,000, compared to $3.6 million for the nine months ended September 30, 2005. The decrease was attributable to the conversion of certain minority interests after the initial public offering.

Discontinued Operations

The Company sold one of its long-term acute care hospitals during the nine month period ended September 30, 2006 for $1.2 million. The Company recognized a gain of $958,000 on the sale of this hospital. The Company also sold a clinic in the nine months ended September 30, 2006 for promissory notes totaling $946,000 and recognized a loss on the sale of $28,000. The Company also closed one other location of another clinic. Additionally, the Company closed virtually all of its private duty business during the nine month period ended September 30, 2006. Finally, the Company also sold one of its home health agencies during the nine month period ended September 30, 2006 for $250,000. The Company recognized a gain of $98,000 on the sale of this agency. The results of these operations are reported as discontinued operations in the accompanying consolidated statement of income.

Revenue from discontinued operations for the nine months ended September 30, 2006 and 2005 was $6.1 million and $7.2 million, respectively. Costs, expenses, and minority interest and cooperative endeavor allocations were $6.5 million and $9.9 million respectively, for the nine months ended September 30, 2006 and 2005. Losses from discontinued operations were $272,000 and $1.7 million for the nine months ended September 30, 2006 and 2005, respectively.

Liquidity and Capital Resources

Our principal source of liquidity for our operating activities is the collection of our accounts receivable, most of which are collected from governmental and third party commercial payors. Our reported cash flows from operating activities are impacted by various external and internal factors, including the following:

Operating Results Our net income has a significant impact on our operating cash flows. Any significant increase or decrease in our net income could have a material impact on our operating cash flows.

Start Up Costs Following the completion of an acquisition, we generally incur substantial start up costs in order to implement our business strategy. There is generally a delay between our expenditure of these start up costs and the increase in net service revenue, and subsequent cash collections, which adversely effects our cash flows from operating activities.

Timing of Payroll Our employees are paid bi-weekly on Fridays; therefore, operating cash flows decline in reporting periods that end on a Friday. Conversely, for those reporting periods ending on a day other than Friday, our cash flows are higher because we have not yet paid our payroll.

Medical Insurance Plan Funding We are self funded for medical insurance purposes. Any significant changes in the amount of insurance claims submitted could have a direct impact on our operating cash flows.

Medical Supplies A significant expense associated with our business is the cost of medical supplies. Any increase in the cost of medical supplies, or in the use of medical supplies by our patients, could have a material impact on our operating cash flows.

Cash used in investing activities is primarily for acquisitions of home nursing agencies and other healthcare facilities and property and equipment, while cash provided by financing activities is derived from the proceeds from our revolving debt arrangement.

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Operating activities during the nine months ended September 30, 2006 provided $19.4 million in cash and $0.4 million in cash for the nine months ended September 30, 2005. Net income provided cash of $13.7 million. Non-cash items such as depreciation and amortization, provision for bad debts, equity-based compensation, compensation expense, minority interest in earnings of subsidiaries, deferred income taxes and gain on sale of assets totaled $7.5 million. Changes in operating assets and liabilities, excluding cash, offset these non-cash charges totaled $(1.7) million.

Days sales outstanding, or DSO, for the three months ended September 30, 2006 was 72 days compared to 79 days for the same three-month period in 2005. DSO, when adjusted for acquisitions and unbilled accounts receivables, was 66 days. The adjustment takes into account $4.4 million of unbilled receivables that the Company is delayed in billing at this time due to the lag time in receiving the change of ownership recognition after acquiring companies. There were no such adjustments for the comparable period in 2005.

Investing activities used $22.3 million and $2.9 million in cash for the nine months ended September 30, 2006 and 2005, respectively. In the nine months ended September 30, 2006, cash used by investing activities included $21.1 million primarily for acquisitions and by cash used of $2.7 million for the purchases of property and equipment, offset by cash provided of $1.4 million from the sale of entities.

Financing activities provided $16.1 million in the nine months ended September 30, 2006 and provided $22.3 million in the nine months ended September 30, 2005. Cash provided in financing activities in the nine months ended September 30, 2006 included $21.0 million from the issuance of common stock, offset primarily by minority interest distributions of $3.4 million and principal payments on debt of $1.2 million.

