Zacks Small-Cap Research

August 27, 2012

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University General Health System, Inc.

(UGHS –OTCQB)

UGHS: Zacks initiates coverage with an Outperform rating and target of $0.58.

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	08/27/2012
Current Price (08/24/12)	$0.43
Six- Month Target Price	**$0.58**

OUTLOOK

University General Health System is a multi-specialty health care provider that owns and operates a regional healthcare network comprised of a core hospital and several complementary healthcare facilities in Houston. Management is executing an aggressive growth plan to acquire additional facilities, further developing the company's footprint in Houston and later expanding geographically in Texas. The company's business model includes the delivery of concierge, patient-oriented care by motivated physicians which own over 46% of the company. We initiate coverage of University General Health System with an Outperform rating.

SUMMARY DATA

52-Week High	**$0.85**
52-Week Low	**$0.18**
One-Year Return (%)	**-41.10**
Beta	**-0.70**
Average Daily Volume (shrs.)	**51,707**
Shares Outstanding (million)	**319**
Market Capitalization ($ mil.)	**$137**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**2**
Insider Ownership (%)	**46.4**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/M**
P/E using 2012 Estimate	**14.3**
P/E using 2013 Estimate	**10.8**
Zacks Rank	**N/A**

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

ZACKS ESTIMATES

Revenue
(in thousands of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2010	N/A	N/A	N/A	N/A	56.1 A
2011	15.4 A	17.9 A	20.7 A	18.5 A	72.5 A
2012	19.1 A	29.1 A	30.3 E	31.6 E	110.1 E
2013					139.3 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2010	N/A	N/A	N/A	N/A	-$0.01 A
2011	-$0.00 A	-$0.00 A	$0.00 A	-$0.01 A	-$0.01 A
2012	$0.00 A	$0.02 A	$0.01 E	$0.01 E	$0.03 E
2013					$0.04 E

Zacks Projected EPS Growth Rate - Next 5 Years % **N/A**

Results originally reported under March FY; results re-arranged as Dec. year.

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KEY POINTS

- University General Health System is a specialty health care provider that owns and operates a general acute care hospital, eight hospital outpatient departments, one ambulatory surgical center and three senior living facilities in the Houston market. The company also owns and utilizes a support services organization that provides billing and other administrative services to health care companies.
- Since March 2011, University General Health System has pursued an aggressive **acquisition strategy**, building an integrated network of ancillary and complementary healthcare services in the Houston area with University General Hospital at its core. Management expects both to continue filling in its health care network in the Houston market and also to replicate the process in other metropolitan areas.
- Through acquisitions and organic growth, total revenues increased 29.2% in 2011 to $72.5 million. Continuing the trend, total revenues during the first half of 2012 advanced 44.5% over the comparable first half of last year to $48.2 million.
- By delivering **concierge, patient-oriented care**, the University General network provides uniquely competitive health-related services.
- The **physician-centric model** encourages the delivery of patient-oriented services while concurrently generating incremental revenues within the company's network. Moreover, management believes physician-centric model incentivizes doctors to minimize costs, which in turn helps University General to maintain cost controls.
- The acquisition of the revenue cycle management firm Autimus provides scalable billing capabilities for further geographical expansion through acquisition.
- The domestic hospital industry is highly fragmented. Despite significant consolidation in recent years, the four largest private sector operators combined only represent approximately 9% market share, The industry provides ample opportunities for merger and acquisition (M&A) activity.
- **As the U.S. population ages, healthcare expenditures overall and specifically within the hospital sector are expected to increase**. The Centers for Medicare & Medicaid Services (CMS) projects total U.S. healthcare spending to grow by an average of 5.8% per annum through 2020, with the hospital services category expected to grow by at least 4.7% per annum over the same period.
- The sector has been relatively insulated from economic downturns. Although the most recent recession has posed challenges, consumer expenditures on hospital services have held relatively stable at about 30% of total national health expenditures between 2001 and 2009.
- We initiate coverage of University General Health System with an Outperform rating and a target of $0.58.

OVERVIEW

Based in Houston, Texas, University General Health System, Inc. (UGHS: OTCQB) is a health care facilities company. The company's primary business unit is University General Hospital, a general acute care hospital in Houston, which was opened in 2006. Initially, the hospital was owned and operated by a Texas Limited Partnership (University General Hospital, LP) with a Delaware Limited Partnership (University Hospital Systems, LLP) acting as the general partner. University General Health System, Inc. became a publicly-traded company in March 2011 through a reverse merger with Seabridge Freight Corp. whereby the former partners (approximately 90 physicians) received approximately 100 million shares of stock.

Strategic Growth Plan

Long-term, management's strategic growth plan entails the creation and operation of regional health care networks developed around general acute-care host hospitals in other metropolitan areas, replicating the process employed in Houston. Each network is anticipated to be built through the acquisition of a host hospital and ancillary healthcare facilities within a radius such that they can operate under the hospital's

licenses as Hospital Outpatient Departments (HOPDs). Each locally concentrated system may consist of HOPDs at the core hospital, along with free-standing centers such as Ambulatory Surgical Centers (ASCs), procedure facilities, diagnostic imaging centers, physical therapy clinics, among others. By consolidating providers into HOPDs, the University General network benefits from higher reimbursement rates. In addition, the company's physician-centric model allows the network to capture incremental revenues for procedures referred within the system.

The Implementation of the Acquisition Strategy in Houston

After completing the reverse merger in March 2011, management embarked on an **aggressive acquisition campaign** designed to create a regional health care network around a core hospital (University General Hospital) **in the Houston area**. During 2011, the company acquired three senior living facilities (**Trinity**), a support services organization that provides billing and other administrative services (**Autimis**) and a luxury hospitality service provider and facility management company (**Sybaris**). In addition, the company acquired 51% of the support services company that manages the six senior living facilities (**TrinityCare**) and 15% of Mainland Surgery Center. So far in 2012, University General has acquired the **Baytown Endoscopy Center, 1960 Digital Imaging** (a diagnostic imaging and physical therapy center) and **three clinics** (diagnostic imaging, physical therapy and sleep) located at the Kingwood Diagnostic and Rehabilitation Center. University General Health System is expected to continue acquiring ancillary healthcare facilities in the Houston area in order to help fill out in its health care network, including free-standing emergency rooms, ambulatory surgical centers, diagnostic imaging centers, physician practices, post-acute skilled nursing facilities (SNFs) and other complementary facilities. The company recently announced the acquisition of **Robert Horry Center for Sports and Physical Rehabilitation Center**. In addition, it is possible that additional host hospitals may be acquired.

Timeline

• August 2005	University General Hospital LP founded
• September 27, 2006	University General Hospital opens
• May 2010	Opened hyberbaric wound care center as HOPD
• March 28, 2011	UGHS becomes public company in reverse merger with SeaBridge Freight
• April 25, 2011	Opened Kingwood Neighborhood Emergency Center as HOPD
• May 1, 2011	Acquired 15% of Mainland Surgery Center as ASC
• June 30, 2011	Acquired Trinity Oaks, Trinity Shores and Trinity Hills senior care facilities
• June 30, 2011	Acquired 51% of TrinityCare Senior Living, LLC
• June 30, 2011	Acquired Autimis, LLC and Autimis Medical Billing, LLC
• December 31, 2011	Acquired The Sybaris Group, LLC
• February 10, 2012	Kingwood Neighborhood Emergency Center exits UGHS network
• April 13, 2012	Acquired Baytown Endoscopy Center as HOPD
• June 1, 2012	Acquired 1960 Digital Imaging
• August 1, 2012	Acquired three clinics at the Kingwood Diagnostic and Rehabilitation Center
• August 27, 2012	Acquired Robert Horry Center for Sports and Physical Rehabilitation Center

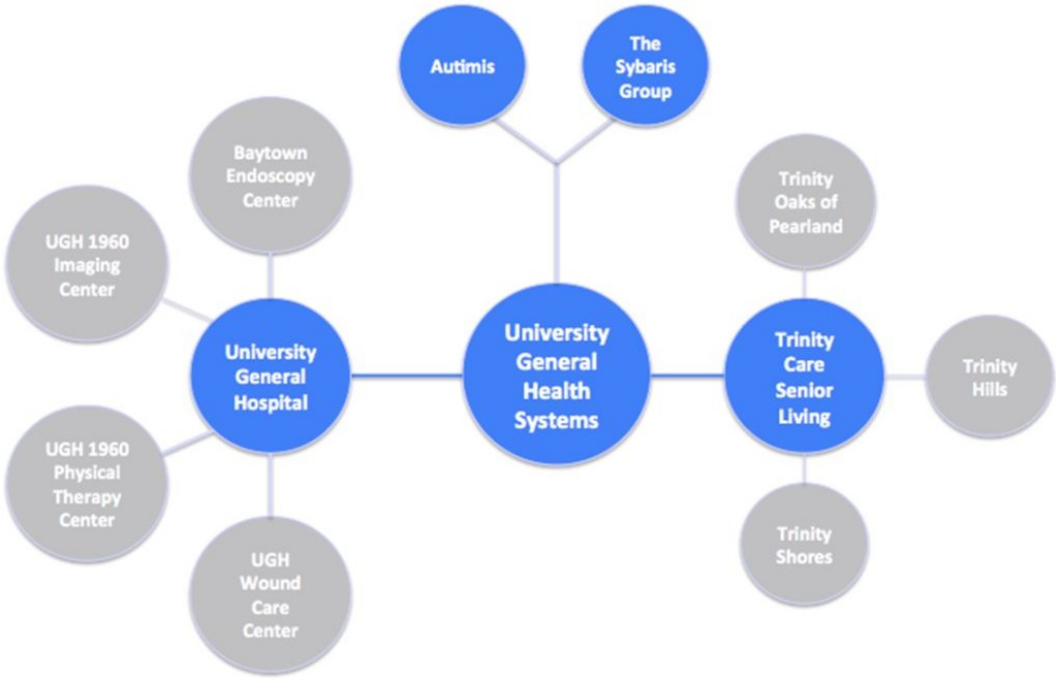
University General Health System operates **three business units**: Hospital, Senior Living and Support Services.

