

**Banner Health**  
**Management's Discussion and Analysis of Results of Operations and Financial Position**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make assumptions and estimates that affect the amounts reported in the financial statements, including the notes thereto, and related disclosures of commitments and contingencies, if any. Management relies on historical experience and other assumptions believed to be reasonable under the circumstances in making its judgments and estimates. Actual results could differ materially from those estimates.

We recommend that you read this discussion together with our audited consolidated financial statements and related notes of Banner Health ("Banner") for the year ended December 31, 2015 and our unaudited quarterly report as of March 31, 2016. The audited consolidated financial statements and the unaudited quarterly report are available from the Municipal Securities Rulemaking Board (the "MSRB") on its Electronic Municipal Market Access ("EMMA") system, found at <http://emma.msrb.org>.

# **Banner Health**

## **Management's Discussion and Analysis**

### **For The Three Months Ended March 31, 2016**

#### **Overview**

Banner is one of the nation's largest secular nonprofit healthcare systems. Its stated mission is to "make a difference in people's lives through excellent patient care" and it seeks to achieve that mission through continuous improvement in clinical and service performance for the patients and members it serves. Headquartered in Phoenix, Arizona, Banner provides a broad range of healthcare and related services concentrated in three regions—the Greater Phoenix metropolitan area, the Greater Tucson metropolitan area, and in northern and northeastern Colorado, with the remaining facilities located in small or rural communities in Wyoming, Nebraska, Arizona, Nevada, California and Alaska. Centralized corporate and other support services for these operations are provided from Banner's corporate offices in Phoenix and Mesa, Arizona.

#### **Financial Performance**

Banner Health generated operating income of \$106.5 million and a net loss of \$15.3 million on revenue of \$1.931 billion for the quarter ended March 31, 2016. Compared to the same quarter in 2015, this represents a 21.9% increase in revenue, a 24.2% increase in operating income, and a decline of 114.2% in net income. The decline in net income is due to the combined impact of unrealized losses on investments and mark-to-market losses on fixed interest rate swaps, both of which reflected the general performance of investment markets and interest rate instruments. This performance equates to operating and total margins of 5.5% and (0.8)%, respectively, compared to 5.4% and 6.7% reported for the same period a year earlier. The quarter's results were impacted by three elements, all of which are continuations of conditions noted in Banner Health's 2015 performance results:

- Strong "same store" delivery system performance which yielded \$127.6 million in operating income, the equivalent of an 8.3% margin, compared with \$90.9 million and a 6.4% margin in the first quarter of 2015. Part of the increased profitability in 2016 is due to an increase in hospital payments from Banner's Accountable Care Organization in the Phoenix market, Banner Health Network, on certain contracts. Without this change, 2016 first quarter operating margin would have been 7.9%.
- Operating losses from "new store" delivery operations acquired or opened in 2015. These include Banner Fort Collins Medical Center in Colorado, which opened in April, 2015, Banner University—Medical Center Tucson, Banner—University Medical Center South, and Banner—University Medical Group, acquired in February, 2015 as part of the University of Arizona Health Network (UAHN) transaction, and Banner Payson Medical Center, acquired in August, 2015. The "new store" delivery operations generated operating losses of \$32.5 million in the quarter compared with a loss of \$5.5 million in the same quarter of 2015 (which included only one month of UAHN operations).
- An operating loss of \$14.4 million for the Banner Health Network. This represents a significant performance decline from a \$2.5 million operating loss in the same 2015 quarter however, the comparison is impacted by the 2015 lag in claims information which delayed the recognition of early year losses to later quarters. The majority of the performance decline was caused: a) by the performance of the Blue Advantage Medicare Advantage plan which is owned jointly with Blue Cross

Blue Shield of Arizona and for which Banner Health Network assumes considerable risk through a percent-of-premium provider network contract and b) the accrual of an estimated 2016 underwriting loss on the Blue Alliance product, a commercial health insurance product for which Banner Health Network shares 50% of the financial risk.

## Revenue and Volume

### Operating Performance By Segment

#### First Quarter 2016 Performance Compared to Prior Year

(\$ in thousands)	Same Store Delivery	New Store Delivery	Health Plans	Elims/Other	Consolidated
Operating Revenue	\$ 1,529,993	\$ 280,036	\$ 270,100	\$ (148,870)	\$ 1,931,259
Operating Expense	1,402,428	312,529	281,718	(171,963)	1,824,712
Operating Income	\$ 127,565	\$ (32,493)	\$ (11,618)	\$ 23,093	\$ 106,547

Operating Income PY	\$ 90,855	\$ (5,499)	\$ (1,244)	\$ 1,700	\$ 85,812
Op Income Change (\$)	\$ 36,710	\$ (26,994)	\$ (10,374)	\$ 21,393	\$ 20,735
Op Income Change (%)	40.4%	-490.9%	--833.9%	1258.4%	24.2%




Banner's 21.9% revenue growth in the quarter was primarily the result of acquired and start-up operations with "same store" revenue growing at 4.6%. Insurance premium revenue grew faster than other components of Banner's revenue stream, increasing to 13.4% of revenue in the current quarter from 11.6% in the same quarter a year ago. This growth in premium revenue is largely due to the acquisition of University Family Care (UFC) as part of the 2015 UAHN transaction.