As of September 30, 2006, we had working capital of $63.4 million compared to $49.2 million at December 31, 2005, an increase of $14.2 million.

Offering Proceed

The Company completed its initial public offering on June 14, 2005. The net offering proceeds received by us, after deducting the total expenses of $7,393,000 (including $3,430,000 in underwriting discounts and commissions), were approximately $41,607,000. As of September 30, 2006, $21.9 million of the net offering proceeds have been used to repay the following indebtedness: (1) $21.1 million on the credit facility, bearing interest at prime plus 1.5% and due April 10, 2010, with Residential Funding Corporation; (2) $643,000 of outstanding obligations under our loan agreement, bearing interest at 12.0% and due July 1, 2006, with The Catalyst Fund, Ltd. and Southwest/Catalyst Capital, Ltd.; and (3) approximately $178,000 of outstanding indebtedness assumed by us in connection with acquisitions completed by us in 2004. Additionally, $3.3 million has been used to pay minority interest holders for their interests and $14.0 million has been used to fund acquisitions since the initial public offering.

During the three months ended September 30, 2006, the Company closed its follow on public offering of 4,000,000 shares of common stock at a price of $19.25 per share. Of the 4,000,000 shares of common stock offered, 1,000,000 shares were offered by the Company, with the remaining 3,000,000 shares of common stock sold by the selling stockholders identified in the prospectus supplement. The underwriters exercised an over-allotment of an additional 600,000 shares, 150,000 of which were sold by the Company. The additional net cash provided to the Company from this offering after deducting expenses and underwriting discounts and commissions amounted to approximately $21 million.

During the three months ended September 30, 2006, the Company used approximately $14.7 million of the proceeds from its follow on public offering in order to acquire the Kentucky-based assets of Lifeline Home Health Care, a privately-held company based in Somerset, Kentucky.

Indebtedness

Our total long-term indebtedness was $4.7 million at September 30, 2006 and $5.4 million at December 31, 2005, respectively, including the current portions of $720,000 and $1.8 million, respectively. In April 2005, we entered into an amended and restated senior secured credit facility with Residential Funding Corporation due April 15, 2010. We, together with certain of our subsidiaries, are borrowers under the credit facility. Our obligations and the obligations of our subsidiary borrowers under our credit facility agreement are secured by a lien on substantially all of our assets (including the capital stock or other forms of ownership interests we hold in our subsidiaries and affiliates) and the assets of those subsidiaries and affiliates.

Our credit facility makes available to us up to $22.5 million in revolving loans. The total availability may be increased up to a maximum of $25.0 million, subject to certain terms and conditions. Total availability under our credit facility may be limited from time to time based on the value of our receivables. This facility was paid in full as of the quarter ended September 30, 2005. As of September 30, 2006 and December 31, 2005, we had no outstanding balance under our credit facility.

Interest on outstanding borrowings under our credit facility accrues at a variable base rate (based on Wells Fargo Bank s prime rate or the federal funds rate), plus a margin of 1.5%.

Our credit facility contains customary affirmative, negative and financial covenants. For example, we are restricted in incurring additional debt, disposing of assets, making investments, allowing fundamental changes to our business or organization, and making certain payments in respect of stock or other ownership interests, such as dividends and stock repurchases. Financial covenants include requirements that we maintain: a debt to EBITDA ratio of no greater than 1.5 to 1.0 and a fixed charge coverage ratio of not less than 1.4 to 1.0.

Our credit facility also contains customary events of default. These include bankruptcy and other insolvency events, cross-defaults to other debt agreements, a change in control involving us or any subsidiary guarantor (other than due to this offering), and the failure to comply with certain covenants.

Off-Balance Sheet Arrangements

We do not currently have any off-balance sheet arrangements with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not engage in trading activities involving non-exchange traded contracts. As such, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in these relationships.

