Zacks Small-Cap Research

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Northstar Healthcare Inc. (T.NHC - TSE)

T.NHC: Net patient service revenue increases 109% in 4th quarter. Reiterate Outperform rating.

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	01/20/2014
Current Price (04/10/14)	$1.03
Six- Month Target Price	**$2.10**

OUTLOOK

Northstar Healthcare, Inc. holds interests in and operates four ambulatory surgical centers (ASCs) in Houston, Dallas and Scottsdale. The company has experienced a dramatic increase in revenues over the last several quarters as a result of the implementation of management's growth strategy composed of enhanced Direct-to-Consumer marketing programs, re-syndication of partnerships and acquisitions. A new ASC was opened recently in Scottsdale, and two MRI and one Urgent Care Centers were acquired in the metropolitan Houston area. We reiterate our Outperform rating.

SUMMARY DATA

52-Week High	**1.64**
52-Week Low	**0.28**
One-Year Return (%)	**178.4**
Beta	**-0.41**
Average Daily Volume (shrs.)	**61,470**
Shares Outstanding (million)	**43.2**
Market Capitalization ($ mil.)	**44.5**
Short Interest Ratio (days)	**1.9**
Institutional Ownership (%)	**25**
Insider Ownership (%)	**35**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**25.1**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**25.8**
P/E using 2014 Estimate	**12.9**
P/E using 2015 Estimate	**7.4**
Zacks Rank	**3**

Risk Level	**Above Average**
Type of Stock	**Small-Growth**
Industry	**Medical Care**
Zacks Rank in Industry	**N/A**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	3.2 A	5.1 A	6.1 A	6.5 A	20.9 A
2013	4.1 A	5.9 A	7.6 A	13.5 A	31.1 A
2014	6.2 E	9.4 E	12.2 E	21.5 E	49.3 E
2015					67.7 E

Earnings per Share
(EPS is operating earnings before non recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	-$0.02 A	$0.01 A	$0.03 A	$0.01 A	$0.03 A
2013	-$0.02 A	-$0.02 A	-$0.01 A	$0.08 A	$0.04 A
2014	-$0.00 E	$0.01 E	$0.03 E	$0.05 E	$0.09 E
2015					$0.14 E

Zacks Projected EPS Growth Rate - Next 5 Years % **17**

Quarterly EPS may not equal annual EPS total due to rounding.

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KEY POINTS

- Northstar Healthcare is a Canadian healthcare company that develops, acquires, owns and manages Ambulatory Surgical Centers (ASCs) in the United States. Currently, the company holds equity interests in four ASCs (two in Houston, one in Dallas and one in Scottsdale), along with two MRI (Magnetic Resonance Imaging) and one Urgent Care Centers in the metropolitan Houston area.
- Management's **growth strategy** entails generating organic growth through physician referrals and targeted direct-to-consumer marketing campaigns, augmented by acquisitions.
- Northstar has developed an enhanced **Direct-to-Consumer marketing program** model designed to educate and motivate prospective patients to contact the company's ASCs. The company launched its first direct-to-consumer marketing programs during 2013, which helped contribute to the 49% increase in net patient revenues.
- The company's **acquisition strategy** entails building a complementary network of ASCs and other healthcare facilities in metropolitan of the United States. Currently, Northstar has operations in the Houston, Dallas and Scottsdale markets and is targeting to replicate the ASC network-building process in other metropolitan areas.
- The domestic ASC industry is highly fragmented. With an estimated 5,900 ASCs, only about 1,300 are managed by multi-facility chains, and the largest chain controls only 239 centers.
- The **turnaround and subsequent consistent sequential quarterly growth of net patient revenues** during 2013 was largely driven by the company's Direct-to-Consumer marketing effort. To date, the strategy has been accretive since net income has grown despite the coincident increase in General and Administrative expenses, which includes the higher marketing expenses.
- Management aspires to list NHC to a U.S. exchange, such as NASDAQ or NYSE.
- We reiterate our Outperform rating.

RECENT NEWS

Financial results for the 2013

On March 6, 2014, Northstar Healthcare reported financial results for the fourth quarter and year ending December 31, 2013. **For the fourth quarter**, net patient service revenue increased 108.7% to $13.5 million compared to $6.5 million in the fourth quarter of 2012, primarily due to an increase in case volume. Total cases increased 37.7% to 1,811 and increased in all specialties except pain management and gastro-intestinal. Procedure volume increased 18.7% to 5,977. Operating salaries and benefits increased 51.1% to $1.8 million, primarily due to increased staffing at the MSID location. Higher case volume drove medical supply expense higher by 186.2% to $2.2 million. Operating general and administrative expense increased 253.5% to $4.4 million, primarily due to higher marketing expense, physician contracting and revenue cycle expenses. Corporate costs increased 67.0% as a result of hiring new corporate employees and stock-based compensation expense. Net income attributable to common shareholders improved to $0.08 per diluted share compared with $0.01 per diluted share in the comparable quarter last year. However, without the one-time gain of $2.39 million from a bargain purchase, net income attributable to common shareholders would have been $0.02 per diluted share.

During 2013, **net patient service revenue increased 49.0%** from to $20.9 million to $31.1 million primarily due higher case volume in all specialties, along with the addition of the gynecology specialty. **Total cases for the year increased 23.0%** from 4,468 to 5,496 cases. **Procedure volume increased 26.6%** from 15,579 to 19,718.

Northstar Healthcare Inc.						
Number of Cases	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Pain Management	4,855	3,074	2,540	2,799	2,884	2,887
Orthopedics	2,330	1,871	1,171	858	694	724
Podiatry	607	247	21	346	156	286
Gastro-intestinal	793	420	5	-	70	269
General Surgery	423	393	331	469	353	787
GYN	-	-	-	-	-	77
Ear, Nose, Throat (E.N.T.)	643	471	265	243	311	466
Total	9,651	6,476	4,333	4,715	4,468	5,496

Northstar Healthcare Inc.						
Percentage of Cases	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Pain Management	50.3%	47.5%	58.6%	59.4%	64.5%	52.5%
Orthopedics	24.1%	28.9%	27.0%	18.2%	15.5%	13.2%
Podiatry	6.3%	3.8%	0.5%	7.3%	3.5%	5.2%
Gastro-intestinal	8.2%	6.5%	0.1%	-	1.6%	4.9%
General Surgery	4.4%	6.1%	7.6%	9.9%	7.9%	14.3%
GYN	-	-	-	-	-	1.4%
Ear, Nose, Throat (E.N.T.)	6.7%	7.3%	6.1%	5.2%	7.0%	8.5%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Northstar Healthcare Inc.						
Procedures	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Pain Management	28,576	14,942	10,704	11,098	9,838	11,928
Orthopedics	5,996	4,623	2,756	2,191	2,737	2,417
Podiatry	2,490	1,140	56	1,686	703	1,566
Gastro-intestinal	956	651	7	-	97	400
General Surgery	966	823	719	1,081	1,190	1,689
GYN	-	-	-	-	-	98
Ear, Nose, Throat (E.N.T.)	3,337	1,998	980	917	1,014	1,620
Total	42,321	24,177	15,222	16,973	15,579	19,718

Percentage of Cases	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Pain Management	67.5%	61.8%	70.3%	65.4%	63.1%	60.5%
Orthopedics	14.2%	19.1%	18.1%	12.9%	17.6%	12.3%
Podiatry	5.9%	4.7%	0.4%	9.9%	4.5%	7.9%
Gastro-intestinal	2.3%	2.7%	0.0%	-	0.6%	2.0%
General Surgery	2.3%	3.4%	4.7%	6.4%	7.6%	8.6%
GYN	-	-	-	-	-	0.5%
Ear, Nose, Throat (E.N.T.)	7.9%	8.3%	6.4%	5.4%	6.5%	8.2%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Operating salaries and benefits increased 39.1% to $5.33 million, primarily due to increased staffing needs. Higher case volume increased medical supply expense higher by 85.0% to $4.42 million. Operating general and administrative expense increased 137% to $10.6 million, primarily due to the company's growing marketing effort, along with higher physician contracting and revenue cycle expenses. The operating margin for the year was 32.4%. Total corporate costs increased 38.3% as a result of hiring new corporate employees and stock-based compensation expense. Management determined that no provision for bad debts was necessary in 2013. The company's payer mix improved as the percentage of net patient revenue from Private insurance and other private pay increased year-over-year from 91.0% to 95.8% while the proportion of revenue from Medicare reimbursements declined from 3.7% to 1.8%.

Northstar Healthcare Inc.						
	2008	**2009**	**2010**	**2011**	**2012**	**2013**
Private insurance and other private pay	91.4%	87.1%	82.5%	86.5%	91.0%	95.8%
Workers compensation	4.9%	8.1%	12.4%	8.6%	5.3%	2.4%
Medicare	1.5%	2.7%	5.1%	4.9%	3.7%	1.8%
Other	2.2%	2.1%	0.0%	0.0%	0.0%	0.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Net income attributable to common shareholders increased 18.1% from $1.199 million to $1.416 million driving diluted EPS up 12.2% from $0.03 to $0.04 per share. Diluted weighted **average shares outstanding increased 5.2%** to 37,637,662 from 35,764,295.

During 2013, Northstar Healthcare raised net proceeds of approximately $4.09 million through a private placement and about $168,000 from the exercise of stock options. Working capital improved from $7.11 million at the end of 2012 to $8.69 million on December 31, 2013.

Acquisitions

On January 21, 2014, Northstar Healthcare announced the closing of an **acquisition of** ownership interests in **two imaging centers** and **one urgent care clinic** in the **Houston area**. The total purchase price was $1.4 million comprised of $0.9 million in cash and 431,711 shares of NHC common stock. Through the purchase of Spring Northwest Management, LLC (Katy, TX), Spring Northwest Operating, LLC (Katy, TX) and Willowbrook Imaging, LLC (Houston, TX), Northstar Healthcare's revenue generation platform will be augmented with additional revenue streams derived from the 19 physician partners in these facilities.

On December 12, 2013, Northstar announced that the company was the **winning bidder** to acquire the **former Brown Hand Center outpatient surgery facility** in an upscale neighborhood of Phoenix, Arizona. The winning bid was $460,000. The surgery center has four operating rooms and 27,000 square feet of floor space. The company also announced that it had made a bid on the former Brown Hand Surgery Center in Dallas, but was out-bid by a competitor.