Volumes were also impacted by acquisitions and start-up operations but on a same store basis, inpatient admissions declined 3.6% to 56,554 in the first quarter of 2016. Again on a same store basis, emergency room visits totaled 250,099, an increase of 4.3% from the first three months of 2015, and accounting for 59.5% of Banner's inpatient admissions in the first three months of 2016, down just slightly from 59.7% in the first three months of 2015. Surgical volumes were up 2.7% and totaled 36,110 on a same store basis however the outpatient mix of these cases grew markedly from 62.7% to 65.0% of total cases, negatively impacting revenue yield. Non-hospital volume growth was strong as a result of continued additions to medical group capacity as clinic encounters grew 12.5% on a same store basis and 21.0% on a consolidated basis.

### Operating Expense and Performance

Delivery system (both new and same store) operations produced operating income of \$95.1 million on revenue of \$1.8 billion, a 5.3% operating margin, compared to a 5.7% margin in 2015. Many factors impacted delivery system performance including the turnaround challenge of the previously mentioned new operations. Labor costs decreased slightly to 58.0% of patient revenue from 58.3% in the prior year. Supply expenses increased from 19.0% to 19.6% of patient revenue due to continued growth of Banner MD Anderson Cancer Center, the clinical intensity of a growing academic medical center footprint, and general increases in pharmaceutical prices. A summary of selected key performance indicators for the three months ended March 31, 2016 and 2015 are shown in the following table.

Consolidated	Metric	YTD 2016	YTD 2015	PY Var
Volume	Adj Admits	130,216	120,898	7.7%
Bad Debt & Charity	BD&C% of Pt Rev	9.0%	10.9%	17.6%
Labor Cost	SWB% of Pt Rev	58.0%	58.3%	0.5%
Supplies as % of Rev	SE% of Pt Rev	19.6%	19.0%	-3.2%
Labor Productivity	FTE / AOB	6.00	5.92	-1.4%
Premium Revenue as % of Rev	Prem Rev% of Op Rev	13.4%	11.6%	15.8%
Full Risk Members	Avg. Members	211,041	175,285	20.4%
Shared Risk Members	Avg. Members	211,223	177,865	18.8%

 Positive Trend
  Neutral
  Negative Trend

## Non-operating Performance

As noted above, non-operating performance more than offset a strong operating performance as both investment returns and interest rate swap movements were adverse to our positions. Banner's \$4.0 billion consolidated investment portfolio generated a loss of \$43.8 million in the quarter as a result of market conditions compared to a gain of \$69.8 million in the year ago quarter. Fixed interest rate swaps generated a mark-to-market loss of \$68.9 million for the quarter, compared to a loss of \$41.1 million a year ago.

## Capital Structure & Balance Sheet

As a result of investment and operating performance during the quarter, Banner's financial position was modestly impacted as shown in the table below:

### Selected Balance Sheet Ratios

	Quarter Ended March 31, 2016	Quarter Ended March 31, 2015	Year Ended December 31, 2015	Year Ended December 31, 2014
LT Debt to Capital	37.6%	34.4%	38.1%	35.5%
Days Cash on Hand	213	270	239	301
Cash to LT Debt	146%	174%	151%	161%
MADS Coverage	4.9	6.1	4.5	4.7

**Banner Health and Subsidiaries**

**Unaudited Financial Statements**

**As of March 31, 2016**

**Contents**

Unaudited Consolidated Balance Sheets	2
Unaudited Consolidated Income Statements	4
Unaudited Consolidated Statements of Changes in Net Assets	5
Unaudited Consolidated Statements of Cash Flows	6
Notes to Consolidated Unaudited Financial Statements	7

Banner Health and Subsidiaries

Consolidated Balance Sheets

As of March 31

Unaudited

(\$ in thousands)

	Banner Health Consolidated		Non-Obligated Group		Obligated Group	
	3/31/2016	3/31/2015	3/31/2016	3/31/2015	3/31/2016	3/31/2015
<b>Assets</b>						
Current assets:						
Cash and cash equivalents	\$ 81,462	\$ 228,130	\$ 62,746	\$ 39,548	\$ 18,716	\$ 188,582
Short-term investments	241,323	172,111	75,174	266	166,149	171,845
Collateral held under securities lending program and repurchase agreements	318,954	200,900	-	-	318,954	200,900
Assets limited as to use	34,921	51,054	33,675	50,091	1,246	963
Patient receivables, net of allowance for doubtful accounts	856,578	779,291	90,592	81,242	765,986	698,049
Inventories	186,807	184,013	13,457	11,365	173,350	172,648
Other receivables	136,294	173,816	48,190	77,466	88,104	96,350
Other, primarily prepaid expenses	73,417	56,737	4,342	39,409	69,075	17,328
Total current assets	1,929,756	1,846,052	328,176	299,387	1,601,580	1,546,665
Assets limited as to use:						
Funds designated by:						
Board of Directors	1,692,975	1,739,074	-	-	1,692,975	1,739,074
Lease agreements	3,107	4,444	-	544	3,107	3,900
Funds held by trustees under:						
Self-insurance funding arrangements	165,410	187,482	150,525	169,938	14,885	17,544
Indenture agreements	-	13,412	-	-	-	13,412
Other funds	246,658	356,154	885	981	245,773	355,173
Total assets limited as to use, less current portion	2,108,150	2,300,566	151,410	171,463	1,956,740	2,129,103
Assets held for sale	2,140	2,140	-	-	2,140	2,140
Property and equipment, net of depreciation	3,099,931	3,070,935	61,747	72,959	3,038,184	2,997,976
Leased hospital assets	249,282	185,705	-	-	249,282	185,705
Other assets:						
Long-term investments	1,999,878	2,045,670	29,284	32,441	1,970,594	2,013,229
Other	542,091	487,426	149,869	152,400	392,222	335,026
Total other assets	2,541,969	2,533,096	179,153	184,841	2,362,816	2,348,255
	<u>\$ 9,931,228</u>	<u>\$ 9,938,494</u>	<u>\$ 720,486</u>	<u>\$ 728,650</u>	<u>\$ 9,210,742</u>	<u>\$ 9,209,844</u>

