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HEALTH FACILITIES &
SERVICES REVIEW BOARD

Ms. Courtney Avery
Administrator
Illinois Health Facilities and Services Review Board
525 W. Jefferson St., Second Floor
Springfield, IL 62761

Dear Ms. Avery:

Ziegler Capital Markets writes in support of the Certificate of Need Application filed on December 29, 2010 by Mercy Alliance, Inc. ("Mercy") for the construction of a new hospital facility and multi-specialty physician clinic to be located in Crystal Lake (Project No. 10-089) (the "Project"). We have reviewed the proposed Project as described in the CON application and amendments and assessed potential implications of the Project to Mercy's financial position and service area.

We support Mercy's CON primarily due to: strong historical financial operations which mitigate the risks inherent with the construction of a new hospital and increasing competition in the market which will positively affect healthcare consumers in the form of lower healthcare costs.

Mercy Alliance, Inc.

Mercy is an integrated healthcare delivery system which provides a comprehensive range of services to residents in southern Wisconsin, McHenry County, Illinois and communities in northern Illinois. Mercy operates three hospitals, including Mercy Harvard, a 25 bed critical access provider, located in Harvard, Illinois. In addition, Mercy operates a 45-bed skilled nursing facility and a specialty clinic at the Mercy Harvard campus. Mercy has invested over $20 million recently in Mercy Harvard for the renovation and remodeling of the facility including larger, state of the art surgical suites, expanded laboratory, restructuring the emergency department, an enlarged conference and community center, additional parking areas and working capital.

Mercy also utilizes extensive clinic operations to serve the needs of residents in each of its service areas. Currently, Mercy operates 38 community-based clinics ranging from single-physician practices to large, multi-specialty centers with outpatient surgery, urgent care services and diagnostics. Mercy currently operates 18 community-based clinics in northern Illinois.

A key factor that differentiates Mercy from other health systems is its physician partnership model. This model involves forming virtual partnerships with employed physicians. These partnerships allow Mercy to achieve full system integration, a key strategy linked to the mission, vision, values and Mercy's culture of excellence. Mercy employs approximately 320 physicians located in community-based clinic practices and in hospital-based practices. Of those physicians, approximately 230 physicians are located in community-based clinics.

Mercy has been a leading provider of healthcare services in its market and has been recognized nationally for its achievements in quality patient care and workplace environment. In 2007 Mercy received the Malcolm Baldrige National Quality Award from President George W. Bush, the nation's highest Presidential honor for quality and organizational excellence. In 2009 Mercy was ranked number 20 in the top 100 Integrated Healthcare Network by SDI and Modern Healthcare. From 2006-2009, Mercy was named to Working Mother magazine's 100 Best Companies for working mothers.

Financial Operations

Over the last five years Mercy has generated strong operating performance. Net patient revenues have grown 10.3% over the past five years, primarily due to new programs, increased utilization from existing services and clinical sites, good patient satisfaction scores and strong quality measures. In FY08 Mercy's operating profitability softened to $14 million or a 2.84% operating margin which is still consistent with Moody's 'A' category medians. In response, Mercy's management team implemented several performance improvement initiatives including aggressive expense management, elimination of underperforming programs and alignment of FTE's to operations. In FY09 and FY10, operating performance strengthened despite continued economic weakness and Mercy's operating income grew to $17 million or 3.59% and $15 million or 3.16%, respectively. Operating cash flow has also been significant and consistent as the organization has produced operating cash flow aggregating to approximately $119 million since FY08. Mercy's metrics compare favorably to rating agency medians for "A" rated hospital credits as depicted in the chart below. Ziegler strongly believes that the ability to produce strong and consistent operating performance, as Mercy has clearly done over the last four fiscal years, is the single most important factor in determining if a large capital project such as a new hospital is affordable to an organization.

Mercy Alliance, Inc.