Financing

In December 2013, the company completed a private placement of 5,862,500 Units at C$0.80 per Unit, each consisting of one common share and one-half of a two-year common share purchase warrant exercisable at C$1.10. Net proceeds were approximately $4.09 million.

OVERVIEW

Northstar Healthcare Inc. (NHC: TSE, NRTSF:) is a Canadian healthcare company that develops, acquires, owns and manages Ambulatory Surgical Centers (ASCs) in the United States, thus far focusing on the Dallas and Houston metropolitan markets and most recently Scottsdale. Founded in 2007, Northstar attained partnership interests in two ASCs: The Palladium for Surgery in Houston (through the Palladium Partnership) and the Kirby Surgery Center in Houston (through the Kirby Partnership aka Medical Ambulatory Surgical Suites, LP). The company also provided management services for three River Oaks Pain Management facilities in Humble, Baytown and the Galleria. In early 2011, Northstar Healthcare acquired partnership interests in the Palladium for Surgery in Dallas and in December 2013, formed Northstar Healthcare Surgery Center - Scottsdale. In general, the company's ASCs offer certain clinical specialties, including pain management, orthopedic surgery, podiatry surgery and ENT (ear, nose and throat) surgery. The company's facilities include:

- **Northstar Healthcare Surgery Center - Houston** Operations began in December 2003 with specialties in pain management, ENT (ear, nose and throat), podiatry and orthopedics. Formerly operating as Palladium for Surgery – Houston and Houston Microsurgery Institute, Northstar acquired ownership interests from all the physician limited partners through various transactions, until in October 2013, Northstar took over all existing operations. Located within four miles of the Texas Medical Center in Houston, the facility has 3 surgical suites, 2 treatment rooms (suitable for colonoscopy and interventional pain procedures), 7 pre-op beds and 8 post-op beds. The facility

now also offers general surgery, gastrointestinal and chiropractic services. Northstar directly **owns 100%** of Northstar Healthcare Surgery Center - Houston.

- **Northstar Healthcare Surgery Center - Dallas**. Originally opened in 2005, this facility provides healthcare services of pain management, ENT, podiatry, orthopedics and general surgery as an outpatient ambulatory surgery center. The ASC formerly operated as Microsurgery Institute of Dallas (MSID), which leased medical equipment from Palladium for Surgery – Dallas (PFSD). In October 2013, Northstar syndicated a private placement for certain physicians to become partners of the operation. The center was folded into a new entity, NHC ASC – Dallas, in which Northstar Healthcare currently holds a **35% interest**.

- **Kirby Surgical Center** - Houston - Opened in June 2004, Northstar acquired a 65.5% interest in Medical Ambulatory Surgical Suites, LP (the Kirby Surgical Center) in 2007. The facility is located less than four miles from the Texas Medical Center in Houston. Through three subsequent transactions, the company sold 40.5% of its interests to physician limited partners, effectively decreasing the company's ownership **interest** to **25.0%**. Physicians at the Center provide care in the specialties of ENT, orthopedic surgery, general surgery, interventional spine care, sports medicine and pain management.

- **Northstar Healthcare Surgery Center** - Scottsdale – Formed in December 2013, this ASC operates utilizing the assets from a former Brown Hand Center outpatient surgery center that were acquired through a business combination. The Scottsdale facility opened during the first quarter of 2014. Northstar directly **owns 100%** of Northstar Healthcare Surgery Center - Scottsdale.

Northstar Healthcare also owns and operates the newly opened **Northstar Urgent Care & Imaging Center** in Spring, Texas (in the metropolitan Houston area) and the **Northstar Imaging Center** in Houston. All told, Northstar holds partnership interests in ASCs that operate 18 operating/procedure rooms with over 150 surgeons on staff.

Northstar Healthcare was founded by current CEO, Dr. Donald Kramer, M.D., in May 2007 and was capitalized through an initial public offering (IPO) that same month. Approximately $138.7 of the $139.7 million in net proceeds were utilized to purchase a 70% indirect partnership interest in the Palladium Partnership (a limited partnership of physicians performing surgeries at the Palladium for Surgery – Houston facility) and a 60% interest in the Medical Ambulatory Surgical Suites, LP (aka Kirby Partnership consisting of a similar limited partnership of physicians performing procedures at the Kirby Surgical Center in Houston).

Dr. Donald Kramer has founded many healthcare enterprises including Omniplus Healthcare in 1995, Access Mediquip in 1996 and Palladium for Surgery-Houston in 2003. Access Mediquip was acquired by Water Street Capital in 2011 for $80 million. Northstar Healthcare acquired a 70% interest of the Palladium for Surgery-Houston in May 2007 (Dr. Kramer retained approximately 18% of the partnership after the transaction). Northstar Healthcare also acquired Dr. Kramer's 95% ownership interest of Palladium for Surgery – Dallas in January 2011.

Management's **growth strategy** entails generating organic growth through physician referrals and targeted direct-to-consumer marketing campaigns, augmented by acquisitions. Northstar Healthcare's **business model** revolves around establishing **strategic partnerships** with the physicians associated with Ambulatory Surgical Centers in order to drive organic growth (cases and procedures) through increasing patient flow. At the Northstar Healthcare Surgery Center - Dallas and the Kirby Surgical Center, physician-partners are incentivized through equity ownership. At the Northstar Healthcare Surgery Centers in Houston and Scottsdale, physicians are motivated through non-equity contract relationships. By aligning the economic interests of physicians with the company's organic growth strategy, not only is case volume growth bolstered through physician referrals, but also surgeons can be more easily recruited into the Northstar ASC system of facilities.

To generate incremental patient flow through the company's facilities, Northstar embarked upon a program of marketing campaigns to drive case volume. By educating and motivating potential patients to contact the physicians at the ASCs, the marketing campaigns augment the traditional source of net patient revenue (physician referrals). Initially, the company developed the **integrated marketing campaign** to educate and motivate prospective patients to contact the company's ASCs. The first campaign was launched in the Dallas and Houston markets during the fall of 2011. Building upon that platform, the company developed the enhanced **Direct-to-Consumer marketing** program, augmenting the campaigns with dedicated websites, listings on local online directories, social media pages, YouTube videos and paid search-engine keywords. Northstar Healthcare launched its first direct-to-consumer marketing programs during 2013, which helped contribute to the 49% increase in net patient revenues.

Northstar Healthcare's **acquisition strategy** entails building a network of ASCs and other complementary healthcare facilities in metropolitan areas of the United States. Management is focused on replicating the ASC network-building process thus far employed in the Houston market, where the healthcare facilities act as a platform for scalable growth through in-network physician referrals and lead generation from Direct-to-Consumer marketing campaigns. Potential acquisition candidates may be in-network local hospitals, ASCs, Urgent Care Centers, MRI facilities or other complementary healthcare service offices in order to leverage the effect of current marketing programs or out-of-network operations that establish platforms in new geographic locations.

For 2014, management's primary focus is to increase net patient revenues and EBITDA through scaling direct-to-consumer marketing programs in the Houston, Dallas and Scottsdale markets, along with completing selective acquisitions. During the first quarter, the NueStep podiatry direct-to-consumer marketing campaign was launched in Dallas, and management is planning an advertising program for bariatric weight-loss surgery in Dallas. In addition, Northstar will present at several national surgical center meetings in order to identify potential new partnerships for surgical centers elsewhere in the U.S. Longer-term, management anticipates entering two new markets in 2015 (possibly San Antonio) and four additional markets in 2016.

Northstar Healthcare' net patient revenues are seasonal with the fourth quarter being substantially stronger than the first quarter. Since health insurance deductibles reset at the beginning of each new calendar year, potential patients tend to delay procedures in the first few months of the year.

SUMMARY OF CORPORATE HISTORY

Northstar has a complex history that includes difficulties in connection with a rapidly changing reimbursement environment in the first two years of its existence, which were exacerbated by a conflict with a major insurer. As a result of these difficulties, the share price dropped dramatically, from an all-time high of $18.30 in 2007 to as low as $0.10 in late 2012. The company's share price has recently rebounded to the $1.00 range, primarily due to a rebound in the company's net patient revenues and EPS driven by syndication/re- syndication of partnerships to motivate physician partners, consumer-centric marketing campaigns and selective acquisitions. While the company's recovery is still in an early stage, management has taken some positive and innovative steps to initiate the turnaround.

Historical Timeline

- March 16, 2007 — Northstar Healthcare incorporated in British Columbia
- May 17, 2007 — Northstar Healthcare completes IPO of 12,087,698 shares at $12.25
- May-June 2007 — Acquire 70% interest in **The Palladium for Surgery – Houston** and 60% interest in the **Kirby Surgery Center** in Houston for $138.7 million
- June 5, 2007 — Overallotment of IPO exercised for 1,813,154 shares

- September 2008 Stephen Linehan appointed CEO
- February 2009 Dr. Kramer makes tender offer for Northstar Healthcare
- October 27, 2010 Dr. Kramer & Donna Alexander rejoined Northstar as CEO and COO
- November 1, 2010 MSIH begins utilizing Palladium Partnership's facility
- January 1, 2011 Acquire **The Palladium for Surgery - Dallas** (PFSD) for $2.2 million
- Spring 2011 Launch first **integrated marketing campaign** (colonoscopy)
- September 2011 Launch NueStep podiatry integrated marketing campaign
- 2013 Launch **Direct-to-Consumer marketing programs** for Curaspine and NueStep in Houston
- December 2013 Form **Northstar Healthcare Surgery Center – Scottsdale**
- December 12, 2013 Acquire former Brown Hand Center outpatient surgery facility in Phoenix

The Early History of Northstar Healthcare: IPO and Acquisitions (2004-2006)

Northstar Healthcare was formed as a Canadian Corporation in March 2007 to indirectly own and/or manage ambulatory surgery centers in the United States, focusing initially on Houston and other metropolitan areas in Texas. Approximately $138.7 of the $139.7 million in net proceeds from the initial public offering of 13,900,852 shares (including overallotment) were utilized to indirectly acquire a 70% interest in the Palladium Partnership (The Palladium for Surgery – Houston) and a 60% acquisition in the Kirby Partnership (Kirby Surgery Center).

