



OUR PEOPLE MAKE THE DIFFERENCE



Financial Highlights

(Dollars in thousands, except per share amounts)

Operating results:	Year ended December 31,	
	2006	2005
Revenues	\$4,266,661	\$3,852,975
Net income:		
Income from continuing operations	\$71,239	\$131,391 (a)
Discontinued operations, net of income taxes:		
Income from operations	7,504	14,899
Loss on divestiture of operations	(32)	(1,381)
Net income	\$78,711	\$144,909
Diluted earnings per common share:		
Income from continuing operations	\$1.74	\$2.90 (a)
Discontinued operations:		
Income from operations	0.18	0.33
Loss on divestiture of operations	-	(0.03)
Net income	\$1.92	\$3.20
Diluted shares (000)	40,923	45,239
Cash flows from operations	\$129,984	\$263,133
Financial position:	Dec. 31, 2006	Dec. 31, 2005
Cash and cash equivalents	\$20,857	\$83,420
Working capital	395,563	324,337
Total assets	2,016,127	1,760,561
Long-term debt	130,090	26,323
Stockholders' equity	995,578	870,536

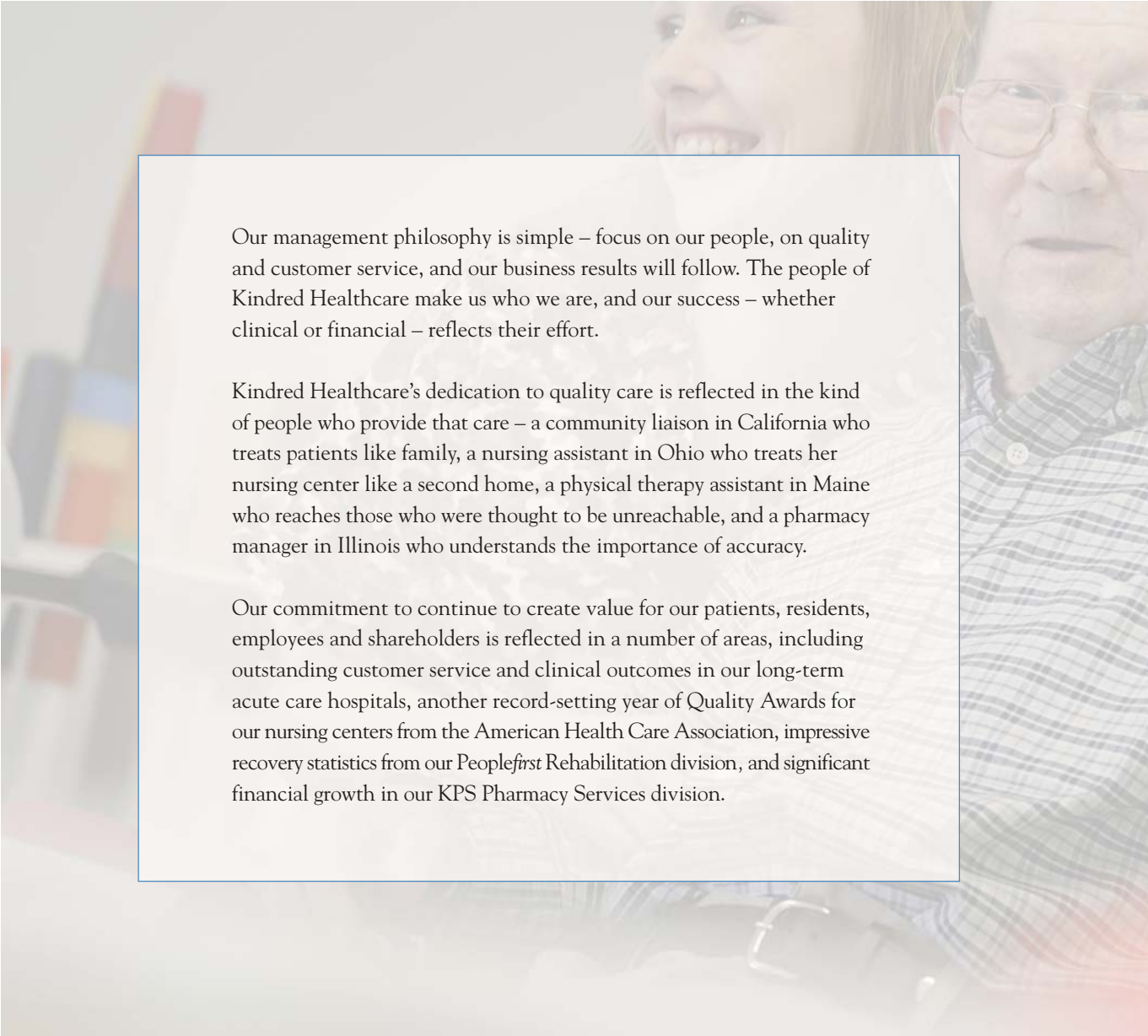
(a) Included certain items that, in the aggregate, increased net income from continuing operations by approximately \$37.7 million or \$0.83 per diluted share.