Banner Health and Subsidiaries

Consolidated Balance Sheets

As of March 31

Unaudited

(\$ in thousands)

	Banner Health Consolidated		Non-Obligated Group		Obligated Group	
	3/31/2016	3/31/2015	3/31/2016	3/31/2015	3/31/2016	3/31/2015
<b>Liabilities and net assets</b>						
Current liabilities:						
Current portion of long-term debt	\$ 156,080	\$ 762,655	\$ 1,654	\$ 10,666	\$ 154,426	\$ 751,989
Current portion of hospital lease obligations	22,719	23,967	-	-	22,719	23,967
Trade accounts payable	207,454	176,842	20,494	15,037	186,960	161,805
Payable under securities lending program and repurchase agreements	318,954	200,900	-	-	318,954	200,900
Estimated current portion of third-party payor settlements	14,580	10,506	1	-	14,579	10,506
Accrued expenses:						
Salaries and benefits	330,178	380,601	63,583	70,763	266,595	309,838
Claims payable	108,228	120,852	125,188	148,569	(16,960)	(27,717)
Other	202,967	174,586	69,727	54,853	133,240	119,733
Total current liabilities	1,361,160	1,850,909	280,647	299,888	1,080,513	1,551,021
Long-term debt, less current portion	2,745,965	2,401,639	-	1,699	2,745,965	2,399,940
Hospital lease obligation, less current portion	234,754	155,087	-	-	234,754	155,087
Estimated third-party payor settlements, less current portion	12,079	15,873	-	-	12,079	15,873
Estimated self-insurance liabilities, less current portion	176,231	154,148	122,467	130,703	53,764	23,445
Interest rate swaps	429,921	397,662	-	-	429,921	397,662
Other	235,228	200,080	5,483	4,797	229,745	195,283
Total liabilities	5,195,338	5,175,398	408,597	437,087	4,786,741	4,738,311
Net assets:						
Unrestricted	4,559,287	4,587,706	181,045	165,485	4,378,242	4,422,221
Temporarily restricted	143,403	145,484	98,324	96,872	45,079	48,612
Total Banner Health net assets	4,702,690	4,733,190	279,369	262,357	4,423,321	4,470,833
Noncontrolling interests - unrestricted	33,200	29,906	32,520	29,206	680	700
Total net assets	4,735,890	4,763,096	311,889	291,563	4,424,001	4,471,533
	<u>\$ 9,931,228</u>	<u>\$ 9,938,494</u>	<u>\$ 720,486</u>	<u>\$ 728,650</u>	<u>\$ 9,210,742</u>	<u>\$ 9,209,844</u>

Banner Health and Subsidiaries

Consolidated Income Statements

For the Three Months Ending March 31

Unaudited

(\$ in thousands)

	Banner Health Consolidated		Non-Obligated Group		Obligated Group	
	3/31/2016	3/31/2015	3/31/2016	3/31/2015	3/31/2016	3/31/2015
Revenues:						
Net patient service	\$ 1,643,980	\$ 1,409,794	\$ 247,374	\$ 189,821	\$ 1,396,606	\$ 1,219,973
Provision for doubtful accounts	65,081	79,848	8,813	4,376	56,268	75,472
Net patient service revenue, less provision for doubtful accounts	1,578,899	1,329,946	238,561	185,445	1,340,338	1,144,501
Other revenue	352,360	254,908	339,238	249,052	13,122	5,856
Total revenues	1,931,259	1,584,854	577,799	434,497	1,353,460	1,150,357
Expenses:						
Salaries and benefits	916,165	775,196	267,635	190,660	648,530	584,536
Supplies	309,176	253,169	42,327	30,290	266,849	222,879
Physician and professional fees	38,151	35,725	10,883	8,532	27,268	27,193
Depreciation and amortization	99,443	86,248	2,253	2,137	97,190	84,111
Interest	34,849	34,466	1,392	1,103	33,457	33,363
Other	426,928	314,238	308,900	220,765	118,028	93,473
Total expenses	1,824,712	1,499,042	633,390	453,487	1,191,322	1,045,555
Operating income (loss)	106,547	85,812	(55,591)	(18,990)	162,138	104,802
Other income (losses):						
Investment income-realized	3,311	57,007	134	1,065	3,177	55,942
Investment (loss) income - unrealized	(17,876)	1,687	(77)	(84)	(17,799)	1,771
(Loss) income from alternative investments	(29,207)	11,075	(549)	87	(28,658)	10,988
Investment (loss) income	(43,772)	69,769	(492)	1,068	(43,280)	68,701
Unrealized (loss) gain on interest rate swaps	(68,947)	(41,112)	-	31	(68,947)	(41,143)
Other	(1,917)	(1,200)	(163)	(53)	(1,754)	(1,147)
	(114,636)	27,457	(655)	1,046	(113,981)	26,411
(Deficiency) excess of revenues over expenses	(8,089)	113,269	(56,246)	(17,944)	48,157	131,213
Less excess of revenues over expenses attributable to noncontrolling interests	7,174	5,528	7,098	5,410	76	118
(Deficiency) excess of revenues over expenses attributable to Banner Health	(15,263)	107,741	(63,344)	(23,354)	48,081	131,095
Amortization of cumulative loss on interest rate swaps	57	57	-	-	57	57
Equity transfers	-	-	79,075	57,972	(79,075)	(57,972)
Other changes in net assets, primarily distributions of earnings	1,196	3,957	(4,136)	74,201	5,332	(70,244)
(Decrease) increase in unrestricted net assets	\$ (14,010)	\$ 111,755	\$ 11,595	\$ 108,819	\$ (25,605)	\$ 2,936