In 2006, the last full financial year prior Northstar Healthcare's acquiring interests in the two partnerships, Palladium and Kirby generated $47.0 million in revenue and $29.7 million in net income. Based on a 61.25% share of earnings from the Palladium Partnership and a 52.5% share of earnings from the Kirby Partnership, the acquisitions occurred at a relatively modest pre-tax price-to- earnings ratio of 7.3 times. At the time of the IPO, the company had pre-negotiated an agreement to provide management services for the Palladium-Dallas and River Oaks Pain Management Centers (both owned by Dr. Kramer) for 10% of net revenues. This management fee was anticipated to provide an additional $360,000 in annual revenue to Northstar.

Pre-Acquisition Revenues and Pre-Tax Income of the Palladium and Kirby Partnerships

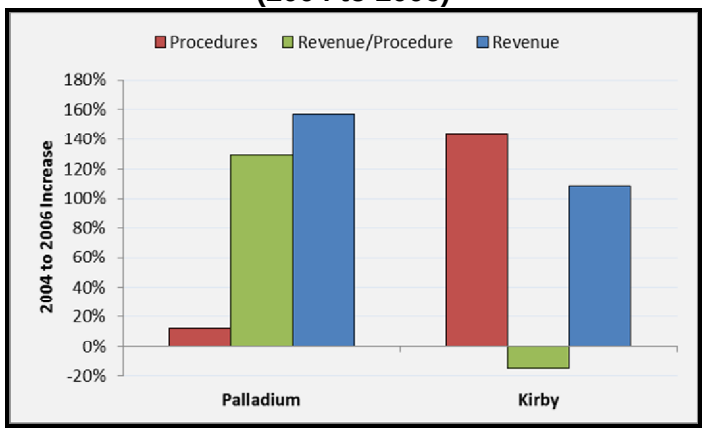
In Thousands	2004	2005	2006	CAGR
Palladium Houston				
Revenues	$9,578	$18,344	$24,623	60%
Pre-Tax Income	$5,719	$11,425	$15,040	62%
Kirby				
Revenues	$10,743	$16,804	$22,399	44%
Pre-Tax Income	$6,681	$9,829	$14,699	48%
Combined				
Revenues	$20,320	$35,148	$47,023	52%
Pre-Tax Income	$12,400	$21,254	$29,739	55%

The IPO prospectus describes the Palladium facility as operating at 44% of capacity, and the Kirby facility at 29% of capacity, allowing for considerable additional growth through better facility utilization. Both the Kirby and the Palladium Partnerships had historically pursued a business strategy of focusing on highly reimbursed out-of-network procedures performed for patients with private insurance. In 2006, over 90% of the combined revenues of the two partnerships were derived from private payers, with most of the remainder coming from Worker's Compensation.

The economics of the two ASCs differed in some aspects. The Kirby Partnership's revenue was entirely derived from procedures performed by physician partners, and the 108% growth in total revenue from 2004 to 2006 was derived from an increase in procedures. The revenue base of the Palladium Partnership was less secure. With fewer partner physicians, Palladium relied on outside physicians to boost utilization of the facility, incentivizing them with a fraction of the facility fee. Growth in the number

of procedures performed at the Palladium facility from 2004 to 2006 was modest at compared to the increase in revenue per procedure.

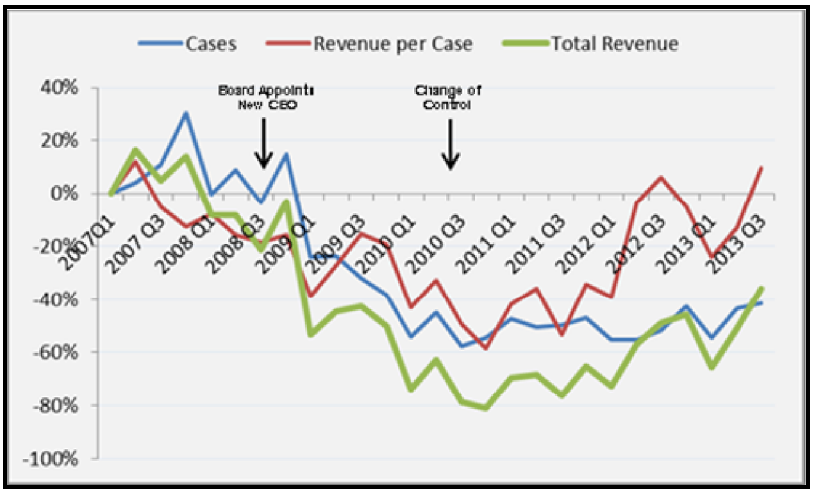
Growth in Procedures, Revenue per Procedure and Total Revenue (2004 to 2006)



Revenue Decline, Conflict with Major Payer and a Fight for Control (2007-2010)

In spite of the rapid growth in revenues and profits seen from 2004 to 2006, Northstar encountered severe difficulties in its first year as a public company. Decreases in reimbursement at the Kirby ASC relative to those seen when the facility was private (1Q 2007) were noted in the company's 1Q 2008 financial report and attributed to a "less favorable mix of payors". Similar concerns were noted in the 2Q 2008 report. The 3Q 2008 report noted a 25.1% decline in revenues relative to the same period of 2007, which was attributed to a 12.7% decrease in case volume and a 19.4% decrease in reimbursement per case relative to the same period in 2007. The company recognized a $78.9 million goodwill and intangible asset impairment, equivalent to 63% of the cash value raised in the company IPO of just one year earlier. An additional $52.2 million write-down occurred in 4Q of 2008. The declines in procedures and in revenue per procedure occurred during the early months of the severe stock market decline of 2008- early 2009, and also correspond to the early phase of the transition of the ASC business from a high growth to a relatively mature industry. We further note that the Partnerships' historic strategies of pursuing highly reimbursed, out-of-network patients may have left it unusually vulnerable to such an economic turndown compared to other ASC chains with a higher proportion of revenues derived from government agency payers.

Changes in Revenue, Revenue per Case, and Total Revenue Relative to 1Q 2007



On September 20, 2008, the company announced that a new CEO had been appointed, with founder Donald Kramer transitioned as the company's Vice Chairman for Medical Affairs. This marked the beginning of a protracted and bitter fight for control of the company that occurred in parallel with the company's declining financial position. The decline in cases treated and revenue per case accelerated after Dr. Kramer's replacement, owing in part to the deep recession that the United States entered in late 2008.

Further complicating the issue was a major conflict with one of the Palladium Partnership's main payers, who belatedly discovered and objected to the Palladium Partnership's splitting of facility fees with non-partner physicians, characterizing this practice as an unlawful kickback. This insurer not only refused to pay for future surgeries conducted under this arrangement but also sought to claw back historical payments. Procedure volume at the Palladium for Surgery plunged due to uncertainties regarding the reimbursement of surgeries performed by non-partner physicians. Although the dispute was resolved with abandonment of past claims and the signing of an in-network agreement with the problematic payer in November 2009, long term damage resulted in the form of inability to continue previous practices regarding non-partner physicians. The incident also damaged relationships with some of the Palladium partners, as indicated by company statements that it was attempting to re-syndicate the Palladium Partnership in August of 2009.

Change of Control

In February of 2009, Dr. Kramer announced that he was planning to make an offer for all the outstanding shares of the company at $0.95 per share. The Board recommended against this offer and refused to waive relevant provisions of the company's Shareholder Rights Plan, in spite of the fact that the company had announced a strategic review just weeks before. In May 2009, the company initiated a binding arbitration process against Dr. Kramer, alleging false contractual representations and warranties in the Palladium purchase agreement about the state of Palladium's business and its relationships with health insurers. The company further alleged that Dr. Kramer used his position as an 18% shareholder in the Palladium Partnership to frustrate the company's efforts to re-syndicate the partnership and turn the facility around financially. Northstar sought damages of up to $55 million.

Dr. Kramer made counter-claims, alleging mismanagement of the Palladium Partnership, defamation and tortuous interference with business relationships. On July 22, 2009, the Palladium Partnership cancelled its agreement with a Kramer-owned entity providing anesthesia services to the Partnership, and on December 31st, the Palladium for Surgery - Dallas, 95% owned by Dr. Kramer, terminated its management services contract with Northstar.

In May of 2010, a press release from Dr. Kramer announced his intention to launch a hostile tender offer at his previously offered price of $0.95 per share. This release warned shareholders of his intention to use the appeals process to drag litigation out until the company became insolvent should he not prevail in the initial round of arbitration hearings. The following month this offer was withdrawn, citing a decline in financial conditions at the company. In July of 2010, the Board of Northstar agreed to a private placement, issuing 18.7 million shares at $0.343 per share, after which Dr. Kramer controlled 56.2% of the company's voting shares. The Board was replaced, and a special committee emplaced to re-evaluate the company's claims against Dr. Kramer.

On December 15, 2010, the Special Litigation Committee of the Board of Directors determined that it would not be in the best interest the Company or its shareholders to continue to pursue the claims against Dr. Donald Kramer and related entities. The Committee determined that Northstar would be unlikely to succeed if it pursued the arbitration to a final conclusion. Dr. Kramer concurrently agreed to abandon his arbitration claims against the company.

The Situation in Q4 of 2010

With full control of the company and the added liquidity provided by his own capital injection, Dr. Kramer re-assumed the CEO position in October 2010 and began to focus on turning around the company's fortunes. At the time, not only was the business environment challenging, but also the ASC industry was being pressured by reimbursement and physician recruitment issues. The reimbursement environment was much more difficult and competition among ASCs grew more intense as the market had matured. As a result, physician recruitment became more challenging as the ratio of eligible physicians to ASCs has fallen.

Under Dr. Kramer's leadership, the company has since pursued a pragmatic and empirical strategy of syndication and re- syndication of partnerships to motivate physician partners, consumer-centric marketing campaigns and selective acquisitions. To the extent that these advances prove sustainable and replicable, Northstar Healthcare represents a potential turnaround and potential growth opportunity for investors.