- ***Hospital*** (94.2% of revenues in 2011) Located in Houston, the Hospital unit is comprised of a 69-bed general acute care hospital, the company's corporate offices and several Hospital Outpatient Departments (HOPDs), including a hyberbaric wound care center, UGH Diagnostic Imaging, UGH Physical Therapy, Baytown Endoscopy Center, three clinics at Kingwood Diagnostic and Rehabilitation Center, the Robert Horry Center for Sports and Physical Rehabilitation Center and an Ambulatory Surgical Center (ASC) known as Mainland Surgery Center.

- ***Senior Living*** (4.9%) Owning three senior living communities in Texas (Trinity Oaks in Pearland, Trinity Shores in Port Lavaca and Trinity Hills in Knoxville), the Senior Living unit offers housing and assistance to elderly and mid-acuity frail residents. All three senior living facilities were acquired in June 2011. Also, University General purchased a 51% controlling interest in Trinity Care Senior Living, the support services company that manages the facilities. In total, UGHS operates six senior living facilities.
- ***Support Services and Other*** (0.8%) Composed of the Autimus and Sybaris acquisitions, Support Services provides revenue management, food, hospitality and facility services to University General Hospital and other healthcare companies. Acquired in June 2012, Autimus provides billing and coding services while Sybaris, which was acquired in December 2012, offers food, hospitality and facility management services.

HOSPITAL FACILITIES (HOUSTON)

The Hospital segment of University General Health System is composed of a regional health care network serving the Houston market, which consists of an acute-care hospital (University General Hospital), an ambulatory surgical center (Mainland Surgery Center) and several HOPDs (Baytown Endoscopy Center, a hyberbaric wound care center, UGH Diagnostic Imaging, UGH Physical Therapy and three clinics performing diagnostic imaging, physical therapy and sleep studies operating in Kingwood Diagnostic and Rehabilitation Center). The Hospital segment represented **90.1% of UGHS's revenues** for the first half of 2012.



HOSPITAL segment

University General Hospital, the company's initial healthcare facility, opened on September 27, 2006. Located at 7501 Fannin Street in Houston, the facility is a 69-bed general acute-care hospital with six intensive care unit beds and 11 intermediate care unit beds. The hospital provides a wide range of patient care, including 24-7 emergency services, inpatient surgery, outpatient surgery, heart catheterization procedures, pain management, physical therapy, sleep study, diagnostic imaging and respiratory therapy, among others. Also, University General Hospital offers concierge care, delivering amenities that a patient would have at home or at an upscale hotel. Some of these amenities include private rooms with hardwood floors, flat screen televisions, internet access and meals served on china.

Hospital Outpatient Departments

Integral parts of University General's regional health care network are the company's Hospital Outpatient Departments (HOPDs), namely the **University General Hospital-Hyperbaric Wound Care Center**, **1960 Digital Imaging**, **three clinics** (diagnostic imaging, physical therapy and sleep) located at the Kingwood Diagnostic and Rehabilitation Center and the **Robert Horry Center for Sports and Physical Rehabilitation Center**.

An important aspect of University General's **accretive acquisition model** is the pricing benefit inherent to the migration a medical clinic from the status of an ASC to a HOPD. Procedures performed at hospitals and HOPDs are under a higher reimbursement payment structure for various reasons. For example, hospitals are held to more rigorous standards of safety and quality of care, in addition to having higher overhead costs. Therefore, hospital reimbursement rates by third-party payors and Medicare and Medicaid are generally 30% to 75% higher. Legally, a hospital can only pay "fair market value" for a physician's interest in an ASC, and according to the definition by the IRS, the assessment of fair market value may not consider an anticipated higher payment structure. Given the disparity in reimbursement rates and the transaction valuation of HOPDs and ASCs, it is attractive for hospitals to acquire clinics and ASCs at fair market value. For the physician owners of the clinics, the benefits of joining an integrated delivery model far exceed the reduction of a portion of the autonomy of an independent practice. Also, under the umbrella of a hospital network, both University General and the physicians of the acquired clinics benefit from greater, hospital-based reimbursement rates by third-party payors and Medicare and Medicaid under the HOPD payment system.

The **hyberbaric wound care center** in University General's network operates as a HOPD under the name University General Hospital -Hyperbaric Wound Care Center. Located on the 6th floor of the hospital, the hyperbaric wound care center includes 4,000 square feet of patient treatments rooms, waiting and reception areas and three monoplace hyperbaric oxygen chambers. At University General podiatrists, cardiologists, endocrinologists, vascular surgeons and plastic surgeons utilize hyperbaric oxygen therapy (HBOT) to treat diabetes-related injuries, radiation tissue damage, vascular wounds, venous/arterial disease, burns etc.

Hyperbaric oxygen therapy is a well-established treatment in which a patient breathes 100% pure oxygen while inside a chamber at a pressure higher than sea level pressure. A hyperbaric treatment increases the amount of oxygen not only in the blood but also in blood plasma, which offers distinct benefits, including 1) enhanced formation of new blood vessels (which promotes wound healing)[1] and 2) infection control by increasing the number of white blood cells in the affected tissues. The number of treatments and the duration of each treatment is dependant on the severity of the condition and the progress made once treatments begin. Generally, the duration of each treatment is between 90 minutes and two hours per day, and treatment schedules can last for several weeks or months, depending on the severity of the condition.

University General operates **UGH Diagnostic Imaging** and **UGH Physical Therapy** located approximately 20 miles north of University General Hospital. The diagnostic imaging center and physical therapy clinic are now classified as HOPDs in the University General network. Originally acquired as 1960 Diagnostic Imaging**,** the diagnostic imaging center was rebranded as **UGH Diagnostic Imaging** and provides several digital imaging services including Computed Tomography scans (CT), cardiac CT scans, mammograms, Magnetic Resonance Imaging (MRI), X-rays, ultrasounds[2], Doppler ultrasounds[3], CT bone density exams and Fluoroscopy exams. The physical therapy clinic was renamed **UGH Physical Therapy**. Though 1960 Digital Imaging is associated with Woodlands Imaging in The

[1] Wound healing is promoted through the increased production of new fibroblasts and collagen, which are needed to repair muscle and skin cells).
[2] Ultrasounds are used to detect aneurysms, gallstones, cysts and tumors as well as to monitor prenatal development.
[3] Doppler ultrasound is used to evaluate blood flow in order to identify blockages in arteries and vein, especially in the neck (carotid arteries), heart, abdomen and legs.

Woodlands, Texas (about eleven miles north of 1960 Digital Imaging), Woodlands Imaging is not part of the University General network.

In August 2012, University General expanded its regional network by acquiring three clinics operating in Kingwood Diagnostic and Rehabilitation Center, which is situated in Kingwood, a northern suburb of Houston. The **diagnostic imaging, physical therapy and sleep clinics** were acquired from Management Affiliates of Northeast Houston, LLC for an undisclosed combination of stock, cash and assumed debt. The Kingwood Diagnostic and Rehabilitation Center is a two-story, 40,733-square-foot medical office building which contains at least 11 independent healthcare-related practices and is located on the Campus of Kingwood Medical Center. The three clinics acquired are composed of an association of 13 physicians and primary care practitioners, including assistants and nurses, and are connected with Diagnostic Affiliates at Kingwood aka Kingwood Diagnostic Affiliates. Located approximately 28 miles NNE of University General Hospital, the diagnostic imaging, physical therapy and sleep clinics have been renamed the UGH Kingwood Diagnostic and Rehabilitation Center under the company's branding strategy and will operate as hospital outpatient departments (HOPDs) of University General Hospital. Management expects that the three clinics to generate at least $6.5 million in annual net patient revenues and produce annual EBITDA of $2.6 million

Over the past ten years, the number of **free-standing emergency rooms** across the country has grown dramatically in response to the increase in visits to emergency rooms. This has also helped offset the decline in the number of hospital-based emergency rooms, which has dropped 27% since 1990. According to the Journal of the American Medical Association, there were to 1,779 hospitals with emergency departments in non-rural areas in 2009, down from 2,446 in 1990. Freestanding emergency rooms are generally less costly to build and maintain than a full service hospital and can often provide a means of serving a population that does not have sufficient access to emergency medical care otherwise. There were 241 free-standing emergency rooms in 2009 according to the American Hospital Association, up from 146 in 2004. Given their focus on emergency medical care, patients generally see a doctor sooner at a freestanding emergency room than at the emergency room of a full service hospital. According to the AHA, on average patients see a doctor in 30 minutes or less compared to a wait of 55.8 minutes at a hospital emergency room. Freestanding emergency rooms also trump hospital emergency rooms on discharge times, averaging 90 minutes or less compared to 180 minutes for hospital emergency rooms. We would expect University General to enter this market with 100%-owned free-standing emergency rooms.

In February 2011, University General signed a two-year agreement to establish emergency room operations at **Kingwood Neighborhood Emergency Center** as a HOPD of University General Hospital. The Emergency Center was opened in April 2011, however, in February 2012, University General and Kingwood mutually agreed to terminate the agreement.

Baytown Endoscopy Center was acquired during the second quarter of 2012 for a seller's note[4] and the assumption of certain equipment financing commitments. Classified as a HOPD, Baytown Endoscopy Center is a 3-bed ambulatory surgery center is located at 910 N Highway 146, Baytown, TX, approximately 30 miles east of University General Hospital.

Ambulatory Surgical Centers

Ambulatory surgical centers (ASCs) are healthcare facilities that perform 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.

[4] A seller's note is a form of debt financing where the seller agrees to receive a portion of the purchase price through a series of installment payments.

The Texas Ambulatory Surgical Center Licensing Act was enacted in 1985, and ASCs are subject to Chapter 135 of Title 25 of the Texas Administrative Code (TAC) of the Department of State Health Services. Many simple procedures including cataract surgery, some types of bariatric surgeries, colonoscopies, tonsillectomies, hernia repairs, gallbladder removals, some cosmetic surgeries, certain pain management therapies and orthopedic surgeries are now performed in ASC facilities. In Texas, the Texas Ambulatory Surgery Center Society monitors and reports on the ASC industry. In the latest reporting period (2009), ASCs over 1.2 million surgeries and procedures were performed in Texas, which were estimated to have had a $1.7 billion economic impact employing over 7,300 Texans and generating $424 million in taxes.