Banner Health and Subsidiaries

Consolidated Statements of Changes in Net Assets

For the Three Months Ending March 31

Unaudited

(\$ in thousands)

	Banner Health Consolidated		Non-Obligated Group		Obligated Group	
	3/31/2016	3/31/2015	3/31/2016	3/31/2015	3/31/2016	3/31/2015
Unrestricted net assets:						
(Deficiency) excess of revenues over expenses attributable to Banner Health	\$ (15,263)	\$ 107,741	\$ (63,344)	\$ (23,354)	\$ 48,081	\$ 131,095
Amortization of cumulative loss on interest rate swaps	57	57	-	-	57	57
Equity transfers	-	-	79,075	57,972	(79,075)	(57,972)
Other changes in net assets, primarily distributions of earnings	1,196	3,957	(4,136)	74,201	5,332	(70,244)
(Decrease) increase in unrestricted net assets	(14,010)	111,755	11,595	108,819	(25,605)	2,936
Temporarily restricted net assets:						
Contributions and other	6,224	24,165	2,258	14,671	3,966	9,494
Net unrealized (loss) gain on investments	(171)	108	(189)	103	18	5
Net assets released from restriction	(5,466)	(6,482)	(3,204)	(1,903)	(2,262)	(4,579)
Increase (decrease) in temporarily restricted net assets	587	17,791	(1,135)	12,871	1,722	4,920
Noncontrolling interests:						
Excess of revenues over expenses attributable to noncontrolling interests	7,174	5,528	7,098	5,410	76	118
Other changes, primarily distributions of earnings to noncontrolling interests	(5,057)	(147)	(4,900)	-	(157)	(147)
Increase (decrease) in noncontrolling interests	2,117	5,381	2,198	5,410	(81)	(29)
(Decrease) increase in net assets	(11,306)	134,927	12,658	127,100	(23,964)	7,827
Net assets, beginning of period	4,747,196	4,628,169	299,231	164,463	4,447,965	4,463,706
Net assets, end of period	\$ 4,735,890	\$ 4,763,096	\$ 311,889	\$ 291,563	\$ 4,424,001	\$ 4,471,533

Banner Health and Subsidiaries

Consolidated Statements of Cash Flows

For the Three Months Ending March 31

Unaudited

(\$ in thousands)

	Banner Health Consolidated		Non-Obligated Group		Obligated Group	
	3/31/2016	3/31/2015	3/31/2016	3/31/2015	3/31/2016	3/31/2015
<b>Operating activities:</b>						
(Decrease) increase in net assets	\$ (11,306)	\$ 134,927	\$ 12,658	\$ 127,100	\$ (23,964)	\$ 7,827
Adjustments to reconcile (decrease) increase in net assets to net cash provided by (used in) operating activities:						
Depreciation and amortization	99,443	86,248	2,253	2,137	97,190	84,111
Decrease (increase) in investments designated as trading	255,982	(117,947)	5,430	(54,946)	250,552	(63,001)
Equity transfers	-	-	(79,075)	(57,972)	79,075	57,972
Net unrealized loss (gain) on interest rate swaps	68,890	41,055	-	(31)	68,890	41,086
Loss (gain) on sale of assets	3	(637)	-	-	3	(637)
Temporarily restricted contributions	(6,224)	(24,165)	(2,258)	(14,671)	(3,966)	(9,494)
Changes in operating elements, net of acquisitions:						
Patient receivables	(87,015)	(63,646)	(13,592)	(7,497)	(73,423)	(56,149)
Inventories and other current assets	27,715	(53,214)	2,919	(13,564)	24,796	(39,650)
Accounts payable and accrued expenses	(34,879)	16,423	(34,940)	(9,667)	61	26,090
Estimated third-party settlements	(819)	209	-	(15)	(819)	224
Estimated self-insurance liabilities	10,678	24,967	1,602	24,293	9,076	674
Other liabilities	(327)	(19,171)	52	(18,999)	(379)	(172)
Net cash provided by (used in) operating activities	322,141	25,049	(104,951)	(23,832)	427,092	48,881
<b>Investing activities:</b>						
Net purchases of property and equipment	(86,332)	(86,541)	(3,475)	(2,647)	(82,857)	(83,894)
Decrease in funds held under indenture agreements	-	44,072	-	-	-	44,072
Acquisitions	-	(548,780)	-	(9,525)	-	(539,255)
(Increase) decrease in other assets	(1,560)	29,665	1,985	28,864	(3,545)	801
Net cash (used in) provided by investing activities	(87,892)	(561,584)	(1,490)	16,692	(86,402)	(578,276)
<b>Financing activities:</b>						
Proceeds from temporarily restricted contributions	6,224	24,165	2,258	14,671	3,966	9,494
Proceeds from issuance of debt	-	700,000	-	-	-	700,000
Intercompany activity, including equity transfers	-	(803)	97,639	26,735	(97,639)	(27,538)
Payments of hospital lease obligations	1,214	(4,210)	-	-	1,214	(4,210)
Payments of long-term debt	(252,208)	(61,715)	(117)	(12,194)	(252,091)	(49,521)
Net cash (used in) provided by financing activities	(244,770)	657,437	99,780	29,212	(344,550)	628,225
Net (decrease) increase in cash and cash equivalents	(10,521)	120,902	(6,661)	22,072	(3,860)	98,830
Cash and cash equivalents at beginning of period	91,983	107,228	69,407	17,476	22,576	89,752
Cash and cash equivalents at end of period	\$ 81,462	\$ 228,130	\$ 62,746	\$ 39,548	\$ 18,716	\$ 188,582
<b>Noncash activities</b>						
Capital leases, primarily NCMC, Inc. and Greater Fairbanks Community Hospital Foundation	\$ 10,576	\$ 3,813	\$ -	\$ -	\$ 10,576	\$ 3,813