The task facing the new management in Q4 2010 can be roughly measured by comparing Northstar Healthcare's performance in that quarter against 2011 benchmarks compiled by the VMG group. The VMG Group's survey found that on average, ASCs treat 765 surgical cases per surgical suite and 1,144 cases per treatment room. Based on the seven surgical suites and three treatment rooms in the Northstar facilities, average performance can be crudely estimated as 2,197 cases per year. The survey also provides a breakdown of average payment per case by physician specialty. Based on the breakdown of cases completed in the Northstar Q4 2010 10-Q, average performance can be estimated as $1,794 per case. Comparing these benchmark values to those achieved by Northstar in Q4 of 2010, the company was utilizing its procedure rooms at about 50% of the industry average. The company's revenue per procedure was about 20% above the industry average; however, at the time, Northstar Healthcare's strategy focused on attracting highly reimbursed out-of-network cases. Operating expenses per case were nearly double the mean value in the survey, no doubt due in part to under-utilization of its facilities.

Turnaround Initiatives (2010 – Present)

Re-syndication and Acquisitions

Initial turnaround initiatives under the new management focused on re-syndication of partnerships and the acquisition of the Palladium for Surgery - Dallas. On November 1, 2010, the company announced the long-awaited re-syndication of the Palladium for Surgery ASC. Northstar purchased 18% of Dr. Kramer's 27.5% interest in the Palladium Partnership, raising the company's total stake to 92%. The Palladium Partnership ceased operations, and the newly created partnership of the Microsurgery Institute of Houston leased the Palladium for Surgery – Houston facility for a 25.7% equity share. The attempt to incentivize productivity among the physician partners did not fully achieve the expected results; therefore, ultimately, Northstar bought out the MSIH partners and raised its stake to 97.5%.

In January 2011, Northstar Healthcare acquired the Palladium for Surgery – Dallas (PFSD) by purchasing the 95% interest held by Dr. Kramer and a related party's 5% interest for $2.2 million, which based on an independent third-party valuation. The facility expanded the company's number of surgical suites, treatment rooms, active surgeons and physician limited partners by 30-to-50%. Details of the facilities pre-acquisition revenues and earnings have not been disclosed. PFSD initially leased its ASC and medical equipment to the Microsurgery Institute of Dallas, LLC in exchange for a 25% ownership interest in MSID. In August 2012, the company re-syndicated MSID (MSID) by buying out its partners and closing a private placement of a 50% share to a private physician group. In conjunction with the re-syndication, Northstar ASC Management Inc. was created to provide management services to the partnership. In December 2012, the company sold additional stakes to 3 new physician partners, decreasing its ownership share to 36.5%.

Northstar Facilities After Acquisition of the Palladium Dallas Facility

	Surgical Suites	Treatment Rooms	Pre-Op Beds	Post-Op Beds	Active Surgeons	Physician Partners	Percent of Revenues Attributable to Partners
PFSH/MSIH	3	2	7	8	22	7	12.3%
Kirby	4	1	5	9	22	9	98.9%
PFSD/MSID	3	1	9	5	16	9	91.5%
Total	**10**	**5**	**22**	**25**	**49**	**32**	

Other attempts to improve productivity include re-syndications of the Kirby Partnership and increasing the stake of the physician partners. In March 2012, the company sold 18.4% of its interests in the Kirby Partnership to existing physician limited partners; the company's ownership stake was effectively decreased from 65% to 47.1% (the company had previously increased its stake from 60% to 65% due to two partners forfeiting their ownership stakes by violations of the partnership agreement). In November 2012, an additional 6.9% stake was sold to one existing and one new partner, decreasing the company's stake to 40.1%.

In February of 2011, the company formed Gulf Coast Toxicology LLC in partnership with Pioneer Laboratories, LLC. The company has a 20% ownership interest in GCT, a Dallas-based drug screening laboratory. The laboratory screens and quantifies narcotics and other drugs in urine samples.

New Business Model with Value-Added Marketing Campaigns

In 2011, Northstar Healthcare began implementing several initiatives designed to strengthen the company's position by providing not only capital, facilities and business expertise, but also patient flow via direct-to-consumer marketing campaigns. Northstar identified a target audience of highly symptomatic patients suffering from nerve entrapment and developed an **integrated marketing campaign** to educate and motivate prospective patients to communicate with the company's facilities. The campaign was launched in the Dallas and Houston markets during the fall of 2011.

Specifically, each integrated marketing campaign is designed to provide patients with knowledge of the awareness of the disease, the recognition of symptoms, the availability of treatment options and the option of a dialogue with treatment professionals. Once a patient commits to obtaining more information, the company's **call centers** and patient relationship experts actively engage with potential patients to help establish an understanding of the company's healthcare services and to motivate them to schedule appointments at one of the company's facilities. The marketing program employed a **mix of traditional media** (television, print and radio) along with toll-free numbers. In addition, local general practitioner referrals are encouraged with the use of a referral coordinator, fax referral and a patient referral card.

The NueStep Podiatry Integrated Marketing Campaign – Initiated during September 2011 in Dallas and Houston, the NueStep podiatry integrated marketing campaign focuses on foot and ankle pain caused by nerve entrapment, which is treated by a procedure available exclusively at Northstar. Marketing objectives include education on nerve entrapment, recognition of symptoms, education on the availability of advanced procedures to decompress entrapped nerves, and empowering patients to have productive discussions with treatment professionals. In order to ensure a high conversion of inquiries to procedures, the company hired a full-time podiatrist and staff to directly handle prospect calls and manage the program. The campaign is comprised of all marketing modalities, including a website at nuestep.com that was set up in October 2011.

In early 2012, the company began implementing the integrated marketing approach at the Palladium for Surgery - Houston facility. The partners of the Microsurgery Institute Houston were bought out by the company to provide the company with freedom to operate the facility directly and to obtain the full financial benefits of 100% ownership.

During 2012, Northstar Healthcare developed an innovative **Direct-to-Consumer Marketing Campaign** building upon integrated marketing platform developed in 2011.The Direct-to-Consumer marketing program consists of an **on-line presence** with a dedicated websites, listings on local **online directories** (such as Yelp, Yahoo Local Directory, Google Local Directory and Yellowpages.com), **social media** pages (Facebook and Twitter), informative YouTube videos and paid search-engine keywords (google, MSN and Yahoo). In January 2013, Northstar hired a chief marketing officer (and later an external medical marketing consulting firm) and began a series of therapeutic area focused direct-to-consumer campaigns that are designed to achieve critical patient educational objectives and drive brand awareness.



The Houston Colonoscopy Center Direct-to-Consumer Marketing Campaign – A colonoscopy marketing campaign was launched in the spring of 2013 to increase the awareness on importance of colonoscopies and to better educate patients about the importance of colon cancer screening, along with informing them of screening guidelines. The program is bolstered by an on-line presence with a website (houstoncoloncenter.com). The colonoscopy campaign was performed in close coordination with a second campaign on hemorrhoid treatment.

CuraSpine Direct-to-Consumer Marketing Campaign – The online presence of CuraSpine at curaspineprocedure.com was launched in August 2013. CuraSpine is a minimally invasive, rapid recovery protocol for treating herniated disks, spinal stenosis, degenerative disks, facet disease, and arthritis among other maladies.

Bariatric Campaign Direct-to-Consumer Marketing Campaign – Based on the successes in Houston, Northstar initiated a similar marketing program promoting bariatric and spine surgery at the Dallas facility. Weight loss surgery (aka bariatric surgery) includes a variety of procedures designed to help obese patients lose weight. Once patients lose a lot of weight, they usually want plastic/reconstructive surgery to help remove the excess of skin or body contouring to enhance their achievements.

The marketing-enhanced, direct-to-consumer business model not only generates an on-going revenue stream, but also creates an opportunity for the company to motivate physicians and other partners to enter into partnerships for the delivery of ASC services.

Ambulatory Surgery Centers

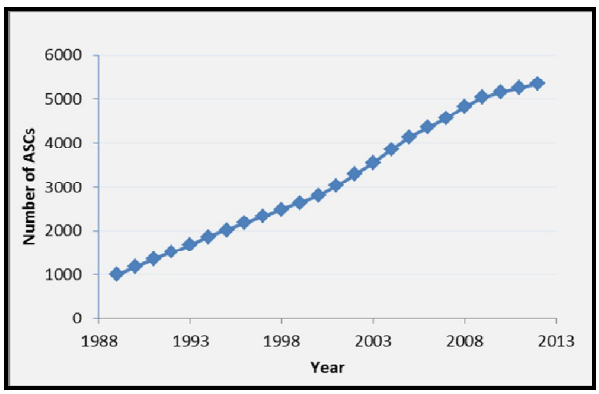
Ambulatory surgical centers (ASCs) are healthcare facilities that perform non-emergency surgical procedures that do not require an overnight hospital stay. Not only are costs lower since there are no hospital room charges and related hospital charges, but also patients find outpatient surgery less stressful since scheduling is more predictable, procedures are performed in more comfortable settings and recovery time at home tends to be easier and more convenient than at a hospital.

The growth of the ASC industry, from a single facility founded in 1970, to over 5,000 ASCs in the United States today, has been fueled by a combination of important factors, including:

- Increased pressure for healthcare cost containment.
- Technology improvements, including advances in anesthesiology and surgical techniques that have greatly reduced procedure recovery times, reducing the need for overnight hospital stays.
- The desire by physicians for the greater convenience and efficiency of performing non-emergency procedures in a dedicated facility, and the opportunity for greater control and income associated with partial ownership of outpatient surgery facilities.
- The preference of patients for ambulatory surgical facilities over hospital outpatient departments, primarily resulting from more convenient locations, more flexible scheduling, shorter waiting times, and more efficient registration procedures than hospital outpatient departments.