Critical Accounting Policies

We prepare our consolidated financial statements in accordance with generally accepted accounting principles, or GAAP. Accordingly, we make estimates and assumptions that affect our reported amounts of assets, liabilities, revenues and expenses, as well as the disclosure of contingent assets and liabilities. In some cases, we could reasonably have used different accounting policies and estimates. Changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ materially from our estimates. To the extent that there are material differences between these estimates and actual results, our financial condition or results of operations will be affected. We base our estimates on past experience and other assumptions that we believe are reasonable under the circumstances, and we evaluate these estimates on an ongoing basis. We refer to accounting estimates of this type as critical accounting policies and estimates, which we discuss further below.

Principles of Consolidation

Our consolidated financial statements include all subsidiaries and entities controlled by us. We define control as ownership of a majority of the voting interest of an entity. Our consolidated financial statements also include entities in which we absorb a majority of the entity s expected losses, receive a majority of the entity s expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity.

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The decision to consolidate or not consolidate an entity would not impact our earnings, as we would include our portion of these entities profits and losses either through consolidation or the equity method of accounting if we did not consolidate.

All significant intercompany accounts and transactions have been eliminated in consolidation. Business combinations accounted for as purchases have been included in the consolidated financial statements from the respective dates of acquisition.

The following table summarizes the percentage of net service revenue earned by type of ownership or relationship we had with the operating entity:

	Three Months Ended September 30,		Nine months Ended September 30,	
	2006	2005	2006	2005
Wholly-owned subsidiaries	40.4%	35.4%	37.6%	31.2%
Equity joint ventures	45.1	49.8	47.7	52.7
Cooperative endeavors	1.3	1.4	1.5	2.2
License leasing arrangements	10.6	10.9	11.1	11.0
Management services	2.6	2.5	2.1	2.9
	100.0%	100.0%	100.0%	100.0%

The following discussion sets forth our consolidation policy with respect to our equity joint ventures, cooperative endeavors, license leasing arrangements and management services agreements.

Equity Joint Ventures

Our equity joint ventures are structured as limited liability companies in which we typically own a majority equity interest ranging from 51.0% to 98.0%. Each member of all but one of our equity joint ventures participates in profits and losses in proportion to their equity interests. We have one equity joint venture partner whose participation in losses is limited. We consolidate these entities, as we absorb a majority of the entities expected losses, receive a majority of the entities expected residual returns and generally have voting control over these entities.

Cooperative Endeavors

We have arrangements with certain partners that involve the sharing of profits and losses. Unlike our equity joint ventures, we own 100.0% of the equity interests in our cooperative endeavors. In these cooperative endeavors, we possess interests in the net profits and losses ranging from 67.0% to 70.0%. We have one cooperative endeavor partner whose participation in losses is limited. We consolidate these entities, as we own 100.0% of the outstanding equity interests, absorb a majority of the entities expected losses and receive a majority of the entities expected residual returns.

License Leasing Arrangements

We lease, through our wholly-owned subsidiaries, home health licenses necessary to operate certain of our home nursing agencies. As with our wholly-owned subsidiaries, we own 100.0% of the equity interests of these entities and consolidate them based on such ownership, as well as our right to receive a majority of the entities expected residual returns and our obligation to absorb a majority of the entities expected losses.

Management Services

We have various management services agreements under which we manage certain operations of agencies and facilities. We do not consolidate these agencies or facilities, as we do not have an equity interest and do not have a right to receive a majority of the agencies or facilities expected residual returns or an obligation to absorb a majority of the agencies or facilities expected losses.

Revenue Recognition

We report net service revenue at the estimated net realizable amount due from Medicare, Medicaid, commercial insurance, managed care payors, patients, and others for services rendered. Under Medicare, our home nursing patients are classified into a home health resource group prior to the receipt of services. Based on this home health resource group we are entitled to receive a prospective Medicare payment for delivering care over a 60-day period. Medicare adjusts these prospective payments based on a variety of factors, such as low utilization, patient transfers, changes in condition and the level of services provided. In calculating our reported net service revenue from our home nursing services, we adjust the prospective Medicare payments by an estimate of the adjustments. We calculate the adjustments based on a rolling average of these types of adjustments for claims paid during the preceding three months. Historically we have not made any material revisions to reflect differences between our estimate of the Medicare adjustments and the actual Medicare adjustments. For our home nursing services, we recognize revenue based on the number of days elapsed during the episode of care.