Mainland Surgery Center is a free-standing ambulatory surgery center (ASC) within the University General network. Located at 3750 Medical Park Drive, Dickinson, TX, approximately 20 miles south of University General Hospital, UGHS acquired a 15% interest in Mainland Surgery Center for $115,000 in May 2011. University General has the option to acquire all or part of the remaining 85% of Mainland for an adjusted agreed value through April 22, 2014.

ACQUISITIONS and PROJECTS

University General Health System has embarked on an aggressive acquisition program. In calendar 2011, UGHS made several acquisitions that greatly expanded and diversified its revenue base. As a result, two new business segments were formed: Senior Living and Support Services. In addition, thus far during 2012, the company has announced three acquisitions: Baytown Endoscopy Center, 1960 Digital Imaging and three clinics located at Kingwood Diagnostic and Rehabilitation Center.

University General acquired three senior living communities in an acquisition completed on June 30, 2011. These facilities are: 1) **Trinity Oaks** of Pearland and 2) **Trinity Shores** of Port Lavaca in Texas, and 3) **Trinity Hills** of Knoxville, Tennessee. Trinity Oaks is an 80 unit senior living community, which has been in operation since 2001. Trinity Shores is a 63 unit senior living community that has been in operation since 2007, and Trinity Hills is an 87 unit senior living community that has also been in operation since 2007. Also, University General acquired a 51% stake in **TrinityCare Senior Living**, which develops and manages senior living communities. TrinityCare manages the three Trinity senior living communities acquired by University General, and three additional facilities in Georgia (assisted living community and two memory care greenhouses). Management intends to continue developing new facilities both nationally and potentially internationally.

The **Senior Living segment** is comprised of the Trinity assets, which were acquired on June 30, 2011 for 23,395,895 shares and certain assumed liabilities. Due to the Trinity assets being acquired mid-year, year-end segment figures for 2011 are misleading; however, during the first half of 2012, the Senior Living segment represented **8.1% of UGHS's revenues**. This business unit derives revenues principally from resident fees, which reflect costs charged for housing, support services and assisted living care. Senior Living residents typically sign resident agreements for one-year renewable terms. The business also generates revenue from entrance fees, community fees and management fees. Despite the difficult economic backdrop, the Senior Living segment recorded an overall occupancy rate above 93.4% for the second quarter ending June 30, 2012. Management has indicated that the TrinityCare concept may be expanded to facilities in Pearland, Texas; Covington, LA; Shreveport, LA; Seymour, TN; Crossville, TN and Cookeville, TN.

The company also strengthened its back office services capabilities through acquisitions in 2011. On June 30, 2011, University General acquired **Autimis** and **Autimis Medical Billing**, two companies that are focused health care billing, coding and revenue cycle management. Both of the Autimis companies serve the healthcare industry including hospitals, ambulatory surgery centers, laboratories and emergency rooms. Autimis has been providing billing, coding and other revenue management services to University General since September 2009. Autimis will continue to provide these services to

University General and generate incremental revenue through service agreements with third party healthcare providers. Autimis results are included in the company's Support Services business segment.

University General acquired **The Sybaris Group** on December 31, 2011. Sybaris provides luxury hospitality and facility management services. In addition to providing food, housekeeping, parking valet and information technology services to University General, Sybaris provides these services and others (such as plant operations & maintenance, executive & conference event planning, etc.) to a total of twelve clients in Houston. Sybaris has about 100 employees and generated revenues of about $5.5 million and estimated earnings of $500,000 in 2011. The company financed the Sybaris acquisition with 5.0 million shares of its common stock. The company expects that the addition of Sybaris will enable University General to leverage its concierge concept as it expands. Sybaris is also included in the company's Support Services operating segment.

The **Support Services segment** is primarily composed of The Sybaris Group, Autimis and Autimis Medical Billing, all three having been acquired in 2011. Since Sybaris was acquired on December 31st, year-end segment figures are misleading; however, during the first half of 2012, the Support Services segment accounted for **1.8% of UGHS's revenues**.

University General is expanding to provide inpatient and outpatient services through an integrated health care delivery system. By strengthening its back office support services organization, University General has assumed some of the roles of an MSO (management service organization), which usually does not qualify for tax exemption status under IRC 501(c). Whether a tax-exempt hospital's participation in an MSO will jeopardize its exempt status is determined by several factors. Management does not believe its tax exempt status is likely to be impacted, given that its services division only accounts for about 1% of total revenue.

In October 2011 University General announced plans to construct the **Alvin Community Hospital**, a 27,000-square-foot critical care hospital on 10 acres in Alvin, Texas. The facility is slated to open in three phases, with the phase one launch set for 2013. It will include ten surgical beds and 12 emergency department beds and a separate medical office building. The second and third phases will provide additional beds and services. The local government has agreed to $2.5 million in performance based reimbursement incentives, as the hospital is expected to generate 275 jobs. The nearest hospital is located about 13 miles away from Alvin, which comprises about 125,000 people who live and work within 10 miles and generate more than 11,000 emergency room visits and 4,000 ambulance transports per annum. This project has apparently undergone several changes in sponsorship over the past several years, with Dallas-based Christus Health originally having signed on to manage the hospital before University General became involved. University General, too, terminated its lease with the landowners (ACHDC LLC and Palicio Gate LP) and is very close to resolving the litigation related to this project (see Risk section).

PHYSICIAN-CENTRIC MODEL

As a result of the acquisitions in the Houston area, University General Health System has developed a health care network with multiple healthcare-related revenue streams and the synergies related to a **physician referral network**. Fostering a physician-centric system, there are approximately 550 physicians with hospital privileges at the University General Hospital, including approximately 90 physicians have an equity interest in UGHS. Obviously, share ownership aligns the interests of the hospital with that of the doctors who feed the hospital with patients through the referral system. In addition, a collaborative culture in the operating rooms, patient floors and ancillary service units encourages physicians without equity ownership to take an active role in hospital operations. In turn, the hospital provides opportunities to benefit from collaborating with UGHS, such as working with large primary care groups to improve their operating performance in their clinics.

CONCIERGE CARE

Concierge medicine has grown significantly since it was first introduced in 1996. According to the AAPP (American Academy of Private Physicians), there are an estimated 3,500 concierge physicians across the nation, up 46% from about 2,400 physicians roughly a year and a half ago. The AAPP also estimates that concierge doctors serve almost a million patients nationwide.

Many concierge practices are “hybrid” ones that provide both concierge and normal healthcare services to patients. Patients who opt in for concierge services generally pay additional fees in exchange for the extra benefits, which often include luxury amenities for in-hospital stays and sometimes priority treatment and healthcare services that are not traditionally covered by insurance. The additional fees for the concierge service can range from $60 to $30,000 annually, depending on the service level the patient requires. The OIG (Office of Inspector General of the U.S. Department of Health and Human Services) has made it clear that physician practices offering concierge services must provide additional services “beyond what is already covered by Medicare” in order to request additional fees.

University General Health System strives to provide patient-centric health care not only by promoting the active involvement of patients and their families in the design and delivery of medical treatments, but also by providing quality patient care in a soothing and restful environment with concierge service. Studies have shown that the concierge environment calms the anxiety surrounding most hospital stays.

At University General Hospital, concierge services are delivered at no additional cost to the patient. By providing concierge-level healthcare that is not associated with a fee, University General possesses a competitive advantage over local competing hospitals for elective medical procedures and diagnostic services.

The interior design of University General Hospital, including the patients’ rooms, reflects the up-scale ambiance of a luxury hotel. Upon arriving, patients and guests are greeted by a parking attendant and are provided complimentary valet parking. The lobby features a baby grand piano and soothing waterfall. Marble floors enhance public areas. The hospital’s interior design creates a comforting environment for the time spent while recovering from an illness or a medical procedure. The rooms are private with hard-wood paneling and are equipped with flat screen televisions. Wireless internet access is complimentary. Meals, which are nutritionally-balanced and designed for high-quality taste and satisfaction, are served on fine china. The ambiance, accoutrements and food service are designed to make one’s hospital stay as pleasant as possible.

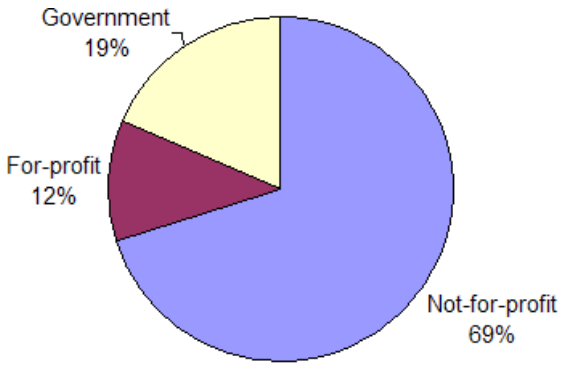
The Sybaris Group, acquired by UGHS, provides the hospitality and facility management services for University General Hospital. Sybaris supplies the housekeeping and valet parking, in addition to the food and nutrition services. The environmental housekeeping services include the cleaning, disinfecting and/or sanitizing of both public areas and rooms. Since Sybaris is capable of delivering a five-star culinary experience at executive & conference events, the menus at University General Hospital include meals that are well-planned, nutritional, healthy and tasty. Also, staff concierge providers can aid family members in arranging transportation to and from the hospital and with hotel, airline and restaurant reservations. The University General concierge can even assist with ordering flowers, renting cars and providing information on and transportation to local cultural sites and activities. Management believes that by providing concierge healthcare through an environment that brings comfort to patients and families, University General should be the hospital of choice in Houston.