Notes to Consolidated Unaudited Financial Statements

March 31, 2016

## 1. Description of Business

Banner Health is a nonprofit corporation exempt from income taxes under Internal Revenue Code Section 501(c)(3) and applicable state income tax codes. Banner Health and its subsidiaries (Banner) own or lease hospitals, multi-specialty physician groups, clinics, nursing homes, clinical laboratories, ambulatory surgery centers, home health agencies, a captive insurance company, foundations, an accountable health care organization, health insurance plans, and other health care-related organizations in seven western states. Banner also holds an interest in several healthcare related organizations, including:

- A 51% controlling interest in Sonora Quest Laboratories (SQL); the financial results of SQL have been included in Banner's consolidated financial statements.
- A 50% noncontrolling interest in Veritage LLC (Veritage) which is accounted for under the equity method of accounting. Banner's share of Veritage LLC's net income has been recorded within other operating revenue.

## 2. Significant Accounting Policies

### Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial reporting, applied on a basis substantially consistent with that of the 2015 audited financial statements of Banner. They do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2016 are not necessarily indicative of the results to be expected for the year ended December 31, 2015. For more information, refer to the audited consolidated financial statements and notes thereto as of and for the year ended December 31, 2015.

Subsequent events have been evaluated through May 13, 2016, the date of the issuance of the unaudited consolidated financial statements.

The separate details of the Obligated and Non-Obligated Group financial statements are presented for purposes of additional analysis and are not a required part of the consolidated financial statements.

### Basis of Consolidation

The accompanying consolidated financial statements reflect the consolidated operations of all owned and leased operating units of Banner and its wholly owned subsidiaries.

Banner also holds a controlling interest in several joint ventures, the financial results of which are included in Banner's consolidated financial statements. Banner records the unrelated investors' ownership share of these joint ventures as noncontrolling interest. The noncontrolling interest balance as of March 31, 2016 and 2015 primarily relates to Banner's investment in SQL, in which Banner holds a 51% interest and Quest Diagnostics, Inc. holds the remaining 49% interest.

### Short-Term Investments

Short-term investments primarily include debt securities with maturity dates of one year or less from the balance sheet date, US Treasury government obligations and actively traded equity securities. These investments are stated at fair value (Refer to Note 3).

## Banner Health and Subsidiaries

### Notes to Consolidated Unaudited Financial Statements

March 31, 2016

#### 2. Significant Accounting Policies (continued)

##### Investments

Banner invests in alternative investments, mainly hedge funds, through limited partnerships. Banner accounts for its ownership share in these alternative investments under the equity method based on the hedge funds' net asset value per share of the fund held by Banner. The hedge fund net asset value is provided to Banner by each of the hedge fund managers. The net asset value is determined based on the estimated fair value of each of the underlying investments held in the hedge fund. However, the hedge fund investment holdings may include investment in private investment funds whose values have been estimated by the hedge fund manager in the absence of readily ascertainable fair values. Due to the inherent uncertainty of these estimates, these values may differ from the values that would have been used had a ready market for these investments existed. Banner's share of the alternative investments' unrestricted realized and unrealized (losses) gains approximated (\$29,207,000) and \$11,075,000 for the three months ended March 31, 2016 and 2015, respectively. The restricted share of alternative investment realized and unrealized (losses) gains is approximately (\$58,000) and \$37,000 for the three months ended March 31, 2016 and 2015, respectively.

Banner uses derivative financial instruments in its investment portfolio to moderate changes in value due to fluctuations in the financial markets. Banner has not designated its derivatives related to marketable securities as hedged financial instruments. Banner offsets the fair value for various derivative instruments including forwards, interest rate swaps, currency swaps, options and other conditional or exchange contracts, if they are executed with the same counterparty under a master netting arrangement. Banner invests in a variety of derivative instruments through fixed income managers that have executed a master netting arrangement with each of its forward and future purchase and sale contracts, interest and credit swap agreements and option agreements, whereby the financial instruments are held by the same counterparty and are legally offset as the instrument is settled. Banner's derivative contracts in a net loss position were immaterial at March 31, 2016 and 2015 and were reported on the accompanying consolidated balance sheets on a net basis. As of March 31, 2016 and 2015, the gross derivative assets and liabilities held and netted together within the investment accounts amounted to assets of approximately \$354,101,000 and \$342,825,000 and liabilities of approximately \$359,037,000 and \$339,392,000, respectively. (See Note 3 for a more complete description of derivative assets and liabilities.)

Banner has entered into repurchase agreements amounting to approximately \$125,905,000 and \$18,400,000 as of March 31, 2016 and 2015, respectively, which are included in long-term investments on the accompanying consolidated balance sheets. In connection with the repurchase agreements, Banner has loaned cash to certain financial institutions in exchange for collateral. Collateral provided by the financial institutions amounted to approximately \$129,789,000 and \$18,797,000 as of March 31, 2016 and 2015, respectively, and is recorded in the unaudited consolidated balance sheets within collateral held under securities lending program and repurchase agreements as of March 31, 2016.