Kindred Healthcare, Inc. (NYSE: KND) is a Fortune 500 healthcare services company, based in Louisville, Kentucky, with annual revenues of \$4.3 billion that provides services in approximately 600 locations in 38 states. Kindred, through its subsidiaries, operates long-term acute care hospitals, skilled nursing centers, institutional pharmacies and a contract rehabilitation services business, Peoplefirst Rehabilitation Services, across the United States. Kindred's 55,000 employees are committed to providing high-quality patient care and outstanding customer service to become the most trusted and respected provider of healthcare services in every community we serve.

For more information, please visit www.kindredhealthcare.com.

DEDICATED PEOPLE EQUAL QUALITY CARE

Quality care – as reflected in patient outcomes as well as customer satisfaction – drives our performance.



Our management philosophy is simple – focus on our people, on quality and customer service, and our business results will follow. The people of Kindred Healthcare make us who we are, and our success – whether clinical or financial – reflects their effort.

Kindred Healthcare's dedication to quality care is reflected in the kind of people who provide that care – a community liaison in California who treats patients like family, a nursing assistant in Ohio who treats her nursing center like a second home, a physical therapy assistant in Maine who reaches those who were thought to be unreachable, and a pharmacy manager in Illinois who understands the importance of accuracy.

Our commitment to continue to create value for our patients, residents, employees and shareholders is reflected in a number of areas, including outstanding customer service and clinical outcomes in our long-term acute care hospitals, another record-setting year of Quality Awards for our nursing centers from the American Health Care Association, impressive recovery statistics from our Peoplefirst Rehabilitation division, and significant financial growth in our KPS Pharmacy Services division.

OUR PEOPLE MAKE US WHO WE ARE

Dear Shareholders,

The year 2006 was another year in which Kindred Healthcare demonstrated steady progress in improving patient outcomes, resident care and employee satisfaction, while laying the foundation to deliver significant shareholder value in future years. In 2006, our consolidated revenues grew 11% to \$4.3 billion. Despite significant external challenges, our 2006 diluted earnings per share from continuing operations of \$1.74 was in line with the goals we set for ourselves at the beginning of the year. Our significant accomplishments in 2006 include the following:

- our operators managed through unprecedented regulatory changes in each of our operating divisions while improving our level of quality and customer service;
- we successfully resolved the last remaining issues associated with our 2001 reorganization, including the Ventas rent reset and the expiration of our warrants;
- we announced the proposed spinoff of our KPS institutional pharmacy business, which we believe will create a stronger competitor in the institutional pharmacy industry and unlock substantial value for our shareholders on a tax-free basis; and
- we continued to grow through acquisitions and organic development while also disposing of underperforming facilities to reposition our portfolio for future growth.

Our hospital division, which has provided substantial growth over the years, faced significant regulatory challenges in 2006. During the second half of 2006, Medicare reimbursement rates were reduced, negatively impacting Medicare revenues by approximately \$34 million, and Medicare patient volumes declined on a same-store basis during the same period.

After a difficult third quarter, our hospital division reported strong fourth quarter results driven primarily by strength in our non-government business and improved operating efficiencies.

Despite Medicare reimbursement difficulties, our hospitals reported growth in revenues and admissions for the full year. Excluding the effect of significant favorable prior year Medicare cost report settlements in 2005, our hospital operating income increased in 2006. In 2007 and beyond, we will continue to explore ways to better utilize our existing hospital capacity by further developing our relationships with managed care providers and expanding our services.

In our health services division, fiscal 2006 was a year in which our continued focus on quality and customer service resulted in significant improvements in our operating results. Over the past several years, the investments we've made in this regard have included, among other things, improved staffing and standardization of clinical programs, the modernization of our facilities and equipment and the expansion of nursing, rehabilitation and other services to effectively care for higher acuity Medicare and managed care patients. We also have continued to execute on our risk management initiatives, which have helped to resolve quality issues when they arise. In addition, these quality initiatives supported our nursing centers' successful transition to the expanded Medicare RUGs categories that became effective on January 1, 2006. Our 2006 operating results in this division were encouraging, with solid growth in revenues, overall occupancy, Medicare and managed care mix and operating income compared to 2005. We believe that there are additional opportunities to improve our nursing center results in the future by continuing to execute our strategy of providing high-quality, cost-effective care to higher acuity patients and residents.