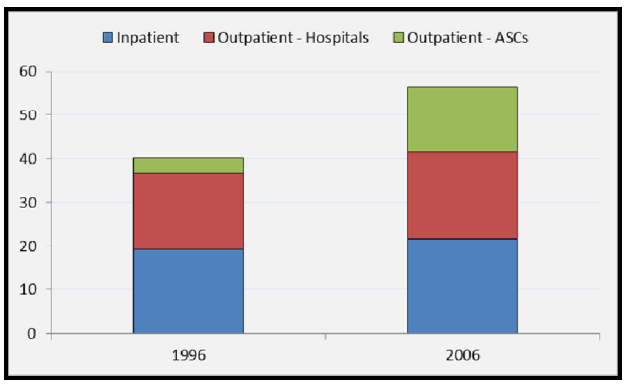
The growth in the number of ambulatory surgical centers in the United States has been driven not only by an increasing number of procedures performed on an outpatient basis, but also by an increasing proportion of outpatient procedures performed in ASCs relative to hospital outpatient departments. Between 1996 and 2006, the number of inpatient surgeries remained mostly flat, as did the number of outpatient surgeries performed in hospitals. In contrast, the number of surgeries performed in ASCs increased from 3.3 million to 14.9 million.

Growth of the Number of ASCs (1988-2012)



VMG Intellimarker11

Breakdown of Surgery Venues 1996 versus 2006



U.S. Department of Health and Human Services

ASC Services

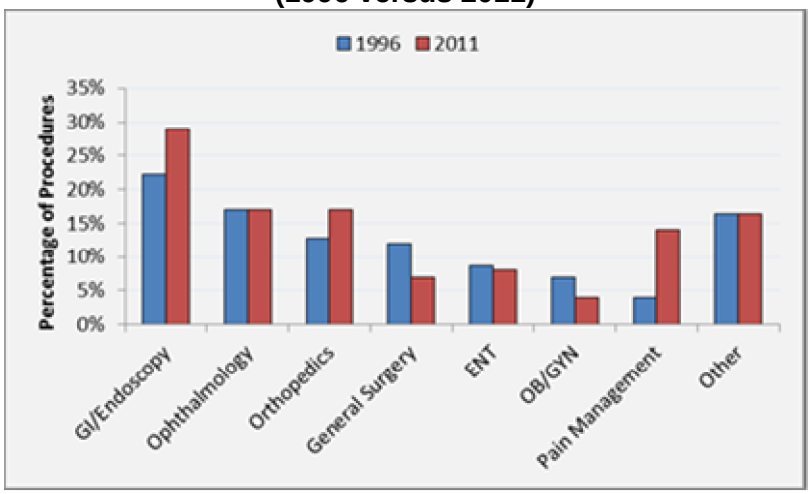
The most defining characteristic of an ASC is that the recovery time for the procedures allows for the patient to return home the same day. The Centers for Medicare and Medicaid Services (CMS) excludes from ASC payment any procedure for which standard medical practice dictates that the beneficiary who undergoes the procedure would typically be expected to require active medical monitoring and care at midnight following the procedure (overnight stay), as well as all surgical procedures that medical advisors determine may be expected to pose a significant safety risk to Medicare beneficiaries. The criteria used under the revised ASC payment system to identify procedures that would be expected to pose a significant safety risk when performed in an ASC include, but are not limited to, those procedures that:

- Generally result in extensive blood loss,
- Require major or prolonged invasion of body cavities,
- Directly involve major blood vessels,
- Are emergent or life-threatening in nature, or
- Commonly require systemic thrombolytic therapy.

New surgical techniques and technology, as well as advances in anesthesia, have significantly expanded the types of surgical procedures that are being performed in ASCs and have helped drive the growth in outpatient surgery. Lasers, arthroscopy, enhanced endoscopic techniques and fiber optics have reduced the trauma and recovery time associated with many surgical procedures. Improved anesthesia has shortened recovery time by minimizing postoperative side effects such as nausea and drowsiness, thereby avoiding the need for overnight hospitalization in many cases. In addition, some states in the United States permit surgery centers to keep a patient for up to 23 hours. This allows more complex surgeries, previously only performed in an inpatient setting, to be performed in an ASC.

Accordingly, the number of procedure types for which Medicare will reimburse ASCs has grown from 200 in the 1980's to over 3,500 in 2012. Nonetheless, the breakdown of procedures by physician specialty has remained largely unchanged since 1996, with over half of procedures performed in ASCs being in the specialties of GI/endoscopy (especially colonoscopy procedures), ophthalmology (cataract surgery) and orthopedics. These specialties share a high prevalence of non-emergency procedures that can be scheduled well in advance, and thus are a good fit with the organizational structure of the ASC environment.

Breakdown of Procedures Performed in ASCs by Physician Specialty (1996 versus 2011)



U.S. Department of Health and Human Services

Operational Efficiencies and Value Proposition

Costs associated with procedures performed in a dedicated Ambulatory Surgery Center are lower than those for performing similar surgeries in the outpatient department of a full-service hospital. ASCs enjoy a number of advantages, including lower facility development costs, more efficient staffing and space utilization, and a specialized operating environment focused on cost containment. While ASCs generally perform scheduled surgeries, large acute care hospitals provide a broader range of services, but especially high priority and emergency procedures.

Medical emergencies often demand the unplanned use of operating rooms and result in the postponement or delay of scheduled elective surgeries, disrupting the practices of physicians and inconveniencing patients. The 2006 National Survey of Ambulatory Surgery (U.S. Department of Health and Human Services, Division of Healthcare Statistics) found that average times for surgical visits at ASCs were lower than those for hospital outpatient surgery departments.

The Central Role of Physicians

Successful ASCs provide a structure that provides the appropriate incentives to capture patient flow. Historically, only physicians are able to bring together all the resources necessary to form an ASC without explicitly partnering with other groups. Physicians bring to the table the key skills that underlie the enterprise, bring patients from their private practices, and are often able to finance the establishment of a new ASC without the help of outside investors. Given their key role, it is not surprising that 63% of ASCs are 100% physician owned and 91% of ASCs are at least partially physician-owned.

Federal and state statutes generally prohibit allocating ownership shares or earnings distribution based on the number of cases brought to the facility by individual physicians, which has created some difficulties for many ASCs in aligning incentives. Surveys performed by VGM Health suggest that in a typical ASC, 35% of procedures are performed by the top two physicians and 54% by the top five. Conflicts can thus arise from the "free-rider" problem. As described below, Northstar has developed interesting and innovative new organizational models that are designed to address this issue. Northstar also has shown in a short period of time the ability to syndicate ASC partnerships that are adaptive and sustainable in a highly regulated environment.

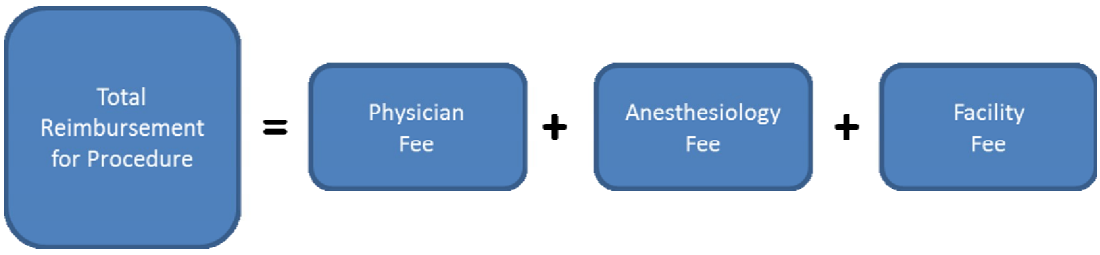
Management companies contribute by bringing expertise in operations, finance, marketing and deal-making that are becoming increasingly more important in an era of constrained reimbursement. The ability to maximize the efficiency of operations and increase revenue, ensure alignment of incentives with institutional goals and find synergies with potential partners are expected to play an increasing role in determining the success of organizations operating in the space as reimbursement pressures grow.

Hospital involvement is becoming an increasingly important part of the strategy of many companies in this space, as majority ownership by a hospital will in many cases offer the advantage of being reimbursed for procedures at the higher hospital rate. This potential synergy is potentially attractive to hospitals as well. Even in the absence of a hospital majority stake, partial hospital ownership may in some cases support a more favorable negotiating position with payers with respect to in-network reimbursement rates.

Reimbursement

Procedures performed in an inpatient or outpatient setting are reimbursed in **three parts**. First, the **physician** receives a professional fee for his/her services. Second, the **anesthesiologist**, if required for the procedure, bills the reimbursement source separately. Finally, the hospital or ASC in which the procedure occurs generates a third bill to cover the cost of providing **the facility**. The opportunity to participate in these facility fees has been a major driver for many physicians to set up their own ASCs. For example, a recent presentation to surgical residents by a recruiter from Rockland Thoracic and Vascular Associates P.C. disclosed that Aetna's total reimbursement for a vascular ablation procedure included $861 in professional fees paid to the surgeon and $4,763 in facility fees paid to the facility.

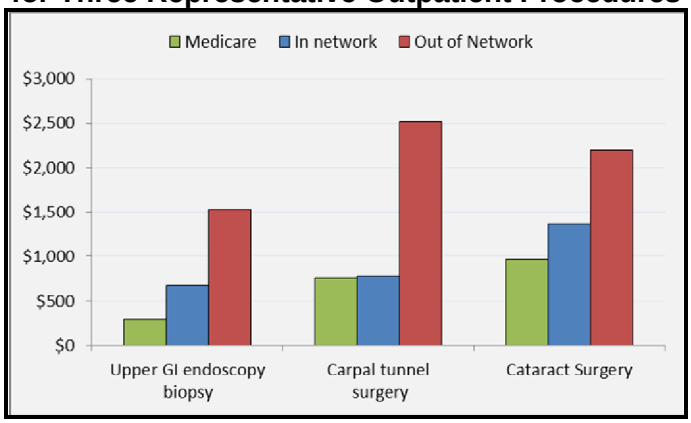
General Reimbursement Scheme



A second key reimbursement concept for understanding the ASC business landscape is the wide range of reimbursements offered by different payers for similar services. The greatest differential is between government payers (Medicare, Medicaid and Worker's Compensation) and private insurers.

Reimbursement for a given procedure may vary widely among private insurers. In order to control costs, the major insurers have all set up “preferred provider” networks, intended to drive insured patients to providers who have agreed to perform services at pre-negotiated rates. Reimbursement rates for **in-network** patients are frequently half or less those for **out-of-network** patients, which are in turn usually higher than those for Medicare and other government-reimbursed patients.