Banner participates in securities lending transactions through its custodian whereby Banner lends a portion of its investments to various brokers in exchange for collateral for the securities loaned, usually on a short-term basis. Collateral provided by the brokers consists of cash and securities and is maintained at levels approximating 102% of the fair value of the securities on loan, adjusted for market fluctuations. Banner maintains effective control of the loaned securities through its custodian during the term of the arrangement in that they may be recalled at any time. Under the terms of the agreement, the borrower must return the same, or substantially the same, investments that were borrowed. The value of collateral held for loaned securities is reported in current assets as collateral held under securities lending program, and a corresponding obligation is

## Notes to Consolidated Unaudited Financial Statements

March 31, 2016

**2. Significant Accounting Policies (continued)**

reported in current liabilities as a payable under securities lending program in the accompanying consolidated balance sheets. At March 31, 2016 and 2015, the fair value of the collateral provided on behalf of Banner was approximately \$189,164,000 and \$182,103,000, respectively. At March 31, 2016 and 2015, the fair market value of securities on loan was approximately \$183,925,000 and \$177,468,000, respectively, and is included in assets limited as to use on the accompanying consolidated balance sheets.

**Premium Revenue and Claims Costs**

Premium revenue of BHN and the University Health Plans is included in other revenue, and medical claims costs, net of elimination of claims paid to Banner facilities and providers, is included in other expenses. Premium revenues and claims costs are as follows (in thousands):

	<u>3/31/2016</u>	<u>3/31/2015</u>
Net premium revenue	\$ 258,609	\$ 183,234
Net claims cost	159,425	99,680
BHN and University Health Plans elimination	89,875	76,205
Gross claims cost, including claims paid to Banner facilities and providers	<u>\$ 249,300</u>	<u>\$ 175,885</u>
Claims cost as a percent of premiums	96.4%	96.0%

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements.

Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates are made in the areas of patient accounts receivable, accruals for settlements with third-party payors, risk pool and insurance settlements, medical claim liabilities, contingent liabilities, and accrued liabilities resulting from self-insurance programs. In the first three months of 2016 and 2015, Banner Health Network recorded prior plan year income of \$9,247,000 and \$6,095,000, respectively, primarily related to adjustment of prior year claim reserves.

**Change in Accounting Principle**

In January, 2016, Banner Health adopted ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs*, which resulted in the reclassification of deferred debt issuance costs from a non-current asset to directly reduce the long-term debt balance. This resulted in a reduction of other assets and long-term debt of \$9,836,000 and \$8,802,000 as of March 31, 2016 and 2015, respectively.

**New Accounting Pronouncements**

In February, 2016 the FASB issued ASU 2016-02, *Leases*. ASU 2016-02 requires companies that lease assets to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the balance sheet. The pronouncement will also require additional disclosures about the amount, timing and uncertainty of cash flows arising from leases. The provisions of ASU 2016-02 are effective for Banner starting January 1, 2019, including interim periods after that date, and early adoption is permitted. Management is currently evaluating the impact of this pronouncement on Banner's consolidated financial statements.

## Banner Health and Subsidiaries

### Notes to Consolidated Unaudited Financial Statements

March 31, 2016

## 2. Significant Accounting Policies (continued)

### Reclassifications

Prior year amounts have been reclassified to conform to the current year presentation. The most significant reclassifications resulted from the breakout of additional balance sheet categories, for other receivables, claims payable, and interest rate swap liabilities.

### 3. Fair Value of Financial Instruments

Fair value is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, Banner utilizes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows:

**Level 1.** Pricing inputs into the determination of fair value are generally observable inputs such as quoted prices in active markets. Financial assets and liabilities in Level 1 generally include listed equities and mutual funds.

**Level 2.** Pricing inputs are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Financial assets and liabilities in this category generally include asset and mortgage-backed securities, U.S. Treasury Securities/government obligations, corporate bonds and loans, municipal bonds, commercial paper, repurchase agreements, forward contracts, interest and credit swap agreements, options and interest rate swaps.

**Level 3.** Pricing inputs are generally unobservable and include situations where there is little, if any, market activity for the investment. The inputs into the determination of fair value require management's judgment or estimation of assumptions that market participants would use in pricing the assets or liabilities. The fair values are therefore determined using factors that involve considerable judgment and interpretations, including but not limited to private and public comparables, third party appraisals, discounted cash flow models, and fund manager estimates.

Assets and liabilities measured at fair value are based on one or more of three valuation techniques identified in the tables below. Where more than one technique is noted, individual assets or liabilities were valued using one or more of the noted techniques. The valuation techniques are as follows:

- (a) *Market approach.* Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.
- (b) *Cost approach.* Amount that would be required to replace the service capacity of an asset (replacement cost).
- (c) *Income approach.* Techniques to convert future amounts to a single present amount based on market expectations (including present value techniques, option-pricing and excess earnings models).

Banner's investment in alternative investments, amounting to approximately \$1,364,030,000 and \$1,437,114,000 as of March 31, 2016 and 2015, respectively, are accounted for using the equity method of accounting. Accordingly, the alternative investments are omitted from the following schedule of financial instruments measured at fair value. Also, included in assets limited as to use are premium payments to be received from Banner's split dollar life insurance policies amounting to \$12,702,000 and \$23,214,000 as of March 31, 2016 and 2015, respectively, which are not measured at fair value.