HEALTHCARE SERVICES INDUSTRY

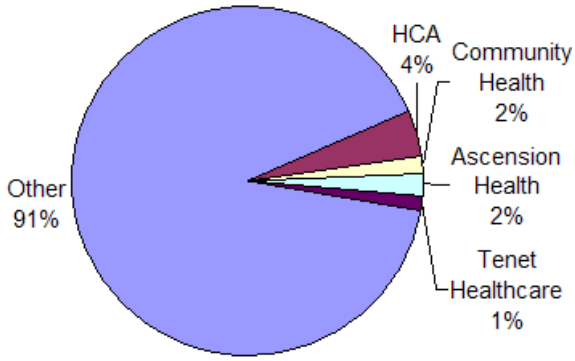
University General operates within the hospital industry of the healthcare services sector. The United States hospital industry is comprised of roughly 5,754 hospitals nationwide that generate over $750

billion in annual patient billed revenue. The majority (69%) of hospitals operate on a not-for-profit basis. Another 11.5% are operated by the private sector as for-profit corporate entities and 18.5% are owned and operated by the state or federal government, including the Veterans Administration. University General Health System operates within the for-profit sector, although it competes with facilities that are both for-profit and not-for-profit, including government-owned hospitals.

Breakdown of Domestic Hospital Facilities



Market Share of Private Sector Hospitals



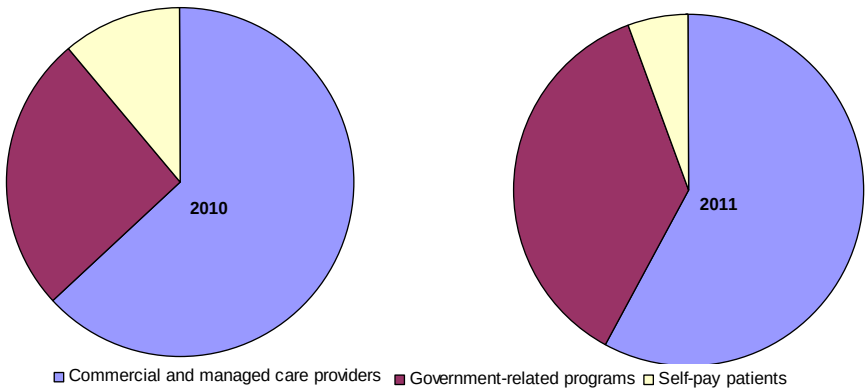
American Hospital Association

All hospitals receive revenues from government programs as reimbursements (Medicare and Medicaid), from private insurers (including employer groups) and directly from uninsured patients. Typically, rates paid by commercial payors are higher than reimbursements from Medicare and Medicaid sources.

Medicare is a federally funded health insurance program, primarily for individuals 65 or older or who are disabled and who are entitled to social security benefits. Medicaid is a health insurance program jointly funded by state and federal governments that provides medical assistance to low-income people. The longer term impact of the Health Care and Education Reconciliation Act of 2010 that went into effect on March 30, 2010 is unclear at this point. However, certain provisions that reduce annual “market basket updates” to providers or that bundle Medicare reimbursements could impact the University General’s business.

On average, hospitals generate roughly 60% of revenues from Medicare, Medicaid and other government programs. By comparison, University General generated less than 40% of total 2011 revenue from government sources, which we believe makes the company less sensitive to potential changes in government reimbursement mandates, although government related reimbursements have grown rapidly as a source of company revenue.

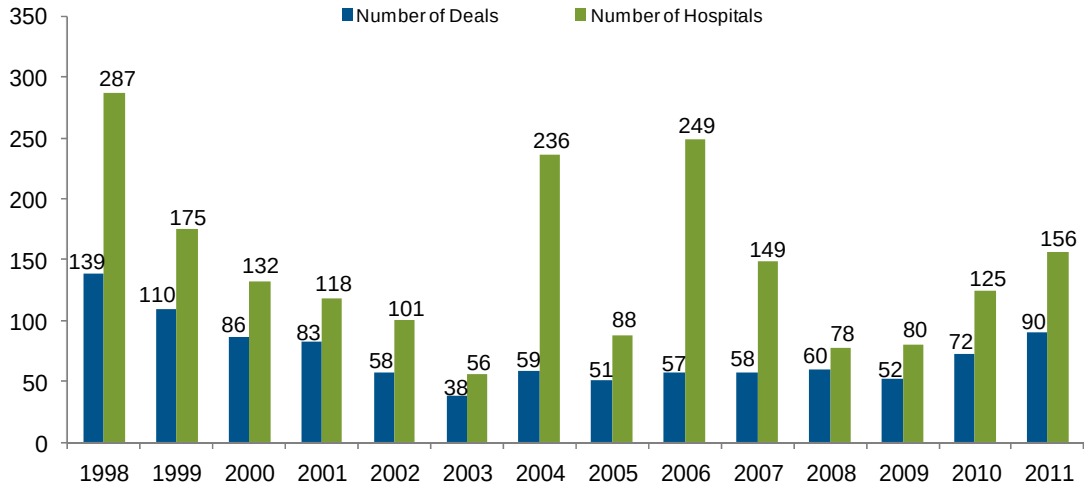
University General Expense Reimbursement Breakdown (2010 & 2011)



Beginning in the 1990s, the U.S. hospital industry has undergone considerable consolidation, fueled largely by two factors. Hospital operators have seen consolidation as a means to 1) combat the impact of managed care and 2) have sought economies of scale, particularly through increased purchasing power. Though the number of mergers and acquisitions combined peaked in 1997 at 310, M&A activity remained

relatively high (see chart below) as industry consolidation has continued. However, despite significant consolidation over the last 20 years, the largest corporate hospital operator, HCA Holdings[5] (HCA: NYSE), still controls only about a 4% market share and the largest four private sector operators combined represent only a 9% market share. Though the number of domestic hospitals in systems is increasing (2,921 in 2009 versus 2,524 in 1999)[6], hospitals that operate on their own (i.e. not as part of a larger system) still comprise approximately 40% of the total number of registered hospital facilities. Therefore, the industry remains highly fragmented, which implies that there is considerable room for further consolidation. The domestic hospital industry has been and remains highly fragmented.

Announced Hospital Mergers and Acquisitions, 1998 – 2011[7]



American Hospital Association Annual Survey of Hospitals and Irving Levin Associates (The Health Care Acquisition Report, 2012)

Consumer expenditures on hospital services have been stable at about 30% of total national health expenditures between 2001 and 2009, according to the CMS (Center for Medicare & Medicaid Services). The CMS data also indicate that total U.S. healthcare expenditures grew by 3.9% in 2010 to about $2.6 trillion.

National Health Expenditures, 2001 and 2009		2001		2009				
Spending Category	2001	Share of NHE	2009	Share of NHE	2001-09 %Chg	2001-09 $Chg	% of 2001-09 $ Chg
National Health Expenditures ($ billions)	1,495.30	100.0%	2,486.30	100.0%	66.3%	991	100.0%
Health Services and Supplies	1401.4	93.7%	2330.1	93.7%	66.3%	928.7	93.7%
Personal Health Care	1264.1	84.5%	2089.9	84.1%	65.3%	825.8	83.3%
Hospital Care	449.4	30.1%	759.1	30.5%	68.9%	309.7	31.3%
Professional Services	422.9	28.3%	674.9	27.1%	59.6%	252	25.4%
Physician and Clinical Services	314.7	21.0%	505.9	20.3%	60.8%	191.2	19.3%
Other Professional Services	40.6	2.7%	66.8	2.7%	64.5%	26.2	2.6%
Dental Services	67.5	4.5%	102.2	4.1%	51.4%	34.7	3.5%
Other Health, Residential and Pers. Care	70.7	4.7%	122.6	4.9%	73.4%	51.9	5.2%
Nursing Home and Home Health	125.2	8.4%	205.3	8.3%	64.0%	80.1	8.1%
Home Health Care	34.4	2.3%	68.3	2.7%	98.5%	33.9	3.4%
Nursing Home Care	90.8	6.1%	137	5.5%	50.9%	46.2	4.7%
Retail Outlet Sales of Medical Products	196	13.1%	328	13.2%	67.3%	132	13.3%
Prescription Drugs	138.7	9.3%	249.9	10.1%	80.2%	111.2	11.2%
Other Medical Products	57.4	3.8%	78.2	3.1%	36.2%	20.8	2.1%
Durable Medical Equipment	25.1	1.7%	34.9	1.4%	39.0%	9.8	1.0%
Other Non-Durable Medical Products	32.3	2.2%	43.3	1.7%	34.1%	11	1.1%
Private Health Insurance	89.8	6.0%	163	6.6%	81.5%	73.2	7.4%
Government Public Health Activities	47.5	3.2%	77.2	3.1%	62.5%	29.7	3.0%
Investment	94	6.3%	156.2	6.3%	66.2%	62.2	6.3%
Research	28.5	1.9%	45.3	1.8%	58.9%	16.8	1.7%
Structures & Equipment	65.5	4.4%	110.9	4.5%	69.3%	45.4	4.6%

CMS, Office of the Actuary, National Health Statistics Group

[5] As of December 31, 2011, HCA Holdings operated 163 hospitals with 40,988 licensed beds, five psychiatric hospitals with 506 licensed beds, and one rehabilitation hospital, along with 108 freestanding surgery centers in 20 states and England.
[6] the American Hospital Association.
[7] 2006 includes the privatization of HCA.