Under Medicare, patients in our long-term acute care facilities are classified into long-term care diagnosis-related groups. Based on this classification, we are then entitled to receive a fixed payment from Medicare. This fixed payment is also subject to adjustment by Medicare due to factors such as short stays. In calculating our reported net service revenue for services provided in our long-term acute care hospitals, we reduce the prospective payment amounts by an estimate of the adjustments. We calculate the adjustment based on a historical average of these types of adjustments for claims paid during the preceding three months. For our long-term acute care hospitals we recognize revenue as services are provided.

For hospice services we are paid by Medicare under a prospective payment system. We receive one of four predetermined daily or hourly rates based upon the level of care we furnish. We record net service revenue from our hospice services based on the daily or hourly rate. We recognize revenue for hospice as services are provided.

Under Medicare we are reimbursed for our rehabilitation services based on a fee schedule for services provided adjusted by the geographical area in which the facility is located. We recognize revenue as these services are provided.

Our Medicaid reimbursement is based on a predetermined fee schedule applied to each service we provide. Therefore, we recognize revenue for Medicaid services as services are provided based on this fee schedule. Our managed care payors reimburse us in a manner similar to either Medicare or Medicaid. Accordingly, we recognize revenue from our managed care payors in the same manner as we recognize revenue from Medicare or Medicaid.

We record management services revenue as services are provided in accordance with the various management services agreements to which we are a party. The agreements generally call for us to provide billing, management, and other consulting services suited to and designed for the efficient operation of the applicable home nursing agency or inpatient rehabilitation facility. We are responsible for the costs associated with the locations and personnel required for the provision of the services. We are generally compensated based on a percentage of net billings or an established base fee. In addition, for certain of the management agreements, we may earn incentive compensation.

Accounts Receivable and Allowances for Uncollectible Accounts

We report accounts receivable net of estimated allowances for uncollectible accounts and adjustments. Accounts receivable are uncollateralized and primarily consist of amounts due from third-party payors and patients who receive final bills once all documentation is completed. Using detailed accounts receivable aging reports produced by our billing system, our collections department monitors and pursues payment. We have adopted a charity care policy that provides the criteria a patient must meet in order to be considered indigent and his or her balance considered for write-off. All other accounts that are deemed uncollectible are turned over to an outside collection agency for further collection efforts. To provide for accounts receivable that could become uncollectible in the future, we establish an allowance for uncollectible accounts to reduce the carrying amount of such receivables to their estimated net realizable value. The credit risk for concentrations of receivables is limited due to the significance of Medicare as the primary payor. The amount of the provision for bad debts is based upon our

assessment of historical and expected net collections, business and economic conditions, trends in government reimbursement and other collection indicators.

A portion of the estimated Medicare prospective payment system reimbursement from each submitted home nursing episode is received in the form of a request for accelerated payment, or RAP, before all services are rendered. The estimated episodic payment is billed at the commencement of the episode. We receive a RAP for 60.0% of the estimated reimbursement at the initial billing for the initial episode of care per patient and the remaining reimbursement is received upon completion of the episode. For any subsequent episodes of care contiguous with the first episode of care for a patient we receive a RAP for 50.0% of the estimated reimbursement at initial billing. The remaining 50.0% reimbursement is received upon completion of the episode. We have earned net service revenue in excess of billings rendered to Medicare. Only a nominal portion of the amounts due to the Medicare program represent cash collected in advance of providing services.

Our Medicare population is paid at a prospectively set amount that can be determined at the time services are rendered. Our Medicaid reimbursement is based on a predetermined fee schedule applied to each individual service we provide. Our managed care contracts are structured similar to either the Medicare or Medicaid payment methodologies. Because of our payor mix, we are able to calculate our actual amount due at the patient level and adjust the gross charges down to the actual amount at the time of billing. This negates the need for an estimated contractual allowance to be booked at the time we report net service revenue for each reporting period.