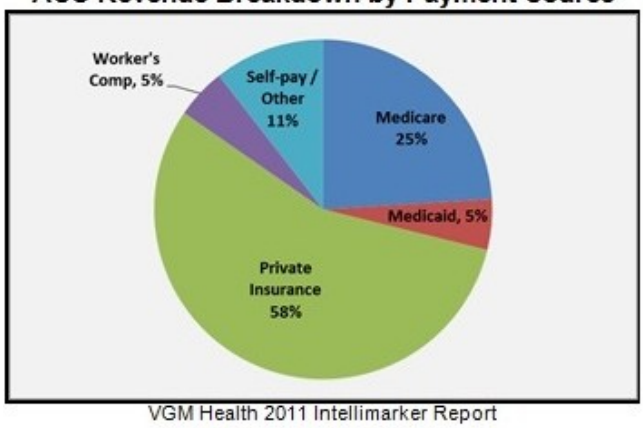
Typical Reimbursement Rates by Payer for Three Representative Outpatient Procedures



Texas Department of Insurance Reimbursement Database
Ambulatory Surgery Center Association Medicare Rate Calculator

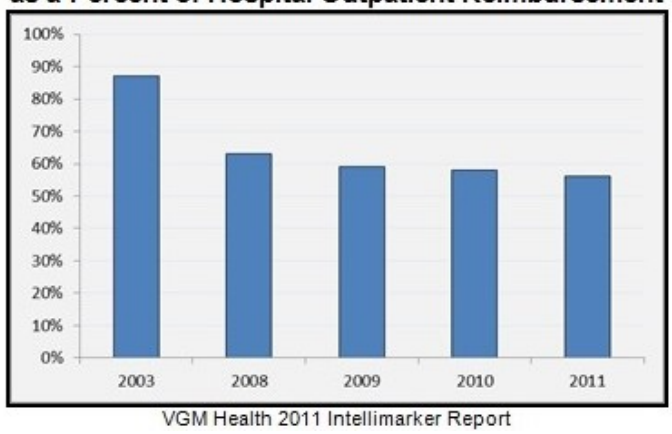
According to the VGM Health 2011 Intellimarker Report, the average ASC receives about 58% of its total revenue from private insurers and 35% from government reimbursement including Medicare, Medicaid and Worker’s Compensation. Given the lower reimbursement rates associated with government relative to private insurance reimbursement, the contribution of government reimbursement is considerably higher when calculated on the basis of percentage of procedures.

ASC Revenue Breakdown by Payment Source



VGM Health 2011 Intellimarker Report

Medicare ASC Reimbursement as a Percent of Hospital Outpatient Reimbursement

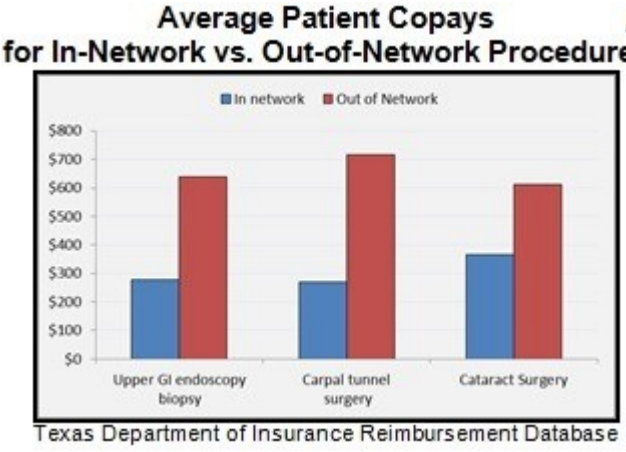


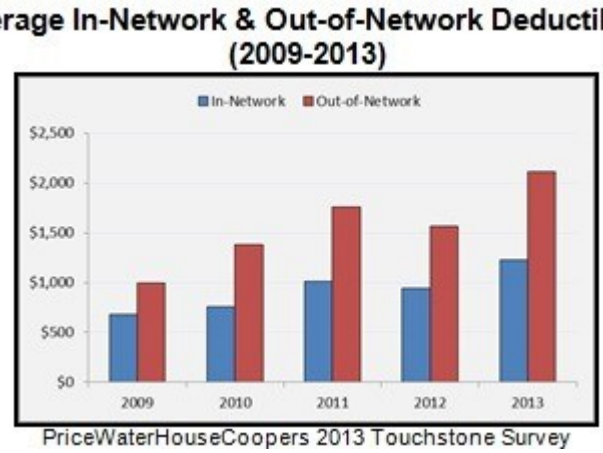
VGM Health 2011 Intellimarker Report

Perhaps the most important business factor trend affecting the industry is the increasing pressure within the U.S. healthcare system to control costs. While this factor has been a primary driver of the increase in outpatient surgery and of performing these surgeries in ASCs, it has also led to increasing pressures on reimbursement as payers seek to appropriate an increasing proportion of the savings generated by the low-cost ASC environment. Recognizing the lower cost structure of ASCs, Medicare has gradually reduced the reimbursement rates for ASCs to 56% of the rate at which hospital outpatient departments are reimbursed for similar procedures. While less detailed information is available for private insurers, private insurance companies typically base their overall reimbursement structures on the Medicare reimbursement schedule.

Like all irrational pricing systems, these policies have led to unanticipated effects as providers attempt to evade or exploit their effects. Many ASCs have sold ownership shares or formed joint ventures with large hospital chains in order to increase negotiating power in pricing discussions with payers. Hospitals have in many cases acquired ASCs and re-designated them as hospital outpatient surgery departments (HOPDs), allowing the hospital to take advantage of the greater cost-efficiency of the ASC operating environment yet still receive the higher reimbursement offered to an HOPD relative to an ASC for the same procedure. While the economic benefits are likely temporary, these policies have served to drive many acquisitions and other deals between ASC owners and hospitals.

Another trend within the reimbursement area is an increasingly forceful stance by payers against out-of-network service providers. Reimbursement rates for out-of-network services can commonly be twice or more those for in-network providers. While it seems that ASC can avoid preferred provider contracts and provide services exclusively to out-of-network patients, consolidation of the insurance industry (most markets are served by five or fewer major insurers) and the widespread adoption of financial incentives to patients to stay in-network makes this difficult. Insurers have gradually increased patient copays for out-of-network services such that the patient often pays hundreds of dollars more than for in-network providers.





Higher annual deductibles for out-of-network services are now the norm as well, and may be increasingly effective deterrents to patients already burdened by the rapid rise in insurance costs. In some cases, it is profitable for ASCs to attract out-of-network patients by waiving the copay, as the difference between in-network and out-of-network reimbursement rates can be larger than the patient co-pay. This practice, however, has in some cases led to conflicts with insurers, including multi-million dollar lawsuits.

Maturing of the Industry

Although the U.S. Center for Health Statistics has not completed a nationwide survey of ambulatory surgery since 2006, available data from individual state surveys suggest a maturing industry. Data collected by the state of Florida shows that the rapid rise in the number of surgeries performed at Florida ASCs from 1997-2006 (compound annual growth rate of 10%) flattened out in the 2007-2012 period (CAGR 0.6%). The average annual number of procedures per ASC has remained steady at 4,067 (standard deviation 123) since 2002. Similar data from the State of Maryland shows the number of procedures performed in ASCs climbing rapidly pre-2008 (CAGR 7.0%) and then leveling off (2008-2011 CAGR 0.5%).

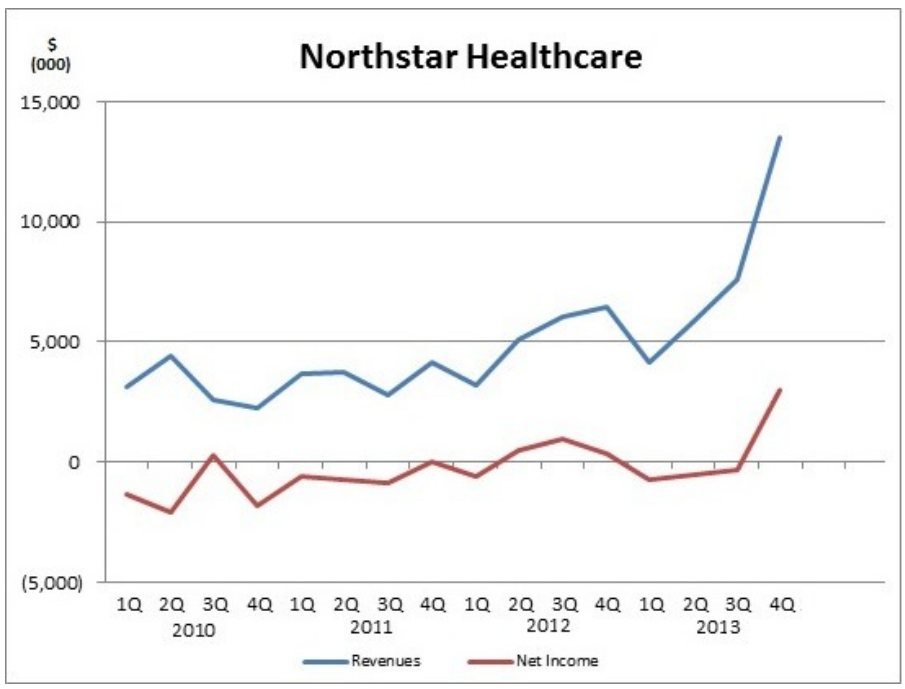
Nonetheless, the industry remains highly fragmented. With an estimated 5,900 ASCs in the U.S., only about 1,300 are managed by multi-facility chains, and the largest chain controls only 239 centers. Only two of the top five pure-play ASC chains are publicly-traded companies, and only another two regularly file financial reports with the SEC: AmSurg (AMSG), Surgical Care Affiliates (SCAI), Symbion (private) and United Surgical Partners International (private).