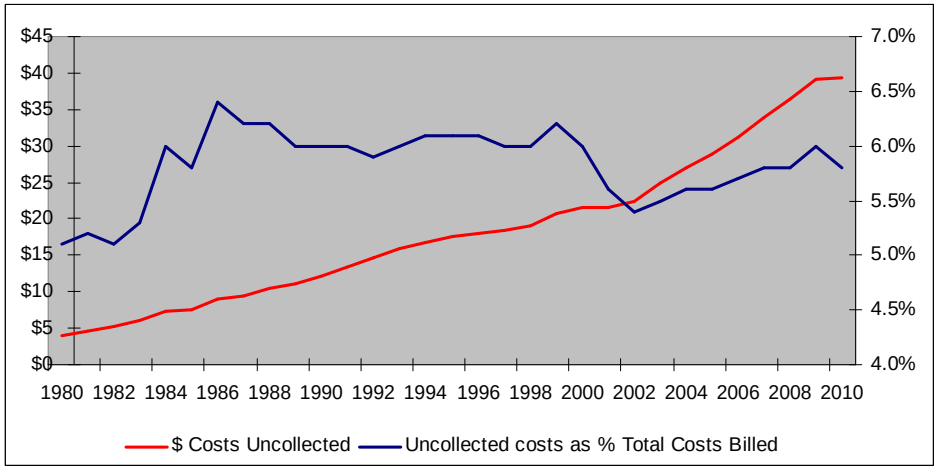
The sector has been relatively insulated from economic downturns, although the recession has posed challenges in recent years, particularly for the private sector healthcare services industry. **Hospital facility utilization, as measured by the percentage of beds occupied and duration of hospital stay, has come under pressure** as patients have frequently deferred elective procedures and also chosen to have a greater percentage of procedures done on an outpatient basis. While primarily attributable to economic factors, this pressure on facility utilization also reflects the introductions of new medical technologies that have mitigated the need for prolonged hospital stay in many situations. In addition, managed care organizations (MCOs) and government insurers, such as Medicare and Medicaid, have increasingly sought to minimize the length of in-patient hospital stays.

Year	Inpatient Admissions in Community Hospitals	Inpatient Admissions Per 1,000	Total Inpatient Days in Community Hospitals	Inpatient Days Per 1,000	Inpatient Surgeries	Avg Length of Stay
1990	31,181,046	125.3	225,971,653	908.4	10,844,916	7.2
1991	31,064,283	123.2	222,858,470	883.9	10,693,243	7.2
1992	31,033,557	121.7	221,047,104	866.8	10,552,378	7.1
1993	30,748,051	119.3	215,888,741	837.6	10,181,703	7.0
1994	30,718,136	118	207,180,278	796	9,833,938	6.7
1995	30,945,357	117.8	199,876,367	760.7	9,700,613	6.5
1996	31,098,959	117.2	193,747,004	730.4	9,545,612	6.2
1997	31,576,960	118	192,504,015	719.3	9,509,081	6.1
1998	31,811,673	117.8	191,430,450	709	9,735,705	6.0
1999	32,359,042	118.7	191,884,270	703.7	9,539,593	5.9
2000	33,089,467	117.6	192,420,368	683.7	9,729,336	5.8
2001	33,813,589	118.7	194,106,316	681.6	9,779,583	5.7
2002	34,478,280	119.7	196,690,099	682.7	10,105,010	5.7
2003	34,782,742	119.6	196,649,769	676.2	9,940,922	5.7
2004	35,086,061	119.5	197,564,172	672.8	10,050,346	5.6
2005	35,238,673	119.2	197,073,770	666.4	10,097,271	5.6
2006	35,377,659	118.2	196,366,512	655.9	10,095,683	5.6
2007	35,345,986	117.3	194,549,348	645.7	10,189,630	5.5
2008	35,760,750	117.6	196,078,468	644.9	10,105,156	5.5
2009	35,527,377	115.7	192,656,804	627.5	10,100,980	5.4
2010	35,149,427	113.7	189,593,349	613.5	9,954,821	5.4

Source: Avalere Health analysis of American Hospital Association Annual Survey data, 2010
US Census Bureau: National and State Population Estimates, July 1, 2010.

At the same time, **uncompensated costs has increased from $21.6 billion in 2000 to $30.3 billion in 2010**, primarily reflecting the nation's rising uninsured population. From 2008 through 2010, on average, 47.9 million people had no health insurance according to the U.S. Census Bureau. Hospitals are required to treat people who come in as emergency patients regardless of whether they have healthcare insurance. In general, hospitals collect only 8% to 10% of the amount billed to uninsured patients. Moreover, the hospital industry faces pressure on reimbursements from government mandates to constrain the costs of Medicare and Medicaid. However, on a percentage basis, uncompensated costs have remained relatively flat at about 6% of total costs invoiced to patients.

Uncompensated Costs



Labor costs, which significantly impact hospital cost structures, are rising. The number of people entering the medical field in nursing or other support positions has declined in recent years, putting pressure on labor costs as demand for support personnel has often outstripped supply. This imbalance has frequently increased labor costs and/or made it difficult for hospitals to be fully staffed. The Bureau of Labor Statistics' Employment Projections for 2010-2020, released in February 2012, cites that the top occupation for expected job growth through 2020 is RNs (Registered Nurses). The report projects that the number of employed RNs will increase by 26% between 2010 and 2020 from 2.74 million to 3.45 million. According to the *Houston Business Journal*, the Houston market n particular ranks 5th among 30 domestic markets analyzed for health care worker demand. Interestingly, among other factors boosting the demand for health care workers, the Journal cites University General's plan for five new hospitals.

The company does not expect the factors noted above to constrain its growth. In fact, these factors could create opportunities for a smaller player such as University General Hospital Systems, which seeks to benefit from consolidation. Moreover, **as the population ages, healthcare expenditures overall and specifically within the hospital sector are expected to grow**. The CMS projects total U.S. healthcare spending to grow by an average of 5.8% per annum through 2020, with the hospital services category expected to grow by at least 4.7% per annum over that period.

TEXAS HEALTHCARE MARKET

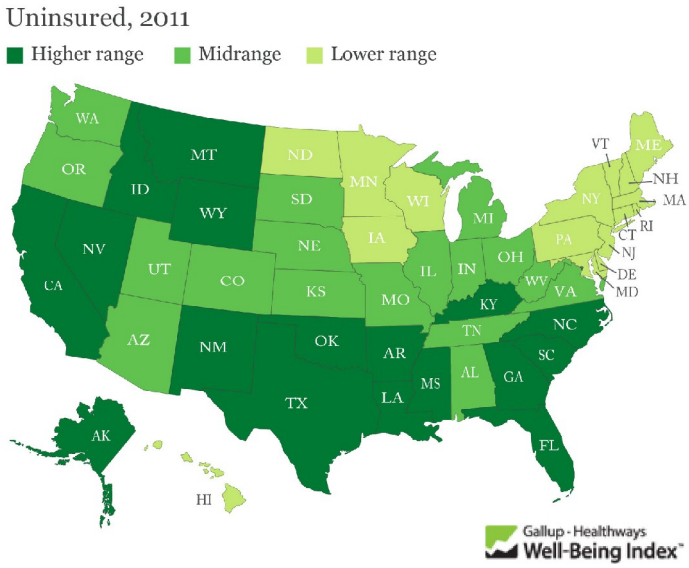
The company's primary facility, the University General Hospital in Houston, competes with at least fifty-four (54) other general hospitals operating in Harris County, Texas. The greater Houston-Baytown-Sugar Land metropolitan area has 99 hospitals, according to U.S. News and World Report, including the Texas Medical Center (TMC), the largest medical center in the world. Founded in 1945, TMC is comprised of 15 hospitals, four nursing schools and three medical schools (dentistry, public health and pharmacy). All of TMC's member institutions are not-for-profit. Among the various institutions with which University General competes, six Houston-based facilities (including the University of Texas M.D., the Methodist Hospital and St. Luke's Episcopal Hospital) were ranked in U.S. News & World Report's 2012-2013 Best Hospitals list. Several other Houston hospitals have announced expansion plans recently. Examples include the University of Texas Medical Branch at Galveston, which is launching its largest construction project ever according to the Houston Business Journal. Nevertheless, the state of Texas overall remains below the national average in terms of hospital beds per inhabitant, with 2.43 beds compared to the roughly 2.85 national average.[8]

Beds per 1,000 Persons by State, 2009 and 2010

State	Beds / 1,000 Persons		State	Beds / 1,000 Persons	
	2009	2010		2009	2010
Alabama	3.25	3.19	Montana	3.92	3.77
Alaska	2.19	2.18	Nebraska	4.14	4.00
Arizona	2.04	2.00	Nevada	1.94	1.96
Arkansas	3.31	3.25	New Hampshire	2.16	2.15
California	1.86	1.89	New Jersey	2.42	2.42
Colorado	2.06	2.00	New Mexico	1.95	1.95
Connecticut	2.26	2.29	New York	3.09	3.04
Delaware	2.40	2.42	North Carolina	2.43	2.43
District of Columbia	5.76	5.66	North Dakota	5.20	5.12
Florida	2.87	2.85	Ohio	2.95	2.98
Georgia	2.59	2.57	Oklahoma	3.07	3.00
Hawaii	2.29	2.42	Oregon	1.69	1.67
Idaho	2.19	2.16	Pennsylvania	3.11	3.16
Illinois	2.62	2.57	Rhode Island	2.39	2.35
Indiana	2.69	2.76	South Carolina	2.74	2.72
Iowa	3.42	3.33	South Dakota	5.10	5.01
Kansas	3.59	3.51	Tennessee	3.33	3.29
Kentucky	3.27	3.28	Texas	2.50	2.43
Louisiana	3.53	3.40	Utah	1.79	1.80
Maine	2.72	2.72	Vermont	2.08	2.07
Maryland	2.09	2.04	Virginia	2.22	2.23
Massachusetts	2.35	2.37	Washington	1.70	1.71
Michigan	2.59	2.58	West Virginia	4.07	4.00
Minnesota	2.96	2.90	Wisconsin	2.41	2.39
Mississippi	4.36	4.37	Wyoming	3.68	3.58
Missouri	3.19	3.12			

[8] Trendwatch Chartbook 2012: Avalere Health Analysis of American Hospital Association Annual Survey data, 2010, for community hospitals. US Census Bureau: National and State Population Estimates, July 1, 2010.

On the other hand, Texas also has one of the nation's highest levels of uninsured inhabitants. An estimated 27.6% of the population was uninsured in 2011, according to the Gallup Healthways Well-Being Index. Although this could impact the company's uncompensated costs over time, we believe this risk is mitigated by University General's focus on providing concierge medical services in an upscale setting and its lower than industry average exposure to Medicare / Medicaid reimbursements.