At September 30 2006, our allowance for doubtful accounts, as a percentage of patient accounts receivable, was approximately 8.5%. For the nine months ended September 30, 2006, the provision for doubtful accounts decreased to 1.8% of net service revenue compared to 1.9% of net service revenue for the nine months ended September 30, 2005. Adverse changes in general economic conditions, billing operations, payor mix, or trends in federal or state governmental coverage could affect our collection of accounts receivable, cash flows and results of operations.

The following table sets forth our aging of accounts receivable as of September 30, 2006:

Payor	0-30	31-60	61-90	91-120	121-150	150+	Total
				(in thousands)			
Medicare	$ 17,582	$ 1,293	$ 1,047	$ 1,101	$ 1,240	$ 6,455	$ 28,718
Medicaid	1,970	955	532	423	529	2,601	7,010
Other	3,846	1,435	1,053	1,268	1,044	7,098	15,744
Total	$ 23,398	$ 3,683	$ 2,632	$ 2,792	$ 2,813	$ 16,154	$ 51,472

Intangible Assets

Goodwill is the excess purchase price over the estimated fair market value of the net assets we have acquired in business combinations. Intangible assets are assets acquired in business combinations that are separable from goodwill including trade names, licenses, and non-compete agreements. On June 29, 2001, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standard, or SFAS No. 142, *Goodwill and Other Intangible Assets,* which changed the accounting for goodwill and intangible assets. Under SFAS No. 142, goodwill and indefinite lived intangible assets are no longer amortized but are reviewed annually or more frequently if impairment indicators arise, for impairment. Prior to the adoption of SFAS No. 142, goodwill had been amortized on a straight-line basis over 25 years through December 31, 2001. We adopted SFAS No. 142 effective January 1, 2002.

We completed our annual impairment test under SFAS No. 142 as of October 1, 2005, based on the estimated fair value of the business and we determined that no impairment of goodwill existed. Due to the allocation of goodwill to businesses that have been sold or have been held for sale as of March 31, 2006, we also completed an impairment test as of March 31, 2006. No impairment of goodwill existed. We concluded no impairment indicators were present at December 31, 2005.

We have concluded that licenses to operate home-based and/or facility-based services have indefinite lives, as we have determined that there are no legal, regulatory, contractual, economic or other factors that would limit the useful life of the licenses and we intend to renew and operate the licenses indefinitely. Accordingly, we have elected

to recognize the fair value of these indefinite-lived licenses and goodwill as a single asset for financial reporting purposes, as permitted by SFAS No. 141, *Business Combinations.*

We estimate the fair value of our identified reporting units and compare those estimates against the related carrying value. For each of the reporting units, the estimated fair value is determined based on a multiple of EBITDA or on the estimated fair value of assets in situations when it is readily determinable.

Components of our home-based services segment are generally represented by individual subsidiaries or joint ventures with individual licenses to conduct specific operations within geographic markets as limited by the terms of each license. Components of our facility-based services are represented by individual operating entities. Effective January 1, 2004 we began aggregating the components of these two segments into two reporting units for purposes of evaluating impairment. Prior to January 1, 2004 we evaluated each operating entity separately for impairment. Modifications to our management of the segments and reporting provided us with a basis to change the reporting unit structure.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Except for an increase of cash from $17.4 million as of December 31, 2005, to cash of $30.6 million as of September 30, 2006, we have no material changes to the disclosure on this matter made in our annual report on Form 10-K for the year ended December 31, 2005.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

(a) We maintain disclosure controls and procedures designed to provide reasonable assurance that information required to be disclosed in our reports under the Securities and Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure. Our management, with the participation and oversight of our chief executive officer and chief financial officer, evaluated the design and effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. As previously reported in our Form 10-K for the year ended December 31, 2005, in conducting this evaluation for the period ended December 31, 2005 a material weakness was identified in our internal control over financial reporting relating to preventing posting errors within the patient billing system for certain rebilled accounts. Specifically, our personnel lacked sufficient knowledge and experience in our billing and revenue management software and we did not establish appropriate controls to detect or correct errors relating to these rebilled transactions. On the basis of this finding, our chief executive officer and our chief financial officer concluded that our disclosure controls and procedures were not effective, as of the end of the December 31, 2005 period. The correction of these posting errors resulted in a $900,000 increase to revenue for the year ended December 31, 2005. The potential effects of these posting errors on our financial statements issued during the interim periods of 2005 were not material. In connection with the 2005 audit of our financial statements, Ernst & Young, LLP, our independent registered public accounting firm, issued a management letter which noted that we had this material weakness in our internal control over financial reporting. No other material weaknesses in our internal control over financial reporting were identified in the management letter.