RISKS

- CEO Dr. Donald Kramer holds considerable control over Northstar Healthcare and its strategy as a result of Dr. Kramer holding a $2.1 million 6.25% promissory note related to the company's purchase of his 95% interest of Palladium for Surgery - Dallas in January 2011. The relationship is further extended by Northstar having entered into a management and cost sharing agreement (for support the company's marketing campaigns) with Northstar Pain Management P.A., which is owned by Dr. Kramer. Also, Dr. Kramer owns 17,144,482 shares of Healthcare Ventures, Ltd., which holds significant interests in Northstar Healthcare Subco LLC and Northstar Healthcare Acquisitions LLC.
- Steve Linehan, the former CEO of Northstar Healthcare, filed suit against the company in the District Court of Harris County, Texas, claiming damages of $1.1 million related to his employment agreement. Northstar denies the claims and has filed a countersuit for fraudulent inducement into that employment agreement. Considering all the relevant facts and circumstances, Northstar Healthcare believes that it is doubtful that a material payment will be paid, and therefore, no provision has been made for this claim. The case is currently scheduled for trial in April 2014.
- The privately-held ASCs that were combined to form Northstar Healthcare in 2007 followed a business model based on aggressive billing practices. The dramatic revenue decline that occurred shortly after the company's IPO, to a significant extent, can be attributed to payer pushback against those practices.
- Physician recruitment and maintenance remains a key variable for success. In 2008, the company's difficulties with payors at the Palladium for Surgery Houston were largely associated with financial terms offered to non-partner physicians to induce them to perform surgery at the facility.

VALUATION

Valuation methodologies for health care services companies usually entail the use the price-to-revenues, price-to-EBITDA and/or P/E metrics in comparison to the industry mean and median as well as relative to the company's historic valuation range. The industry of Specialty Providers of Healthcare Services appears to be the appropriate valuation benchmark. The relatively higher multiples relative to the stock indices reflect the profitability and strong revenue profiles of specialty healthcare-related companies, such as ASCs, and the better growth potential of these relatively smaller companies.



The appropriate valuation methodologies for Northstar Healthcare are based on price-to-sales (P/S) and enterprise value-to-EBITDA (EV/EBITDA) due the character of the company's enterprise, namely a small-capitalization company with a revenue profile that should experience rapid growth both through internal growth as the company's Direct-to-Consumer marketing program is rolled out and through the execution of management's acquisition strategy. The growing revenue stream has already manifested itself into the positive earnings reported for the last two calendar years.

Based on current valuation of similar specialty providers of healthcare services companies, we expect NHC to trade in an EV/EBITDA valuation range between 17.0 and 6.5, and specifically, our target is based on NHC attaining the first quartile valuation benchmark of an 16.8 EV-to-EBITDA ratio due to the revenue and net income progress attained thus far from the implementation of management's growth strategies. **Our share price target is $2.10.**

Also, valuation based on the price-to-sales metric confirms and reinforces the price target. We expect NHC to trade in a P/S valuation range between 3.3 and 1.4, which is also based on current valuations of similar companies. The first quartile valuation benchmark is 2.8 price-to-sales or $2.00 per share utilizing annualized revenues from operations from the most recent quarter's results. Price-to-sales valuation also incorporates a company's ability to increase revenues. Given management's stated business plan of becoming a creator, owner and operator of health care networks in multiple metropolitan areas, Northstar Healthcare is expected to expand its revenue base significantly.

Industry Comparables	**Pr Chg YTD**	**P/E CFY**	**EPS Gr 5Yr Est**	**Price/ Book**	**Price/ Sales**	**Price/ CF**	**EV/ EBITDA**
NORTHSTAR HEALTHCARE	-6.4	5.7	17.0	4.1	1.5	12.6	8.0
Industry Mean	15.2	24.0	13.2	6.8	2.4	21.3	11.5
Industry Median	3.7	19.0	10.8	2.7	1.1	12.6	10.1
S&P 500	1.3	16.0	10.8	4.3	3.1	13.7	N/A
AMSURG CORP.	6.2	19.7	12.7	1.4	1.5	15.1	5.6
SURGICAL CARE AFFILIATES	-12.0	31.9	N/A	2.8	1.4	13.2	8.6
MEDNAX INC.	16.1	19.7	14.0	2.7	2.9	19.5	12.7
PSYCHEMEDICS CORP.	13.1	17.4	11.4	7.2	3.3	18.9	13.6
ACADIA HEALTHCARE	-6.7	33.2	20.2	4.6	3.1	30.6	20.5
US PHYSICAL THERAPY	-6.2	21.4	20.0	2.7	1.5	17.0	9.7
VCA ANTECH INC.	0.4	17.3	12.4	2.1	1.6	12.2	10.1

We are optimistic about Northstar as a turnaround story. The company has experienced a dramatic increase in revenues over the last several quarters that appear to arise from its Direct-to-Consumer Marketing campaigns, the development of innovative new methods for recruiting physicians, and positioning itself as a provider rather than a seeker of patient streams through its branding efforts.

BALANCE SHEET & PROJECTED INCOME STATEMENT

Northstar Healthcare Inc.

(in thousands of $US)	2007 12/31/2007	2008 12/31/2008	2009 12/31/2009	2010 12/31/2010	2011 12/31/2011	2012 12/31/2012	2013 12/31/2013
ASSETS							
Cash and cash equivalents	4,983	3,733	6,182	4,236	2,505	4,222	5,602
Accounts receivable	13,861	8,366	3,040	1,747	2,341	4,090	8,281
Medical supplies	507	575	502	439	488	535	787
Income tax receivable	-	-	310	87	-	-	-
Prepaid expenses and other assets	668	1,258	667	479	255	287	540
Total current assets	**20,019**	**13,932**	**10,701**	**6,988**	**5,589**	**9,134**	**15,210**
Property and equipment - net	5,561	4,658	3,552	2,222	1,875	1,308	4,833
Foreign currency exchange contract	5,467						
Intangible assets	9,076	1,658	285	285	1,097	1,097	1,097
Goodwill	139,443	15,300	1,635	1,635	1,228	1,228	1,228
Note receivable	-	-				0	150
Investment in associate	-	-			67	37	
Other non-current assets, net	43	35	33	41	67	67	121
Total assets	**179,609**	**35,583**	**16,206**	**11,171**	**9,923**	**12,871**	**22,639**
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)							
Accounts payable	1,075	1,185	852	844	576	811	3,018
Accrued liabilities	2,653	1,395	1,522	873	1,068	1,215	1,720
Dividends payable	1,402	659	-	-	-	-	-
Taxes payable	227	410	-	-	-	-	-
Notes payable - current portion	-	-	-	-	-	-	1,693
Capital lease obligations - current portion	-	-	-	-	-	-	49
Other current liabilities	-	-	19	5	125	-	43
Total current liabilities	**5,357**	**3,649**	**2,393**	**1,722**	**1,769**	**2,026**	**6,523**
Notes payable, less current portion	-	-	-	-	2,093	1,693	0
Accrued liabilities	-	1,718	-	-	-	-	-
Future tax liability	3,991	-	-	-	-	-	-
Capital lease obligations (less current)	-	-	-	-	-	0	163
Foreign currency exchange contracts	-	4,750	-	-	-	-	-
Related party deferred distributions	-	-	2,026	-	-	-	-
Class B units	-	-	1,815	-	-	-	-
Other liabilities	28,200	3,400	5	0	0	2	0
Total liabilities	**37,548**	**13,517**	**6,239**	**1,722**	**3,862**	**3,721**	**6,686**
Non-controlling interests	**9,394**	**7,072**	**4,776**	**3,466**	**3,623**	**4,462**	**4,754**
Common stock	139,718	139,718	139,718	145,412	143,747	144,677	146,704
Additional paid-in-capital	-	228	812	886	1,004	1,125	4,193
Accumulated deficit	(7,051)	(124,952)	(135,339)	(140,315)	(142,313)	(141,114)	(139,698)
Total shareholders' equity (deficit)	132,667	14,994	5,191	5,983	2,438	4,688	11,199
Total equity (deficit)	142,061	22,066	9,967	9,449	6,061	9,150	15,953
Total liabilities and shareholders' equity	**179,609**	**35,583**	**16,206**	**11,171**	**9,923**	**12,871**	**22,639**
Shares outstanding	13,900,852	13,900,852	13,900,852	33,344,210	33,385,395	36,082,114	42,729,547

Northstar Healthcare Inc.