Management has targeted Dallas as the next Texas market for potential expansion. The Dallas market has 75 hospitals serving a population of 6.4 million people, which averages to about 85,000 per hospital compared to the national average of 54,000. Therefore, it appears that the Dallas market can support additional hospital and healthcare networks. The market is trying to proactively find ways to manage healthcare and reimbursements effectively as the regulatory climate evolves. For instance, in 2009, the Dallas-Fort Worth Hospital Council put together an Index to track patient readmissions (the Regional Enterprise Master Patient index) in response to the CMS indications that is evaluating ways to track and reduce patient readmissions or cap the reimbursements paid for readmissions. Similar to the state overall, the level of insured people exceeds the national average, at about 24% compared to the national average of roughly 16%.

In October 2011, University General announced plans to develop the Alvin Community Hospital, a planned 27,000-square-foot hospital on 10 acres in Alvin, Texas. The facility is slated to be developed in three phases. Phase One consists of opening the hospital with ten surgical beds and 12 emergency department beds in early 2013. The second and third phases will provide additional beds and services. The local government, the City of Alvin, has agreed to $2.5 million in performance-based reimbursement incentives. Located approximately 25 miles south of downtown Houston, Alvin is centered in a market in which roughly 125,000 people reside and work generating more than 11,000 emergency room visits annually.

The Alvin Community Hospital project has undergone changes in sponsorship. Two years earlier, in late 2009, it was announced that Fort Worth-based Rowland Companies was expected to develop and Dallas-based Christus Health to manage the Alvin Community Hospital. University General became involved with the project in October 2011 and subsequently terminated its lease with the landowner (see Risk section).

RECENT NEWS

Second quarter results

On August 14, 2012, University General Health System reported **financial results for the second quarter** ending June 30, 2012. Total revenue advanced 62.5% over the comparable quarter last year to $29.1 million, primarily due to the 12% increase in the average daily inpatient census at University General Hospital, which was significantly driven by the increase in the number of patients from the acquisitions now classified as HOPDs, namely Baytown Endoscopy Center, UGH Diagnostic Imaging and UGH Physical Therapy. Revenue from the Trinity Senior Living was $1.91 million, while Support Services contributed another $395 thousand of revenue. Net patient revenue at University General Hospital increased 48.3% from $17.9 million to $26.5 million despite a significant increase in the provision for bad debt, which rose to 10.5% of total net patient revenue in the second quarter of 2012 compared to 1.9% in the prior year's second quarter. The increase in net patient revenue was driven by higher facility utilization in terms of average daily census, which increased 12% from 33 to 37 year-over-year. Management attributes the robust revenue growth and to the successful execution of the company's physician-centric, integrated health delivery strategy.

Total operating expenses increased 13.2% to $19.2 million from $17.0 million in the comparable year-ago quarter. As a result, the operating margin increased 2,885 basis points to 33.9%. Operating income increased 996% to $9.85 million compared to 899 thousand in the second quarter of 2011. Consolidated EBITDA was $11.6 million versus $2.66 million in the second quarter of 2011. The EBITDA margin increased 2,511 basis points to 40.0%. Net income attributable to common shareholders was $5.08 million or $0.02 per share compared with a net loss of $227,736 or a loss of $0.00 per share.

Acquisitions

On August 27, 2012, University General announced the acquisition of the Robert Horry Center for Sports and Physical Rehabilitation Center for an undisclosed amount of cash. Located in southwest Houston, the physical therapy clinic expands the number of HOPDs owned and operated by University General Hospital to three. The President and Founder of the Robert Horry Center for Sports and Physical Rehabilitation is Robert Horry, who over 16 years played for the Houston Rockets, Los Angeles Lakers, Phoenix Suns and San Antonio Spurs, winning NBA championships with three different teams. Operating as a HOPD, management expects that the center will generate at least $1.0 million in annual net patient revenues.

On August 1, 2012, University General announced the acquisition of three clinics operating in Kingwood Diagnostic and Rehabilitation Center, which is a medical office building located in Kingwood, a northern suburb of Houston. The diagnostic imaging, physical therapy and sleep clinics were acquired from Management Affiliates of Northeast Houston, LLC for an undisclosed combination of stock, cash and assumed debt. Under the company's branding strategy, the clinics have been renamed the UGH Kingwood Diagnostic and Rehabilitation Center and will operate as hospital outpatient departments (HOPDs) of University General Hospital. Management expects that the three clinics will generate at least $6.5 million in annual net patient revenues and produce annual EBITDA of $2.6 million in the first year under University General Health System.

On June 1, 2012, University General Health System completed the acquisition of 1960 Digital Imaging, a diagnostic imaging and physical therapy center located in northern Houston. Rebranded as UGH Diagnostic Imaging and UGH Physical Therapy, these two free-standing facilities will operate as HOPDs of University General Hospital.

On April 13, 2012, University General completed the acquisition of Baytown Endoscopy Center, a 3-bed ambulatory surgery center. Now operating as a Hospital Outpatient Department (HOPD) and known as the University General Hospital-Baytown Endoscopy Center, the Baytown Center is expected to perform

over 3,100 procedures during its first year of operations under University General Health System adding approximately $12 million in net patient revenue and $5 million of EBITDA. The Baytown Endoscopy Center was acquired for $161,915, which was primarily financed with a one-year promissory note.

Private Placements completed

On April 30, 2012, University General completed a private placement of 35 million shares, raising net proceeds of roughly $5.0 million. The funds were used for tax payments and to extinguish certain outstanding loans.

On May 2, 2012, the company also completed a private placement of 3,808 shares of Series C preferred stock with certain institutional investors, including Hillair Capital Investment LP, and warrants to purchase up to 17.3 million common shares. The preferred shares are convertible into roughly 4,545 common shares. The company raised net proceeds of $3.1 million from the preferred shares and warrants and used the funds to pay taxes and extinguish loan balances. The warrants have an exercise price of $0.26 per share and are exercisable for five years from the date of issuance.

Agreement Signed

On March 12, 2012, University General Hospital signed a three-year deal with Vital Weight Control, Inc., which does business as NeWeigh. Formed in 1991, NeWeigh is a patient advocacy group that provides across the board services to help people obtain and manage treatment for morbid obesity. NeWeigh's services include motivational support and access to several types of bariatric counseling.[9] These services complement the services that University General Hospital offers or recommends to its bariatric patients.[10] NeWeigh can also help people obtain approval from their insurance carriers for such treatment. In conjunction with this agreement, University General Hospital will add four new physicians: Dr. Thirumalariaj Jayakumar, Dr. Said Bina, Dr. Jorge Leiva and Dr. Thomas Taylor. These physicians will join the University General Hospital staff in the bariatric department. The department has grown from four surgeons in 2007 to ten currently and will expand to 14 with the addition of the above named doctors. The hospital performs about 550 primary bariatric surgeries and 150 related procedures each year. Given the expanded surgical staff, these metrics could grow over time. Management estimates that it will not require additional capital investment in order for the Bariatric department to grow, as it already has the sufficient medical equipment and facilities to support the expansion. Management expects this three-year deal with Vital Weight Control will increase the hospital's revenue from bariatric surgery over time.

Award for Distinction

In March, University General Hospital received the designation of Blue Distinction Center for Bariatric Surgery. The designation was awarded following an evaluation of the hospital by Blue Cross and Blue Shield of Texas on a broad range of quality metrics. The hospital became one of only four hospitals in the Houston market to receive that distinction (the others are Memorial Hermann Memorial City Hospital, Memorial Hermann Hospital and Houston Northwest Medical Center).

VALUATION

Valuation methodologies for large-cap hospital 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. Though the risks associated with newer, smaller companies, such as University General, are greater than that for more established companies with longer track

[9] Bariatric counseling includes psychological counseling, dietary counseling, counseling on treatment options (medical, non-medical and surgical) and counseling about support groups available both prior to and following possible surgery.
[10] According to a Bariatric Times August 2007 article, University General asks patients to attend educational and psychological consultations and evaluations prior to surgery.

records, in our view, so are the growth prospects. Therefore, due to University General's size and potential for significant growth, we believe that the large-cap hospital universe is not an appropriate valuation benchmark. Also, University General Health System has not yet established 5-year historic valuation ranges by which the company's industry position, growth profile and financial stability have been assessed by investors.

The industry of Specialty Providers of Hospital-Related Services, however, does appear to be an appropriate valuation benchmark. The significantly higher multiples relative to larger hospital companies reflect the fundamental trend towards HOPDs and the increased utilization of ASCs. In addition, the higher multiples better reflect the growth potential of these smaller companies.

Industry Comparables	**Pr Chg YTD**	**P/E CFY**	**EPS Gr 5Yr Est**	**Price/ Book**	**Price/ Sales**	**EV/ EBITDA**	**Price/ CF**
UNIVERSITY GENERAL	32.1	14.3	13.5	N/A	1.4	6.4	20.7
S&P 500	11.5	13.8	10.8	3.6	2.4	N/A	12.4
LARGE CAP HOSPITALS							
Industry Mean	3.8	13.8	12.6	1.6	0.7	6.0	8.8
Industry Median	-2.6	11.9	12.4	1.6	0.4	6.1	4.7
COMMUNITY HLTH SYS	49.0	7.1	12.8	0.9	0.2	6.3	2.5
HCA HOLDINGS	27.7	7.5	11.4	N/A	0.4	6.2	4.3
HEALTH MGT ASSC	-4.5	8.3	12.0	2.0	0.3	6.0	3.5
LIFEPOINT HOSPITALS	8.3	11.9	10.0	0.9	0.5	6.1	5.1
TENET HEALTH	-1.4	8.6	10.2	1.8	0.2	6.2	3.0
UNIVL HEALTH SVCS	2.5	9.3	12.0	1.5	0.5	6.1	5.6
VANGUARD HEALTH	-3.8	12.1	15.0	2.1	0.1	5.2	2.2
SPECIALTY PROVIDERS							
Industry Mean	102.9	14.6	13.9	2.4	3.4	8.6	10.3
Industry Median	26.9	14.0	12.9	1.8	1.0	8.2	11.0
AMSURG CORP	13.5	14.7	11.7	1.2	1.1	4.4	11.7
ACADIA HEALTHCARE	89.3	31.5	16.2	3.2	2.4	N/M	36.6
CHINA CORD BLD	1.5	16.8	N/A	1.0	3.1	N/M	7.7
LCA-VISION INC	27.6	N/M	N/A	2.5	0.7	N/M	N/M
MEDNAX INC	-4.9	14.3	13.3	1.8	2.0	8.5	13.8
PSYCHEMEDICS CORP	28.0	16.6	11.4	5.4	2.5	9.3	15.8
VCA ANTECH INC	-5.2	13.8	13.0	1.4	1.0	8.0	8.2

The appropriate valuation methodologies for University General 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 hospital network is better utilized and through the execution of management's aggressive acquisition strategy. The growing revenue stream has already manifested itself into positive earnings in the second quarter of 2012. Based on historical norms for similar specialty providers of hospital-related services companies, we expect UGHS to trade in an EV/EBITDA valuation range between 9.3 and 6.0, and specifically, our target is based on UGHS attaining the first quartile valuation benchmark of an 8.5 EV-to-EBITDA ratio due to the positive news flow of the successful implementation of management's growth strategies. Our share price target is $0.58, in which we utilize annualized EBITDA from operations derived from the most recent quarter's results due to the company's rapid EBITDA growth rate. Interestingly, the large-cap hospital universe is currently trading very tightly around its valuation mean and median (approximately 6.0 EV/EBITDA), which should provide a floor valuation for smaller growth companies related to the large-cap hospital facilities industry.