Banner Health and Subsidiaries

Notes to Consolidated Unaudited Financial Statements

March 31, 2016

3. Fair Value of Financial Instruments (continued)

	March 31, 2016 (In Thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique (a, b, c)
Cash and cash equivalents	\$ 414,607	\$ 395,203	\$ 19,404	\$ -	a
Cash and cash equivalent – collateral held under securities lending and repurchase agreement	318,954	318,954	-	-	a
Mutual funds:					a
Mutual funds – U.S. funds	1,118,354	1,118,354	-	-	a
Mutual funds – International	288,311	288,311	-	-	a
Total mutual funds	<u>1,406,665</u>	<u>1,406,665</u>	<u>-</u>	<u>-</u>	
Debt securities:					
U.S. Treasury/government obligations	260,276	-	260,276	-	a
Corporate bonds/Non-U.S. government bonds	143,484	-	143,484	-	a
Asset-backed securities	56,308	-	56,308	-	a
Commercial mortgage-backed securities	18,701	-	18,701	-	a
Non-government-backed collateralized mortgages	8,868	-	8,868	-	a
Government mortgage-backed securities	200,714	-	200,714	-	a
Government commercial backed	2,698	-	2,698	-	a
Total debt securities	<u>\$ 691,049</u>	<u>\$ -</u>	<u>\$ 691,049</u>	<u>\$ -</u>	
Repurchase agreements	<u>\$ 125,905</u>	<u>\$ -</u>	<u>\$ 125,905</u>	<u>\$ -</u>	a
Equity securities:					
U. S. equity securities	\$ 189,435	\$ 189,435	\$ -	\$ -	a
International equity securities	253,255	253,255	-	-	a
Total equity securities	<u>442,690</u>	<u>442,690</u>	<u>-</u>	<u>-</u>	a
Derivative securities					a
Future contracts	48,862	48,862	-	-	a
Forward contracts	300,842	-	300,842	-	a
Interest rate swap agreements	2,846	-	2,846	-	a
Net credit swaps	1,551	-	1,551	-	a
Subtotal derivative assets	<u>\$ 354,101</u>	<u>\$ 48,862</u>	<u>\$ 305,239</u>	<u>\$ -</u>	
Future contracts	(48,862)	(48,862)	-	-	a
Forward contracts	(302,808)	-	(302,808)	-	a
Interest rate swap agreements	(6,608)	-	(6,608)	-	a
Option agreements	(64)	-	(64)	-	a
Net credit swaps	(695)	-	(695)	-	a
Subtotal derivative liabilities	<u>\$ (359,037)</u>	<u>\$ (48,862)</u>	<u>\$ (310,175)</u>	<u>\$ -</u>	
Total fair value Investments	<u>\$ 3,394,934</u>	<u>\$ 2,564,522</u>	<u>\$ 831,422</u>	<u>\$ -</u>	c a
Short-term investments	241,323				
Collateral held under securities lending and repurchase agreements	318,954				
Assets limited as to use	2,143,071				
Long-term investments	1,999,878				
Other assets – Banner Foundation restricted funds	68,440				
Less: alternative investments	1,364,030				
Less: split dollar life insurance	12,702				
Total fair value investments	<u>\$ 3,394,934</u>				
Interest rate swaps included in other long-term liabilities	<u>\$ (429,921)</u>	<u>\$ -</u>	<u>\$ (429,921)</u>	<u>\$ -</u>	c

Banner Health and Subsidiaries

Notes to Consolidated Unaudited Financial Statements

March 31, 2016

3. Fair Value of Financial Instruments (continued)

	March 31, 2015 (In Thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Valuation Technique (a, b, c)
Cash and cash equivalents	\$ 402,263	\$ 393,484	\$ 8,779	\$ -	a
Cash and cash equivalent – collateral held under securities lending and repurchase agreement	200,900	200,900	-	-	a
Mutual funds:					a
Mutual funds – U.S. funds	1,106,043	1,106,043	-	-	a
Mutual funds – International	457,571	457,571	-	-	a
Total mutual funds	1,563,614	1,563,614	-	-	
Debt securities:					
U.S. Treasury/government obligations	320,028	-	320,028	-	a
Corporate bonds/Non-U.S. government bonds	163,531	-	163,531	-	a
Asset-backed securities	61,788	-	61,788	-	a
Commercial mortgage-backed securities	19,966	-	19,966	-	a
Non-government-backed collateralized mortgages	17,681	-	17,681	-	a
Government mortgage-backed securities	96,279	-	96,279	-	a
Government commercial backed	5,411	-	5,411	-	a
Total debt securities	\$ 684,684	\$ -	\$ 684,684	\$ -	
Repurchase agreements	\$ 18,400	\$ -	\$ 18,400	\$ -	a
Equity securities:					
U. S. equity securities	\$ 183,907	\$ 183,907	\$ -	\$ -	a
International equity securities	323,742	323,742	-	-	a
Total equity securities	507,649	507,649	-	-	a
Derivative securities					a
Future contracts	65,186	65,186	-	-	a
Forward contracts	268,477	-	268,477	-	a
Interest rate swap agreements	753	-	753	-	a
Option agreements	4,156	-	4,156	-	a
Net credit swaps	4,253	-	4,253	-	a
Subtotal derivative assets	\$ 342,825	\$ 65,186	\$ 277,639	\$ -	
Future contracts	(65,186)	(65,186)	-	-	a
Forward contracts	(265,810)	-	(265,810)	-	a
Interest rate swap agreements	(1,604)	-	(1,604)	-	a
Option agreements	(75)	-	(75)	-	a
Net credit swaps	(6,717)	-	(6,717)	-	a
Subtotal derivative liabilities	\$ (339,392)	\$ (65,186)	\$ (274,206)	\$ -	
Total Fair Value Investments	\$ 3,380,943	\$ 2,665,645	\$ 715,298	\$ -	c a
Short-term investments	172,111				
Collateral held under securities lending and repurchase agreements	200,900				
Assets limited as to use	2,351,620				
Long-term investments	2,045,670				
Other assets – Banner Foundation restricted funds	70,970				
Less: alternative investments	1,437,114				
Less: split dollar life insurance	23,214				
Total fair value investments	\$ 3,380,943				
Interest rate swaps included in other long-term liabilities	\$ (397,662)	\$ -	\$ (397,662)	\$ -	c