In *Peoplefirst* Rehabilitation, we made progress in 2006 to position this business to grow beyond the Kindred hospital and nursing center portfolio that currently comprises most of its revenues. After operating for less than three years as a separate division, *Peoplefirst* has one of the most effective therapist recruitment and retention programs in the industry and its name recognition and reputation for clinical excellence is expanding in the marketplace. As the labor market for therapists



becomes more competitive, Peoplefirst is well positioned to grow through a program of external contract development and higher levels of productivity. Over the longer term, we believe that this division has opportunities to grow in a clinical practice and policy environment that is generally favorable to providing more rehabilitation therapy services in lower cost settings, particularly nursing centers.

The most significant regulatory changes in 2006 occurred in our KPS institutional pharmacy business. On January 1, 2006, the Medicare Part D program became effective. As a result, a substantial portion of our revenues shifted from a state-sponsored Medicaid payor source to a federally funded program. Like many providers in the industry, the Medicare Part D transition for KPS was challenging and required a number of operational changes as well as an extensive communications and implementation plan for each of our nursing center customers. While 2006 was a transition year for KPS from a regulatory and operational perspective, significant efforts also were required to integrate acquisitions and prepare for the proposed pharmacy spinoff transaction.

Fiscal 2006 also marked the conclusion of all remaining issues related to our 2001 reorganization. The Ventas rent reset issue was successfully concluded through an independent appraisal process that resulted in an annual rent increase of approximately \$33 million beginning on July 19, 2006, and which reduced the amount of our annual future rent increases or escalators on our Ventas facilities from 3.5% to approximately 2.7%. This was a significant event for Kindred, providing clarity around our capital costs and a financial framework that will accommodate our future growth and expansion plans.

In addition to the rent reset issue, all of our outstanding warrants issued in connection with our 2001 reorganization expired in April 2006, resulting in the issuance of a significant number of shares of common stock. We expended all of the \$142 million of warrant proceeds to repurchase shares and expended another \$52 million to complete our previously

announced share repurchase program. These transactions have simplified our equity structure and reduced our diluted share count by approximately 10% compared to 2005.

In October 2006, we entered into a definitive agreement to combine our KPS operations with PharMerica Long-Term Care, the institutional pharmacy business operated by AmerisourceBergen Corporation. We believe that the business prospects underlying the proposed pharmacy spinoff transaction, including the growth opportunities, operational synergies and economies of scale that can be realized over the long term, provide a compelling opportunity to enhance Kindred shareholder value. We expect to complete the proposed pharmacy spinoff transaction in the second quarter of 2007.

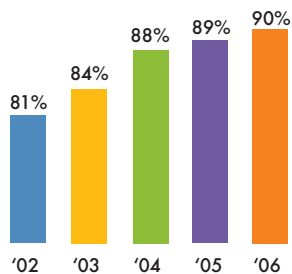
With respect to future growth opportunities, we continued our program of organic development and selective acquisitions. In 2006, we acquired six hospitals (646 licensed beds), 11 nursing centers (1,579 licensed beds), four assisted living facilities (228 licensed beds) and three institutional pharmacies (4,593 customer beds). In addition, we opened two hospitals containing 98 licensed beds and opened five pharmacies in new markets. In 2007, we will continue to seek further organic development and strategic acquisitions that enhance shareholder value and that reflect a more concentrated market-by-market strategy. We have already entered into an agreement to lease eight additional high-quality nursing centers, and we expect to open four hospitals in 2007 that are currently under development.

As Kindred continues to grow, the work performed on a daily basis by our 55,000 dedicated employees will continue to drive our success and create value for our patients, residents and shareholders. On behalf of them, and on behalf of our Board of Directors, we thank you for your continued support.

A handwritten signature in black ink, appearing to read "Paul J. Diaz".