Also, valuation based on the price-to-sales metric confirms and reinforces the $0.58 price target. We expect UGHS to trade in a P/S valuation range between 2.0 and 1.0, which is also based on historical valuations of similar companies. The first quartile valuation benchmark is 1.8 price-to-sales or $0.58 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 and gain market share. Given management's stated business plan of becoming a creator, owner and operator of regional health care networks in multiple metropolitan areas, University General is expected to expand its revenue base significantly.

RISKS

- Operating in a state with one of the nation's higher levels of uninsured inhabitants (an estimated 27.6% of the population), Texas could impact the company's uncompensated costs over time. However, this risk is partially mitigated by University General's focus on providing concierge medical services in an upscale setting, along with its lower than industry average exposure to Medicare and Medicaid reimbursements.
- CEO Dr. Hassan Chahadeh holds super-voting power through his ownership of 3,000 shares of super-voting Series B preferred stock. Though the preferred stock has no economic value, the voting power is equal to the number of votes of all outstanding shares of capital stock plus one additional vote; therefore, Dr. Chahadeh controls a majority of voting rights on all matters that require shareholder approval. Dr. Chahadeh is a practicing physician himself. Having received a degree in medicine from Damascus University in Syria, Dr. Chahadeh also studied general surgery and anesthesiology at Baylor College of Medicine in Houston. He has been involved with University General Hospital since it's inception as a founder and managing general partner.
- University General faces litigation risk. The company has been or is involved in a number of legal disputes, four of which merit disclosure.
  - A judgment against UGHS awarded $2.9 million to Prexus Health Consultants. Management expects that on appeal the amount will be reduced to $861,000, for which UGHS already has accrued $1.0 million.
  - In September 2011, the company and Siemens settled pending litigation related to lease and technology agreements. Management agreed to pay Siemens $4,850,000 over 20 months beginning in October 2011. However, University General alleges that Siemens has breached the settlement agreement and filed an appeal. Payments under the agreement have been suspended.
  - On July 13, 2012, the company entered into a settlement with Regions Bank related to loans in 2006 agreeing to pay Regions $2.75 million on June 29, 2012, $2.215 million on or before September 28, 2012 and $2.125 million on or before December 31, 2012. Management expects to record a one-time gain of approximately $2.6 million as a result of the settlement with Regions Bank.
  - In mid-2012 University General Hospital filed a declaratory judgment against Palicio Gate LP (Alvin minority land owner), and in turn, ACHDC LLC and Palicio Gate LP filed suit against University General Hospital in June 2012., claiming that in 2011, University General entered into negotiations to build a different hospital in Alvin and unilaterally terminated the original agreement in May 2012. In August, ACHDC LLC withdrew its suit, and the attorneys representing both Palicio Gate and ACHDC withdrew as attorneys of record. The court has upheld University General's declaratory judgment, and UGH is currently asking the court to hold that the non-binding letter of intent was non-binding. Management expects the matter is to be resolved quickly and foresees no liability.
- The disparity of reimbursement levels between different classes of surgical health care facilities (hospitals/HOPDs and ASCs) has sparked proposals to revise the Medicare hospital outpatient prospective payment system (OPPS) and the Medicare ambulatory surgical center (ASC) payment system. On average, Medicare pays 56% of the amount to ASCs that is paid to HOPDs for the same medical services. The discrepancy is a major driving force in the conversion of ASCs to HOPDs.

While University General's ASCs likely enjoy similar reimbursement rates to its HOPDs, the level of the company's ASC reimbursements could be at risk if CMS decides to disallow conversions for reimbursement parity.

- The IRS filed tax liens against University General Hospital to collect past due payroll taxes. In August 2011, the hospital entered into an installment agreement with the IRS, under which payments were made until March 2012. As of June 30, 2012, the outstanding balance related to past due payroll taxes was reflected as a $5,149,799 accrued expense. Management anticipates becoming current through the issuance of a short-term note and cash flow generated by operations. Also, UGHS became profitable in the second quarter of 2012; therefore, in anticipation of the payment of income tax, the company began recording an Income Tax Payable liability on the balance sheet ($3.8 million as of June 30, 2012).
- In the Houston market, University General Hospital competes with the Texas Medical Center, which is comprised of 15 hospitals, four nursing schools and three medical schools making it the largest medical center in the world. Given that this competing facility is continuing to expand, the demand nursing and other support staff could put upward pressure on labor and other costs that could negatively impact University General's profit margins.

INCOME STATEMENT & BALANCE SHEET

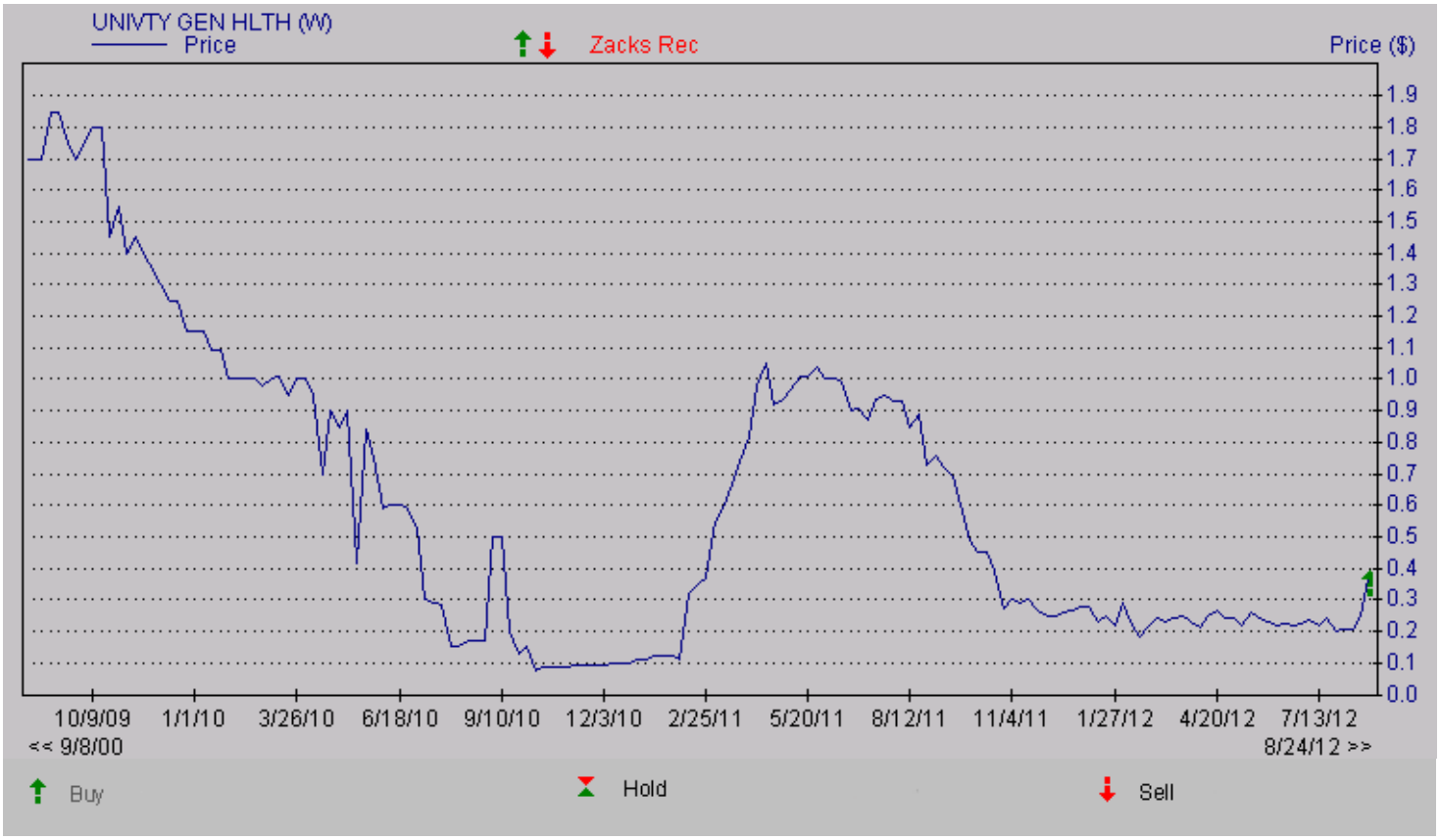
University General Hospital System, Inc.