Although the Company s remediation efforts are well underway with respect to the above referenced material weakness, the deficiency will not be considered remediated until the new internal controls over financial reporting implemented to remediate the material weakness are fully implemented and operational for a period of time and are successfully tested, and management concludes that these controls are operating effectively. As of September 30, 2006, the Company s chief executive officer and chief financial officer concluded that because additional testing is required to determine if the material weakness described in the Company s annual report on Form 10-K for the year ended December 31, 2005 has been fully remedied, the Company did not maintain effective disclosure controls and procedures as of the end of the period covered by this report.

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(b) There have been no changes in our internal control over financial reporting during the period covered by this report that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Subsequent to identifying the material weakness in our internal control over financial reporting with respect to our rebilled transactions, we initiated the process of improving our internal controls over these transactions through additional training on our software for those individuals recording these transactions, strict procedural controls and documentation requirements over rebilled transactions, and newly established monitoring, review and approval controls over these transactions.

On September 21, 2005, the SEC extended the compliance dates related to Section 404 of the Sarbanes-Oxley Act for non-accelerated filers. Under this extension a company that is not required to file its annual and quarterly reports on an accelerated basis (non-accelerated filer) must begin to comply with the internal control over financial reporting requirements for its first fiscal year ending on or after July 15, 2007. We anticipate that we will become an accelerated filer in calendar 2006 and therefore we will be required to comply with these requirements for the year ending December 31, 2006. We are currently in the process of documenting our internal control structure.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

We are involved in litigation and proceedings in the ordinary course of business. We do not believe that the outcome of any of the matters in which we are currently involved, individually or in the aggregate, will have a material adverse effect upon our business, financial condition, or results of operations.

ITEM 1A. RISK FACTORS.

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our annual report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. Except as set forth below, there have been no material changes in our risk factors from those disclosed in our annual report on Form 10-K for the year ended December 31, 2005. The risks described in our annual report on Form 10-K for the year ended December 31, 2005 are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition or operating results.

The risk factors titled CMS has adopted regulations that could materially and adversely impact the revenue and net income of our long-term acute care hospitals , The loss of certain senior management could have a material adverse effect on our operations and financial performance and If we identify deficiencies in our internal control over financial reporting, our business and our stock price could be adversely effected in our annual report on Form 10-K for the year ended December 31, 2005, are amended in their entirety by the following text.

CMS has adopted regulations that could materially and adversely impact the revenue and net income of our long-term acute care hospitals.

In August 2004, CMS adopted regulations that implement significant changes affecting our long-term acute care hospitals. Among other things, these new regulations, effective for hospital cost reporting periods beginning on or after October 2004, mandate that long-term acute care hospitals operating in the hospital within a hospital model receive lower rates of reimbursement for Medicare admissions from their host hospitals that are in excess of specified percentages. For new long-term acute care hospitals opened after October 1, 2004 located within hospitals, the Medicare admissions limitation will be 25.0% for hospitals located in a MSA, and 50.0% for hospitals located in a non-MSA. This means a new long-term acute care hospital located within a hospital will receive lower rates of reimbursement for patients admitted from their host hospitals in excess of 25.0%, or 50.0% if located in a non-MSA.

For existing long-term acute care hospitals within hospitals and those under development that meet specified criteria, the Medicare admissions limitations are being phased in over a four-year period starting with hospital cost reporting periods beginning on or after October 1, 2004 and also provide for different percentages of allowable

admissions based on whether the facilities are located in MSAs or non-MSAs. Further, for cost reporting periods beginning prior to October 1, 2007, the Medicare admissions limitation for each existing long-term acute care hospital is the lesser of the percentage of Medicare discharges admitted from its host hospital during its 2004 cost reporting period or the amount set forth in the table below.