Paul J. Diaz
President and
Chief Executive Officer

**Percent of Hospital Division
Customers Who Rank Kindred
Very Good to Excellent in Overall Care**



*Kindred's Hospital Division
has received increasingly
high marks in overall care
from patients and their
families year after year.*

ANDY



A Vital Link in Patient Care

The largest Vietnamese community outside of Vietnam is in Orange County, California. Kindred Hospital Santa Ana, located in the center of Orange County, provides care to approximately 250 Vietnamese patients per year. Andy Loc Ho, the hospital's Community Liaison, is more than a caregiver – to the families of our patients he is a vital link in a complex medical world, an associate who has a unique understanding of their language and culture, a translator, tour guide, and friend.

Stories about Andy's willingness to go the extra mile for our patients and families abound. Once, he came in on his day off to meet and reassure a son, visiting from out of town, that his father's needs would be addressed. Andy even gave the son his personal cell phone number. The son was so appreciative he cried.

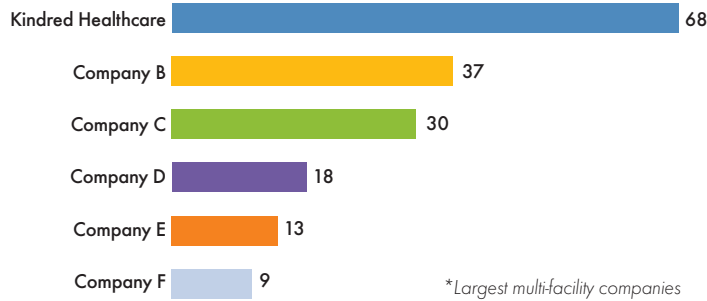
Another patient, now recovered, and his wife took three different buses to visit Andy and tell him, "I was ready to give up, but you were there providing support and compassion to me and my wife. You helped us through a very difficult time. Thank you."

To Andy, this compassion comes naturally and stems at least in part from his own experiences when his father was hospitalized. "I witnessed the good caring and volunteering that went on," he says. "And I saw that there could be a real language barrier at times. It just seemed like there were several areas where I could help."

HOSPITAL DIVISION

**Health Services Division
American Health Care Association Quality Awards
2003 – 2006***

*In the last four years,
Kindred Healthcare has
received 68 quality awards
from AHCA - more than any
other company in America.*



**Largest multi-facility companies*

TANYA



Going Above and Beyond

A 10-year healthcare veteran, Tanya Tomczyk has found a home at Chillicothe Nursing and Rehabilitation Center in Chillicothe, Ohio.

Tanya is a state-tested nursing assistant who works the third shift, but you're likely to see her around the center at all hours. During the holidays, she worked her shift and then stayed to help decorate hallways to mark the season.

"There are countless times she has come in early or stayed late to ensure that the residents were taken care of," says Executive Director Christina Schramm. "She has always volunteered to help – she never has waited for a mandate to occur."

"She takes great care of me," says resident Martin Cosby. "She is always happy to do the extras."

The work Tanya does earned her Kindred's 2006 Above and Beyond Award; and the work of the entire staff at Chillicothe, led by Ms. Schramm, earned the center a 2006 Quality Award from the American Health Care Association.

"Healthcare is something I've always loved doing," Tanya says. "I love the feeling of being able to help somebody."

HEALTH SERVICES DIVISION

Peoplefirst Rehabilitation
Percent of Improvement in Functional Abilities –
Evaluation to Discharge for 2006

Peoplefirst's proprietary nationwide clinical tracking system allows us to follow and measure functional abilities in our patients and residents.



LINDA



Connecting with Patients

Around Brewer Rehab and Living Center in Brewer, Maine, Linda Morse is known as the “sticky note woman.” A physical therapy assistant for over 35 years, Linda visits her patients each day and hands them a sticky note with the time of their physical therapy written on it.

“They all look forward to seeing their sticky notes every morning and I guarantee they will be prepared at exactly that time to work with her,” says Physical Therapist Belinda Beaulier. “Sometimes I have to bargain with them to get a second treatment because they are counting on seeing Linda at the ‘sticky note time.’”

Linda is an employee of Peoplefirst, Kindred's rehabilitation division. Her success stems from the connection she creates with patients, Ms. Beaulier says.

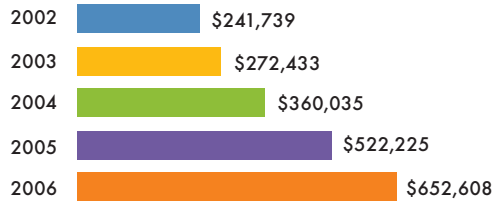
“Anytime there is a difficult patient, Linda excels and finds that simple, important connection necessary to fully understand the patient and get the most therapeutic treatment with them.