($US)	2010 (Restated)	2011 1Q	2011 2Q	2011 3Q	2011 4Q	2011 Year	2012 1Q	2012 2Q	2012 3QE	2012 4QE	2012E Year	2012E Year
Revenues												
Hospital (net patient revenues)	**55,929,507**	15,443,233	17,884,070	18,597,110	16,378,206	**68,302,619**	16,617,733	26,518,937	27,712,289	28,959,342	**99,808,301**	**128,815,892**
Senior living	**-**	-	-	1,723,571	1,840,943	**3,564,514**	1,868,433	1,908,425	1,946,594	1,985,525	**7,708,977**	**7,863,156**
Support services	**-**	-	-	168,279	297,360	**465,639**	483,700	395,364	403,271	411,337	**1,693,672**	**1,727,545**
Other	**205,042**	5,982	2,971	161,996	3,262	**174,211**	117,189	250,351	255,358	260,465	**883,363**	**918,698**
Total Revenues	**56,134,549**	**15,449,215**	**17,887,041**	**20,650,956**	**18,519,771**	72,506,983	**19,087,055**	**29,073,077**	**30,317,512**	**31,616,669**	110,094,313	139,325,292
Operating expenses												
Salaries, wages and benefits	**19,902,304**	6,134,717	6,812,693	8,263,837	7,945,765	**29,157,012**	8,281,991	8,735,661	11,132,268	10,554,623	**38,704,542**	**47,746,010**
Medical supplies	**11,314,219**	3,160,635	3,103,206	3,399,612	3,539,376	**13,202,829**	2,932,125	3,859,736	4,341,139	4,362,294	**15,495,294**	**18,185,809**
Management fees	**2,597,546**	1,389,655	1,303,727	1,412,385	1,240,689	**5,346,456**	0	0	0	0	**0**	**0**
General and administrative expenses	**11,347,868**	3,484,039	4,172,194	4,886,019	5,536,655	**18,078,907**	4,227,502	7,667,311	7,355,192	8,004,248	**27,254,252**	**34,881,418**
Provision for doubtful accounts	**3,439,321**					**1,332,434**						**0**
Gain on extinguishment of liabilities	**(2,781,917)**	(1,303,366)	(160,979)	(1,947,134)	(1,029,970)	**(4,441,449)**	(96,739)	(2,806,787)	0	0	**(2,903,526)**	**0**
Depreciation and amortization	**6,952,007**	1,762,607	1,757,509	2,104,016	1,712,578	**7,336,710**	1,725,173	1,769,920	1,787,619	1,805,495	**7,088,208**	**6,848,122**
Total operating expenses	**52,771,348**	**14,628,287**	**16,988,350**	**18,118,735**	**18,945,093**	70,012,899	**17,070,052**	**19,225,841**	**24,616,217**	**24,726,659**	85,638,770	107,661,359
Operating income	**3,363,201**	820,928	898,691	2,532,221	(425,322)	**2,494,084**	2,017,003	9,847,236	5,701,295	6,890,010	**24,455,544**	**31,663,932**
EBITDA	**10,315,208**	**2,583,535**	**2,656,200**	**4,636,237**	**1,287,256**	9,830,794	**3,742,176**	**11,617,156**	**7,488,914**	**8,695,506**	31,543,751	38,512,055
Interest income (expense) net	**(4,782,168)**	(1,179,696)	(1,045,427)	(1,349,023)	(1,364,457)	**(4,938,603)**	(1,437,965)	(1,385,335)	(1,439,265)	(1,439,265)	**(5,701,829)**	**(6,583,007)**
Other income	**0**	0	0	0	0	**500,000**	11,583	0	0	0	**11,583**	**11,583**
Gain (loss) before income tax	**(1,418,967)**	(358,768)	(146,736)	1,183,198	(1,789,779)	**(1,944,519)**	590,621	8,461,901	4,262,030	5,450,746	**18,765,298**	**25,092,509**
Income tax expense	**300,000**	81,000	81,000	99,000	182,862	**443,862**	99,000	3,407,131	1,662,192	2,125,791	**7,294,113**	**9,786,078**
Gain (loss) before noncontrolling interest	**(1,718,967)**	(439,768)	(227,736)	1,084,198	(1,972,641)	**(2,388,381)**	491,621	5,054,770	2,599,838	3,324,955	**11,471,184**	**15,306,430**
Net income attributable to noncontrolling int.	**0**	0	0	(38,748)	(144,066)	**(182,814)**	(2,183)	30,018	(12,999)	(16,625)	**(1,789)**	**(2,387)**
Net gain (loss) attributable to Company	**(1,718,967)**	(439,768)	(227,736)	1,045,450	(2,116,707)	**(2,571,195)**	489,438	5,084,788	2,586,839	3,308,330	**11,469,395**	**15,304,043**
Basic and diluted income (loss) per share	**($0.01)**	**($0.00)**	**($0.00)**	**$0.00**	**($0.01)**	**($0.01)**	**$0.00**	**$0.02**	**$0.01**	**$0.01**	**$0.03**	**$0.04**
Basic & diluted wgtd. avg. shares out.	123,583,509	174,728,566	253,000,000	276,379,591	279,909,909	254,401,405	283,440,226	326,817,830	376,817,830	378,817,830	341,473,429	375,000,000

University General Hospital System, Inc.

($US)	2010 Year	2011 1Q	2011 2Q	2011 3Q	2011 Year	2012 1Q	2012 2Q
ASSETS							
Cash and cash equivalents	2,246,774	86,645	200,003	622,959	538,018	423,894	475,885
Accounts receivable (less all. for doubtful accts)	10,718,443	11,300,768	15,260,711	16,373,762	10,913,361	11,480,073	17,175,814
Inventories	1,708,974	1,857,421	1,994,793	2,070,087	1,908,177	1,897,444	1,878,266
Receivables from related parties	-	-	621,860	476,379	658,764	584,021	1,084,021
Prepaid expenses and other assets	52,790	139,857	457,875	592,103	1,275,104	960,576	1,315,319
Total current assets	**14,726,981**	**13,384,691**	**18,535,242**	**20,135,290**	**15,293,424**	**15,346,008**	**21,929,305**
Investments in unconsolidated affiliates			115,000	115,000	687,323	687,323	767,323
Property, equip. & leasehold imp. (net)	53,296,070	51,712,566	63,861,625	78,294,372	66,437,316	76,241,012	66,841,636
Intangible asset	-	-	-	1,200,000	7,649,000	1,110,000	7,198,000
Goodwill	-	-	33,365,278	16,457,447	22,199,874	18,299,310	28,900,818
Other non-current assets, net	1,788,397	1,812,772	908,275	1,933,385	2,234,985	1,964,611	1,883,224
Total assets	**69,811,448**	**66,910,029**	**116,785,420**	**118,135,494**	**114,501,922**	**113,648,264**	**127,520,306**
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)							
Accounts payable	13,972,196	12,336,334	15,177,608	12,735,052	11,874,720	10,680,342	10,535,040
Payables to related parties	3,226,630	549,929	2,023,807	2,237,165	2,493,088	2,507,940	2,089,287
Accrued expenses	14,385,115	11,440,205	8,385,719	7,774,265	7,516,940	8,841,149	5,339,916
Accrued acquisition cost	-	-	1,407,546	1,407,546	1,007,380	1,007,380	521,401
Taxes payable	-	-	3,329,091	4,361,799	4,171,826	4,943,678	5,149,799
Income tax payable	-	-	-	-	-	-	3,840,809
Deferred revenue	-	-	24,375	401,515	314,876	349,322	248,954
Lines of credit	8,450,000	8,450,000	8,450,000	8,451,025	8,451,025	8,451,025	8,451,025
Notes payable, current portion	17,276,041	16,016,165	18,870,115	18,314,509	28,982,331	27,298,071	25,528,386
Notes payable to related parties			2,780,683	3,461,831	2,798,783	2,754,455	2,164,527
Capital lease obligations	11,204,153	7,580,441	7,849,141	8,340,357	5,943,685	5,976,202	4,633,186
Capital lease obligations to related party			218,067	235,443	239,409	249,154	253,397
Total current liabilities	**68,514,135**	**56,373,074**	**68,516,152**	**67,720,507**	**73,794,063**	**73,058,718**	**68,755,727**
Notes payable, less current portion	2,412,366	749,791	14,136,174	12,968,377	8,459,474	7,840,348	13,707,523
Notes payable to related parties (less current)	-	-	2,144,062	2,029,297	1,983,514	1,910,040	0
Capital lease obligations (less current)	31,279,277	31,112,801	439,840	50,815	34,893	215,259	331,153
Capital lease obligations - related party (less current)		-	30,925,148	30,867,634	30,803,450	30,732,509	30,671,750
Total liabilities	**102,205,778**	**88,235,666**	**116,161,376**	**113,636,630**	**115,075,394**	**113,756,874**	**113,466,153**
Commitments and contingencies							
Preferred stock Series B	3	3	3	3	3	3	3
Convertible preferred stock Series C	-	-	-	-	-	-	4
Common stock	120,340	253,000	274,896	276,396	283,440	283,440	324,326
Additional paid-in-capital	13,150,907	26,718,247	46,177,453	47,600,953	49,078,223	48,905,461	58,900,069
Shareholders' receivables	-	(2,130,000)	(2,130,000)	(2,130,000)	(2,219,068)	(2,239,068)	(2,409,069)
Accumulated deficit	(45,665,580)	(46,166,887)	(47,479,336)	(46,433,886)	(53,049,030)	(52,393,589)	(47,883,491)
Total shareholders' equity (deficit)	(32,394,330)	(21,325,637)	(3,156,984)	(686,534)	(5,906,432)	(5,443,753)	8,931,842
Noncontrolling interest			3,781,028	5,185,398	5,332,960	5,335,143	5,122,311
Total equity (deficit)	(32,394,330)	(21,325,637)	624,044	4,498,864	(573,472)	(108,610)	14,054,153
Total liabilities and shareholders' equity	**69,811,448**	**66,910,029**	**116,785,420**	**118,135,494**	**114,501,922**	**113,648,264**	**127,520,306**
Shares outstanding	152,501,259	253,000,000	283,440,226	276,395,895	283,440,226	283,440,226	324,326,655

HISTORICAL ZACKS RECOMMENDATIONS



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