	Allowable Admissions From Host Hospital Before Payment Reduction	
Cost Report Period Beginning	MSAs	Non-MSAs
Until September 30, 2005	100.0%	100.0%
October 1, 2005 September 30, 2006	75.0%	75.0%
October 1, 2006 September 30, 2007	50.0%	50.0%
October 1, 2007 and thereafter	25.0%	50.0%

Of our 7 long-term acute care hospital locations, 5 are physically located in a non-MSA. Of these 5 locations, 2 are satellite locations of a parent hospital that is located in a MSA. Based on our discussions with CMS, we believe this satellite location will be viewed as being located in a non-MSA regardless of the location of its parent hospital and will be treated independently from its parent for purposes of calculating its compliance with the admissions limitations. For the nine months ended September 30, 2006, on an individual basis, none of our long-term acute care hospital locations admitted less than 50.0% of its patients from its host hospital, 6 of our long-term acute care hospital locations admitted between 50.0% and 75.0% of their patients from their host hospitals and none of our long-term acute care hospital locations admitted more than 75.0% of its patients from its host hospital. The Eunice long-term acute care hospital is not a hospital within a hospital . For the nine months ended September 30, 2006, 4 of our long-term acute care hospital locations admitted a higher percentage of their patients from their host hospitals than the percentage of Medicare discharges admitted from their host hospitals in the 2005 cost reporting year.

Our ability to quantify the potential reduction in our reimbursement rates resulting from the implementation of these new regulations is contingent upon a variety of factors, such as our ability to reduce the percentage of admissions that are derived from our host hospitals and, if necessary, our ability to relocate our existing long-term acute care hospitals to freestanding locations. We may not be able to successfully restructure or relocate these operations without incurring significant expense or in a manner that avoids reimbursement reductions. If these new regulations result in lower reimbursement rates, our net service revenue and net income could decline. As a result of these new rules, we do not intend to expand the number of hospital within a hospital long-term acute care hospitals that we operate.

We are reimbursed by Medicare for services we provide in our long-term acute care hospitals based on the long-term care diagnosis-related group assigned to each patient. CMS establishes these long-term care diagnosis-related groups by grouping diseases by diagnosis, which group reflects the amount of resources needed to treat a given disease. These new rules reclassify certain long-term care diagnosis-related groups, which could result in a decrease in reimbursement rates. Further, the new rules kept in place the financial penalties associated with the failure to limit the total number of Medicare patients discharged to a host hospital and subsequently readmitted to a long-term acute care hospital located within the host hospital to no greater than 5.0%. If we fail to comply with these readmission rates or if our reimbursement rates decline due to the reclassification of certain long-term care diagnosis-related groups, our net service revenue and net income could decline.

The loss of certain senior management could have a material adverse effect on our operations and financial performance.

Our success depends upon the continued employment of certain members of our senior management, including our co-founder, President, Chief Executive Officer and Chairman, Keith G. Myers, our Executive Vice President, Chief Operating Officer, Secretary and Director, John L. Indest; our Senior Vice President, Chief Financial Officer,

and Treasurer Barry E. Stewart, and our Senior Vice President, Acquisitions and Market Development, Daryl J. Doise. We have entered into an employment agreement with each of these officers in an effort to further secure their employment.

If we identify deficiencies in our internal control over financial reporting, our business and our stock price could be adversely affected.

In connection with the 2005 audit of our financial statements and management s required assessment of our disclosure controls and procedures, Ernst & Young, LLP, our independent registered public accounting firm, issued a management letter which noted a material weakness in our internal control over financial reporting relating to preventing posting errors within the patient billing system for certain rebilled accounts. Specifically, that our personnel lacked sufficient knowledge and experience in our billing and revenue management software and we did not establish appropriate controls to detect or correct errors relating to these rebilled transactions. The correction of these posting errors resulted in a $900,000 increase to revenue for the year ended December 31, 2005. The potential effects of these posting errors on our financial statements issued during the interim periods of 2005 were not material. Subsequent to identifying this material weakness, we initiated the process of improving our internal controls over rebilled transactions through the requirement of additional training on our software for those individuals recording these transactions, the implementation of strict procedural controls and documentation requirements over rebilled transactions, and newly established monitoring, review and approval controls over these transactions. No other material weaknesses in our internal control over financial reporting were identified in the management letter.