“She is constantly connecting with family members to find out what training they need, how the home is set up to accommodate the patient and what equipment is necessary,” adds Ms. Beaulier. “Long after patients go home, they still remember Linda and return to say hello to the person that made such a difference in their life.”

PEOPLEFIRST
REHABILITATION

KPS Pharmacy Services – Significant Growth in Revenues

(Dollars in thousands)



KPS has shown significant growth in revenues over the last five years.

MICHAEL



Satisfaction Delivered

As a Regional Director of Hospital Pharmacy Operations for KPS Pharmacy Services, Michael Fania understands the connection between dispensing accurate prescriptions and projecting a positive attitude.

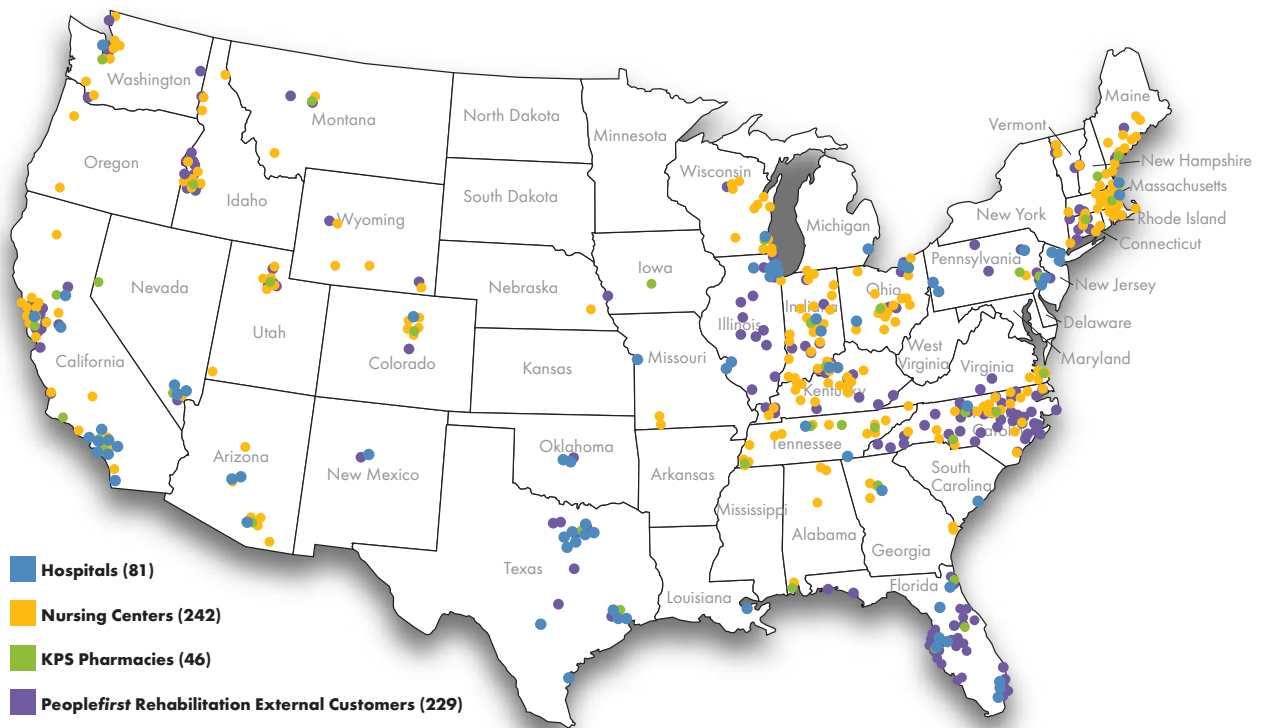
“Our focus is always on the patient,” says Michael, who has been with Kindred for 10 years. “To me it has to come down to one’s attitude – if you come in every morning with the right attitude, you can go through the challenges you meet during the day.”

Michael oversees the operations of over 20 KPS hospital locations in the Midwest. He’s proud of KPS’s high record of prescription accuracy, and he’s aware that KPS serves two customers – the facilities where the patients are cared for and the patients themselves.

“What we do is in the background, but it’s important,” he says. “Helping people – that’s where the satisfaction comes in.”