Key Financial Ratio Comparison vs S&P Medians

	Mercy Alliance, Inc.				Moody's Hospital Medians			
	2007	2008	2009	2010	A2	A3	Baa1	Baa2
Net Patient Revenue	$453,113	$488,712	$526,353	$465,689	$440,454	$354,489	$355,504	$255,208
Operating Margin	3.54%	2.84%	3.28%	3.16%	3.10%	2.60%	1.60%	1.50%
Excess Margin	6.77%	3.97%	0.70%	4.40%	5.10%	4.60%	3.80%	3.00%
Operating Cash Flow Margin	8.62%	7.65%	8.01%	8.54%	9.70%	9.90%	8.10%	8.40%

Mercy has a modest but improving balance sheet. Unrestricted cash has increased to $158.5 million at FYE 10 from $135.5 million at FYE 08. This resulted in increasing days cash on hand by nearly 26 days to 133.7 days in FY10. Mercy's current total debt is approximately $181 million. Debt to capitalization is moderate at 44.6% while debt to cash flow is manageable at 4.33 times. Capital spending has been significant reflecting continued expansion of the organization's outpatient service platform and enhancements to inpatient facilities. Mercy has invested $139 million over the last five years in its physical plants. This substantial capital investment was funded from operating cash flow along with prudent use of leverage. This investment has achieved its intended effect: increased utilization of services offered by Mercy in addition to providing healthcare access to patients through its comprehensive physician partnership model.

New hospital projects carry substantial short-term and long-term risks which can materially affect the outcome of a project and are more appropriate for providers with stronger profitability and liquidity. These risks include: managing construction costs and timetable, meeting revenue and expense assumptions, efficiently transitioning patients to the new facility, and operating a new facility under an entirely different cost structure. On a historical pro forma basis, the inclusion of additional interest and depreciation expense would still result in Mercy being able to achieve better than breakeven operating performance. Pro forma operating income would be $1.3 million generating an operating margin of 0.27%, while EBIDA would be attractive at 9.71%. While we recognize that the increase in indebtedness will put near term rating pressure on Mercy due primarily to weakened balance sheet metrics, the strength of operations will afford Mercy the ability to present a cohesive credit story to the capital markets without a first step of improving its operations, which the organization has clearly demonstrated an ability to do after FY 2008. Further, as investors and agencies put more weighting on revenue diversity, risk dispersion, and scale, the Project creates the opportunity to achieve a higher rating longer term.

Service Area Impact

Healthcare service in McHenry County, Illinois is dominated by one provider, Centegra Health System ("Centegra"). Centegra currently operates two facilities in the County which serves the vast majority of the County and surrounding communities in adjacent counties. Centegra has a dominant market position with nearly 50% market share in its primary service area. While higher acuity patients matriculate to other providers near the Chicago metro market, there is limited competition to Centegra for the services that the organization provides. Centegra has also submitted a Certificate of Need application, Project No. 10-090, for the construction of a third hospital in McHenry County, which will be located in Huntley. Their planned $233 million project, if approved, will further expand their market dominance and grant their organization significantly more leverage with commercial and managed care payers active in the market. Ziegler believes that Centegra, which would have a pro forma balance sheet more consistent with a non-investment grade provider, would need to significantly improve their much more modest operating performance (compared to Mercy) in order to offset the increased depreciation and interest expense and access the capital markets to fund the majority of the project as planned. This is problematic as Centegra's operating income has been declining since 2007. In their most recent fiscal year, Centegra produced operating income of $3.2 million or a margin of less than 1.0%. With the addition of the incremental interest and depreciation expense associated with a new hospital, Centegra's operating income on a pro forma basis would turn significantly negative and well below rating agency investment grade medians. In preparation to access the capital markets at a reasonable cost, Centegra will be pressured to leverage its dominant market position to significantly increase insured reimbursement rates, pushing consumer healthcare costs to McHenry county residents materially higher in order to increase its income from operations to an acceptable level.

Competition typically benefits the consumer and increases the economic benefit to the service area. Health care is no different. The greater choice consumers have of physicians and services will lead to higher quality and lower costs as providers actively compete for patients. McHenry County is currently underserved in physicians and number of hospital beds. Allowing for the leading provider of healthcare services to gain even greater market share will not lead to increased quality at lower prices. Consumers of healthcare will not benefit if Centegra becomes larger. Mercy is a recognized leader in quality and is a proven financial operator in a very difficult environment characterized by continuing reimbursement challenges. Ziegler strongly believes the Project is affordable, consistent with Mercy's mission, vision, and values, and serves the best interests of the community.

Respectfully,

Ziegler Investment Banking
Healthcare Finance