Beginning with our annual report for the year ending December 31, 2006, we will be required to report on the effectiveness of our internal control over financial reporting as required by Section 404 of Sarbanes-Oxley. Under Section 404, we will be required to assess the effectiveness of our internal control over financial reporting and report our conclusion in our annual report. Our auditor is also required to report its conclusion regarding the effectiveness of our internal control over financial reporting. The existence of one or more material weaknesses would require us and our auditor to conclude that our internal control over financial reporting is not effective. If there are identified deficiencies in our internal control over financial reporting, we could be subject to regulatory scrutiny and a loss of public confidence in our financial reporting, which could have an adverse effect on our business and our stock price.
public confidence in our financial reporting, which could have an adverse effect on our business and our stock price.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

The Registration Statement on Form S-1 (File No. 333-120792) for our initial public offering was declared effective on June 9, 2005, and on June 14, 2005 we closed the initial public offering of our common stock. The managing underwriters for the offering were Jefferies & Company, Inc. and Legg Mason Wood Walker, Incorporated. We registered a total of 5,520,000 shares of which we sold 3,500,000 shares and certain of our existing stockholders sold an aggregate of 2,020,000 shares. Of the 2,020,000 shares sold by our existing stockholders, 720,000 were sold in connection with the exercise of the over-allotment option by the managing underwriters. The aggregate price to the public, including the shares sold in the over-allotment option was $77,280,000. We did not receive any proceeds from the shares sold by our stockholders. The aggregate amount of expenses incurred by us in connection with our initial public offering was approximately $7,393,000, including $3,430,000 in underwriting discounts and commissions and $3,963,000 in other estimated offering expenses. None of our offering expenses were paid directly or indirectly to any of our officers, directors or 10% shareholders.

The net offering proceeds received by us, after deducting the total expenses of $7,393,000, were approximately $41,607,000. As of September 30, 2006, approximately $21.9 million of the net offering proceeds have been used to repay the following indebtedness: (1) $21.1 million on our credit facility, bearing interest at prime plus 1.5% and due April 10, 2010, with Residential Funding Corporation; (2) $643,000 of outstanding obligations under our loan agreement, bearing interest at 12.0% and due July 1, 2006, with The Catalyst Fund, Ltd. and Southwest/Catalyst Capital, Ltd.; and (3) approximately $178,000 of outstanding indebtedness assumed by us in connection with acquisitions completed by us in 2004. Additionally, $3.3 million has been used to pay minority interest holders for their interests and $14.0 million has been used to fund acquisitions since the initial public offering. None of the offering proceeds were paid directly or indirectly to any of our officers, directors, or 10% stockholders. The balance of the net offering proceeds has been invested in short-term, investment- graded, interest-bearing securities.

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ITEM 6. EXHIBITS.

3.1 Certificate of Incorporation of LHC Group, Inc. (previously filed as an exhibit to the Form S-1/A (File No. 333-120792) on February 14, 2005)

3.2 Bylaws of LHC Group, Inc. (previously filed as an exhibit to the Form S-1/A (File No. 333-120792) on May 9, 2005).

4.1 Specimen Stock Certificate of LHC s Common Stock, par value $0.01 per share (previously filed as an exhibit to the Form S-1/ A (File No. 333-120792) on February 14, 2005).

4.2 Reference is made to Exhibits 3.1 and 3.2 (previously filed as an exhibit to the Form S-1/A (File No. 333-120792) on February 14, 2005 and May 9, 2005, respectively).

31.1 Certification of Keith G. Myers, Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Barry E. Stewart, Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1* Certification of Keith G. Myers, Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2* Certification of Barry E. Stewart, Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* This exhibit is furnished to the SEC as an accompanying document and is not deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that Section, and the document will not be deemed incorporated by reference into any filing under the Securities Act of 1933.

Items 3, 4 and 5 are not applicable and have been omitted.

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SIGNATURES

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

LHC GROUP, INC.

Date November 14, 2006

/s/ Barry E. Stewart
Barry E. Stewart
Senior Vice President and Chief Financial Officer

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