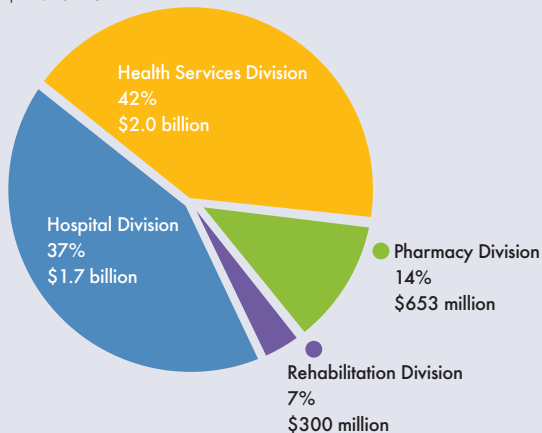
KPS PHARMACY SERVICES

Facility Locations (As of December 31, 2006)

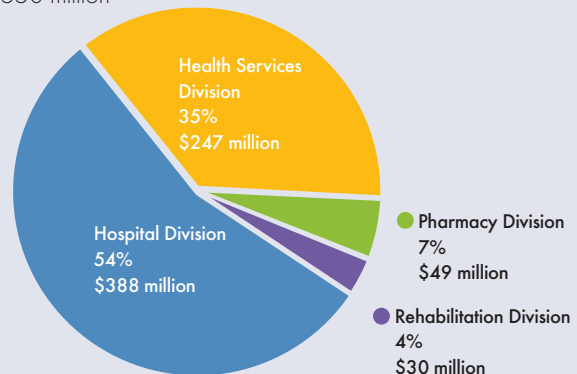


2006 Operating Results

Revenues
Year ended December 31, 2006
\$4.3 billion



Operating Income (a)
Year ended December 31, 2006
\$550 million



(a) Divisional operating income excludes unallocated corporate costs. Operating income is defined as earnings before interest, income taxes, depreciation, amortization and rent. A reconciliation of this measurement is included in the accompanying Annual Report on Form 10-K.

Executive Officers

Edward L. Kuntz
Executive Chairman

Paul J. Diaz
President and Chief Executive Officer

Richard A. Lechleiter
Executive Vice President and Chief Financial Officer

Frank J. Battafarano
Executive Vice President and President, Hospital Division

Lane M. Bowen
Executive Vice President and
President, Health Services Division

Richard E. Chapman
Executive Vice President and Chief Administrative
and Information Officer

M. Suzanne Riedman
Senior Vice President and General Counsel

William M. Altman
Senior Vice President, Compliance and Government
Programs

Joseph L. Landenwich
Senior Vice President of Corporate Legal Affairs
and Corporate Secretary

Gregory C. Miller
Senior Vice President, Corporate Development
and Financial Planning

Mark A. McCullough
President, Pharmacy Division

Benjamin A. Breier
President, Peoplefirst Rehabilitation Division

Directors

Edward L. Kuntz
Executive Chairman

Ann C. Berzin
Private Investor and Former Chairman
and Chief Executive Officer
Financial Guaranty Insurance Company

Thomas P. Cooper, M.D.
Founder and Chairman
Vericare, Inc.

Paul J. Diaz
President and Chief Executive Officer

Michael J. Embler
Officer
Franklin Mutual Advisers, LLC

Garry N. Garrison
Former Senior Vice President
Dynamic Healthcare Solutions, Inc.

Isaac Kaufman
Senior Vice President and Chief Financial Officer
Advanced Medical Management Inc.

John H. Klein
Chairman and Chief Executive Officer
DAVA Pharmaceuticals, Inc.

Eddy J. Rogers, Jr.
Partner
Andrews Kurth LLP

Corporate Information

Annual Meeting

The annual meeting of shareholders will be held at the Company's corporate headquarters, 680 South Fourth Street, Louisville, Kentucky, on May 31, 2007. Formal notice of the meeting, together with the proxy statement and form of proxy, is sent to each holder of common stock.

Additional Information

The Company's reports filed with the Securities and Exchange Commission may be obtained without charge upon written request to the Corporate Secretary at the Company's corporate address or electronically through our website. Please visit our website, www.kindredhealthcare.com, for additional information about the Company, including governance-related documents.

Stock Listings

Kindred Healthcare, Inc. common stock is listed on the New York Stock Exchange under the ticker symbol KND.

Registrar and Transfer Agent

National City Bank
Shareholder Services Operations – LOC 5352
P.O. Box 92301
Cleveland, Ohio 44101-4301
Telephone: 1.800.622.6757
Email: shareholder.inquiries@nationalcity.com

Corporate Address

680 South Fourth Street
Louisville, Kentucky 40202-2412
Telephone: 502.596.7300
www.kindredhealthcare.com



680 South Fourth Street
Louisville, Kentucky 40202

www.kindredhealthcare.com