# Banner Health and Subsidiaries

## Notes to Consolidated Unaudited Financial Statements

March 31, 2016

### 3. Fair Value of Financial Instruments (continued)

Investment income consisted of the following for the three months ended March 31:

(\$ in thousands)

	2016	2015
Interest and dividend Income	\$ 15,985	\$ 20,304
Net realized (loss) gain on sales of investments	(7,080)	47,525
(Loss) gain from alternative investments	(28,762)	11,364
Net realized (loss) on sales of future contracts	(3,523)	(445)
Net realized loss on sales of interest rate swap agreements	(128)	(4,962)
Net realized gain (loss) on sales of option agreements	138	(522)
Net realized loss on sales of net credit swaps	(673)	(402)
Net unrealized (loss) gain on investments	(17,030)	3,344
Net unrealized (loss) on interest rate swap agreements	(2,573)	(3,299)
Net unrealized gain on option agreements	1,685	1,685
Net unrealized loss on net credit swaps	(748)	(23)
	(42,709)	74,569
Less: Investment income credited to other revenue, restricted funds, and capitalized bond project funds	1,063	4,800
Investment (loss) gain income	\$ (43,772)	\$ 69,769

### 4. Debt

In order to finance its payment obligations with respect to the UAHN merger, on February 26, 2015 Banner entered into a \$700,000,000 taxable term loan ("interim loan") with Mizuho Bank, Ltd., acting through its New York branch. In November 2015, a portion of the loan amounting to \$500,000,000 was paid off through proceeds received from the Series 2015 Bonds. On January 29, 2016 Banner paid off the remaining principal balance of \$200,000,000 and terminated the interim loan.

### 5. Interest Rate Swap Agreements

Banner entered into multiple interest rate swaps that currently do not qualify for hedge accounting. For the three months ended March 31, 2016 and 2015, the mark-to-market adjustment resulted in an unrealized loss of \$(68,947,000) and \$(41,112,000) respectively, recorded in excess of revenue over expenses. The net effect of the interest rate swaps, recorded in interest expense, was to increase the overall cost of borrowing for the three months ended March 31, 2016 and 2015, by \$10,893,000 and \$10,956,000, respectively.

Each of the interest rate swap agreements has collateral posting thresholds based on the counterparties' bond ratings. At the AA- rating level, Banner and its counterparties must post collateral when the mark-to-market adjustment exceeds between \$35,000,000 and \$75,000,000 depending on the counterparty. In September 2008, the decline in the mark-to-market adjustment reached the threshold posting level and Banner began posting collateral with its counterparties. At March 31, 2016 and 2015, Banner had \$146,368,000 and \$250,313,000 of collateral outstanding with its counterparties, respectively. The fair value of the collateral is reported as other funds under the assets limited as to use category in the accompanying consolidated balance sheets.

# Banner Health Performance

## 2016 Key Utilization Indicators

	"All Store"		"Same Store"*	
	YTD MAR 2016	YTD MAR 2015	YTD MAR 2016	YTD MAR 2015
<b>Hospital (acute care):</b>				
Licensed beds <sup>(a)</sup>	5,153	5,283	4,314	4,382
Admissions (excl. newborns)	60,969	58,115	53,521	55,616
Observation cases	29,172	23,321	26,513	23,321
Average length of stay	4.57	4.29	4.45	4.23
Patient Days	278,620	249,237	238,284	235,246
Licensed beds occupancy % <sup>(b)</sup>	59.42%	57.74%	60.70%	59.70%
Emergency room visits <sup>(c)</sup>	287,097	250,771	250,099	239,902
Outpatient visits (excl. ER)	263,739	241,477	235,505	233,632
<b>Long-term care/behavioral/rehabilitation:</b>				
Licensed beds <sup>(a)</sup>	698	555	569	555
Resident days	40,665	39,399	35,730	37,574
Licensed beds occupancy % <sup>(b)</sup>	64.02%	78.83%	69.00%	75.18%
<b>Banner Medical Group Clinic Encounters</b>	<b>814,860</b>	<b>761,323</b>	<b>814,860</b>	<b>761,323</b>
<b>Banner Health Network Avg. Full Risk Lives</b>	<b>64,764</b>	<b>65,171</b>	<b>64,764</b>	<b>65,171</b>
<b>Banner Health Network Avg. Managed Lives</b>	<b>212,797</b>	<b>177,865</b>	<b>212,797</b>	<b>177,865</b>

(a) Licensed beds at quarter-end

(b) Occupancy % adjusted for timing when beds went in service

(c) Includes outpatient and admitted, excludes patients who left without treatment.

\*Same store excludes operations formerly UAHN, Payson, and Ft. Collins