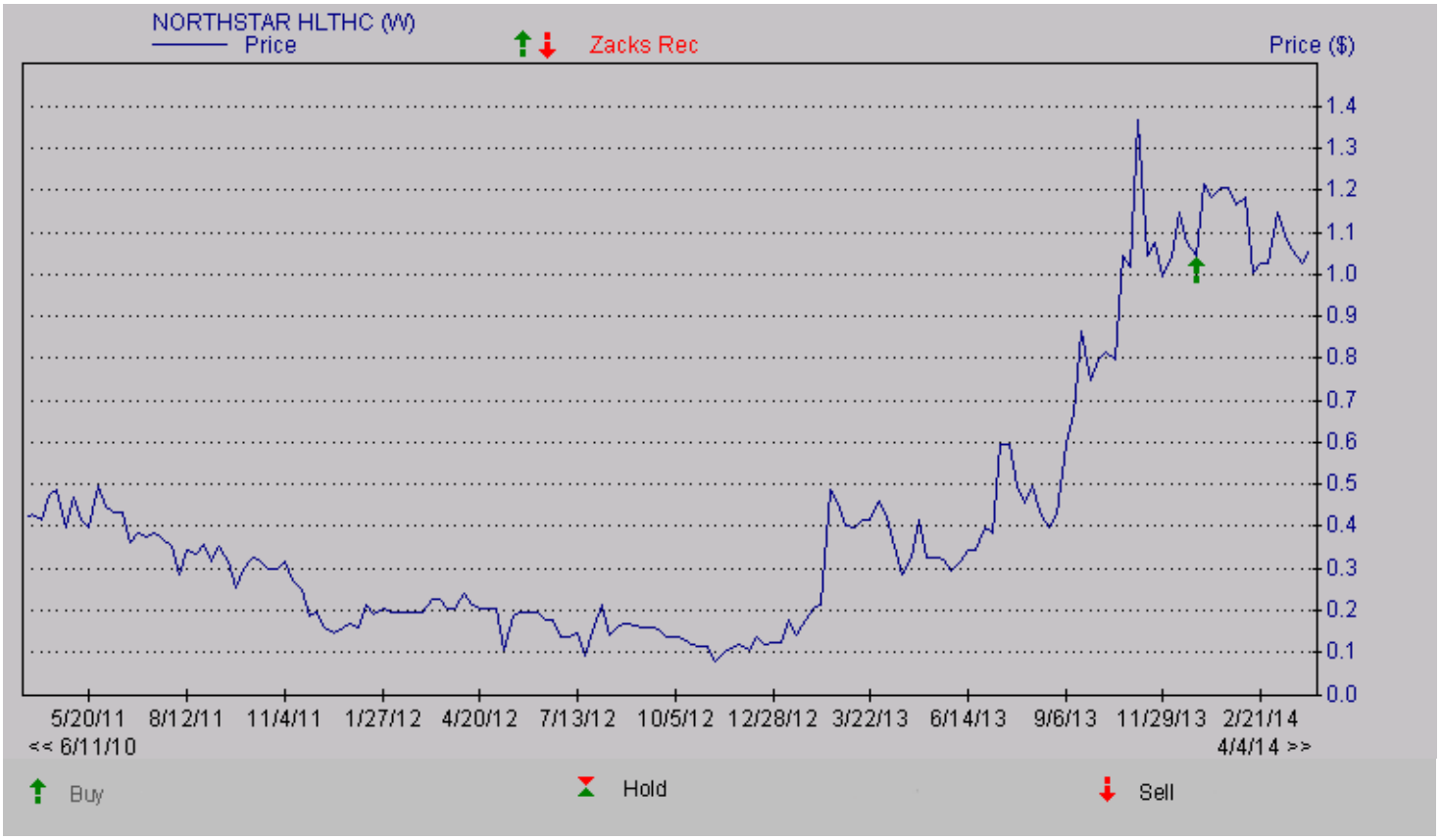
(in thousands of $US)	2007 12/31/2007	2008 12/31/2008	2009 12/31/2009	2010 12/31/2010	2011 12/31/2011	2012 12/31/2012	2013 12/31/2013	2014 E 12/31/2014
Net patient service revenue	**32,919**	**42,779**	**24,924**	**12,329**	**14,380**	**20,897**	**31,128**	**49,307**
Operating expenses								
Salaries and benefits	3,853	6,674	6,334	3,366	3,877	3,832	5,329	7,280
Medical supplies	2,528	4,038	3,206	2,365	2,476	2,391	4,423	6,336
General and administrative expenses	4,136	7,761	10,518	2,821	4,062	4,488	10,648	14,901
Provision for doubtful accounts	-	5,735	1,091	775	912	145	-	50
Depreciation and amortization	1,079	1,783	1,406	1,408	1,047	779	650	600
Total operating expenses	**11,596**	**25,991**	**22,555**	**10,735**	**12,374**	**11,635**	**21,050**	**29,168**
Operating income	**21,323**	**16,788**	**2,369**	**1,594**	**2,006**	**9,262**	**10,078**	**20,139**
Salaries and benefits	-	-	-	1,638	1,730	1,600	2,285	3,022
General and administrative	-	-	-	3,361	1,964	1,681	2,228	2,570
Legal expenses	-	-	-	3,420	242	553	808	934
Amortization	-	-	-	34	38	71	81	92
Total corporate expenses	**0**	**0**	**0**	**8,453**	**3,974**	**3,905**	**5,402**	**6,618**
Other income (expense)								
Gain (loss) on bargain purchase	-	-	-	-	-	-	2,392	-
Distributions, other liabilities, non-controlling int.	(1,088)	(1,384)	(320)	-	-	-	-	-
Withholding taxes (expense)	(857)	(853)	-	-	-	-	-	-
Chg. In fair value, other liabilities, non-controlling int.	(10,236)	24,800	1,585	-	-	-	-	-
Class B units (distributions & gains)	-	-	-	2,138	-	-	-	-
Goodwill and intangible (impairment)	-	(131,141)	(14,880)	-	-	-	-	-
Gain (loss) on foreign currency	6,003	(8,809)	3,886	50	45	-	-	-
State franchise tax (expense)	(225)	(301)	(94)	(76)	(77)	(119)	(177)	(281)
Other income (expense)	82	72	(234)	286	510	3	1	2
Total other (income) expense	**(6,321)**	**(117,616)**	**(10,057)**	**2,398**	**478**	**(116)**	**2,216**	**(279)**
Net Income	**15,002**	**(100,828)**	**(7,688)**	**(4,461)**	**(1,490)**	**5,241**	**6,892**	**13,242**
Current income tax expense (recovery)	227	459	(685)	-	-	-	-	-
Future income tax expense	3,991	(3,991)	0	-	-	-	-	-
Total income tax expense (recovery)	4,218	(3,532)	(685)	0	0	0	0	0
Net income attributable to noncontrolling int.	**7,624**	**6,910**	**3,384**	**515**	**685**	**4,042**	**5,476**	**9,692**
Net gain (loss) attributable to Company	**3,160**	**(104,206)**	**(10,387)**	**(4,976)**	**(2,175)**	**1,199**	**1,416**	**3,550**
Basic income (loss) per share	$0.23	($7.50)	($0.75)	($0.26)	($0.07)	$0.03	$0.04	$0.09
Diluted income (loss) per share	**$0.23**	**($7.50)**	**($0.75)**	**($0.26)**	**($0.07)**	**$0.03**	**$0.04**	**$0.09**
Basic weighted average shares outstanding	13,749,756	13,900,852	13,900,852	18,801,644	33,350,980	35,461,911	36,793,950	38,327,235
Diluted weighted average shares outstanding	13,749,756	13,900,852	13,900,852	18,801,644	33,350,980	35,764,295	37,637,662	39,170,235

Northstar Healthcare Inc.

(in thousands of $US)	2012 12/31/2012	2013 1Q	2013 2Q	2013 3Q	2013 4Q	2013 12/31/2013
Net patient service revenue	**20,897**	**4,121**	**5,862**	**7,640**	**13,505**	**31,128**
Operating expenses						
Salaries and benefits	3,832	1,012	1,142	1,332	1,843	5,329
Medical supplies	2,391	686	724	852	2,161	4,423
General and administrative expenses	4,488	1,217	2,005	2,993	4,433	10,648
Provision for doubtful accounts	145	-	-	-	-	-
Depreciation and amortization	779	156	155	154	185	650
Total operating expenses	**11,635**	**3,071**	**4,026**	**5,331**	**8,622**	**21,050**
Operating income	**9,262**	**1,050**	**1,836**	**2,309**	**4,883**	**10,078**
Salaries and benefits	1,600	520	536	420	809	2,285
General and administrative	1,681	426	470	577	755	2,228
Legal expenses	553	107	174	354	173	808
Amortization	71	19	20	20	22	81
Total corporate expenses	**3,905**	**1,072**	**1,200**	**1,371**	**1,759**	**5,402**
Other income (expense)						
Gain (loss) on bargain purchase	-	-	-	-	2,392	2,392
State franchise tax (expense)	(119)	(17)	(35)	(47)	(78)	(177)
Other income (expense)	3	(13)	(19)	98	(65)	1
Total other (income) expense	**(116)**	**(30)**	**(54)**	**51**	**2,249**	**2,216**
Net Income	**5,241**	**(52)**	**582**	**989**	**5,373**	**6,892**
Total income tax expense (recovery)	0	0	0	0	0	0
Net income attributable to noncontrolling int.	**4,042**	**653**	**1,145**	**1,328**	**2,350**	**5,476**
Net gain (loss) attributable to Company	**1,199**	**(705)**	**(563)**	**(339)**	**3,023**	**1,416**
Basic income (loss) per share	$0.03	($0.02)	($0.02)	($0.01)	$0.08	$0.04
Diluted income (loss) per share	**$0.03**	**($0.02)**	**($0.02)**	**($0.01)**	**$0.08**	**$0.04**
Basic weighted average shares outstanding	35,461,911	36,221,965	36,308,965	36,817,590	37,827,235	36,793,950
Diluted weighted average shares outstanding	35,764,295	36,221,965	36,308,965	36,817,590	37,827,235	37,637,662

(in thousands of $US)	2013 12/31/2013	2014 1Q E	2014 2Q E	2014 2Q E	2014 4Q E	2014 E 12/31/2014
Net patient service revenue	**31,128**	**6,200**	**9,379**	**12,224**	**21,504**	**49,307**
Operating expenses						
Salaries and benefits	5,329	1,054	1,594	1,834	2,798	7,280
Medical supplies	4,423	992	1,219	1,467	2,658	6,336
General and administrative expenses	10,648	2,046	3,001	3,789	6,064	14,901
Provision for doubtful accounts	-	-	-	-	50	50
Depreciation and amortization	650	156	155	154	135	600
Total operating expenses	**21,050**	**4,248**	**5,970**	**7,244**	**11,706**	**29,168**
Operating income	**10,078**	**1,952**	**3,409**	**4,980**	**9,798**	**20,139**
Salaries and benefits	2,285	434	563	733	1,292	3,022
General and administrative	2,228	434	563	550	1,023	2,570
Legal expenses	808	124	188	244	378	934
Amortization	81	23	23	23	23	92
Total corporate expenses	**5,402**	**1,015**	**1,336**	**1,551**	**2,716**	**6,618**
Other income (expense)						
Gain (loss) on bargain purchase	2,392	-	-	-	-	-
State franchise tax (expense)	(177)	(17)	(35)	(47)	(182)	(281)
Other income (expense)	1	(13)	(19)	98	(64)	2
Total other (income) expense	**2,216**	**(30)**	**(54)**	**51**	**(246)**	**(279)**
Net Income	**6,892**	**907**	**2,019**	**3,480**	**6,836**	**13,242**
Total income tax expense (recovery)	0	0	0	0	0	0
Net income attributable to noncontrolling int.	**5,476**	**939**	**1,641**	**2,397**	**4,715**	**9,692**
Net gain (loss) attributable to Company	**1,416**	**(32)**	**378**	**1,083**	**2,121**	**3,550**
Basic income (loss) per share	$0.04	($0.00)	$0.01	$0.03	$0.05	$0.09
Diluted income (loss) per share	**$0.04**	**($0.00)**	**$0.01**	**$0.03**	**$0.05**	**$0.09**
Basic weighted average shares outstanding	36,793,950	38,027,235	38,227,235	38,427,235	38,627,235	38,327,235
Diluted weighted average shares outstanding	37,637,662	38,870,235	39,070,235	39,270,235	39,470,235	39,170,235

HISTORICAL ZACKS RECOMMENDATIONS



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