



Management Discussion and Analysis of Results from Operations and Financial Position

For the Three Months Ended March 31, 2019

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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 the audited consolidated financial statements and related notes of Banner Health ("Banner") for the year ended December 31, 2018. The audited consolidated financial statements 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, 2019

Overview

Banner Health ("Banner") is one of the nation's largest secular nonprofit healthcare systems, combining a portfolio of hospitals, ambulatory care centers, medical clinics, a comprehensive academic medicine division in partnership with the University of Arizona, and an insurance division operating both Banner Health Network and Banner – University Health Plans. Banner's stated mission is "making health care easier, so life can be better" and is achieving that mission for the members and patients it serves through the integration of payer and provider solutions with a customer-obsessed focus. Headquartered in Phoenix, Arizona, Banner provides a broad range of healthcare services, including twenty-eight (28) hospitals concentrated in three geographic areas: the greater Phoenix metropolitan area; the greater Tucson metropolitan area; and its Western States markets including northern and northeastern Colorado, with the remaining facilities located in mainly rural communities in Wyoming, Nebraska, Arizona, Nevada, and California. Centralized services supporting these operations are provided from Banner's corporate offices in Phoenix and Mesa, Arizona.

Financial Performance for the Three Months Ended March 31, 2019

Banner generated \$87.4 million in operating income and \$327.5 million in net income during the first quarter of 2019. These results equate to operating and total margins of 3.8% and 12.8%, respectively, on total operating revenue of \$2.3 billion. Operating revenue increased 11.1% over the prior year driven by growth in premium revenues from additional covered lives in the Insurance Operations coupled with modest increases in patient volumes and commercial reimbursement rates.

Non-operating income for the quarter reflected net investment growth of over \$270.0 million, bringing Banner's investment portfolio to \$4.9 billion, as strong corporate earnings and expected execution of US – Foreign trade agreements have sparked investment markets. Fixed interest rate swaps generated a mark-to-market loss of \$27.3 million year to date, as bond prices have declined due to money supply moving into equity markets.

Financial Highlights
(\$000's in millions)

	2017	2018	Q1 2018	Q1 2019
Revenue	\$7,835.3	\$8,519.8	\$2,095.1	\$2,327.8
Operating Expenses	7,564.6	8,333.4	2,012.8	2,240.4
Operating EBIDA	795.4	727.6	214.2	223.7
Interest, Depreciation and Amortization	524.8	541.3	132.0	136.3
Operating Income	270.7	186.3	82.2	87.4
Nonoperating Income	438.7	(142.4)	12.3	219.4
Revenue over Expenses	709.4	44.0	94.6	327.5
Operating Margin	3.5%	2.2%	3.9%	3.8%
Operating EBIDA Margin	10.2%	8.5%	10.2%	9.6%
Total Margin	8.6%	0.5%	4.5%	12.8%

Year-to-date operating income supports Banner's strategy to leverage its profitable Community Delivery performance to provide the necessary capital to invest in the longer-term development of the Academic Medicine and Insurance Operations divisions, as reflected in the following tables:

For the Three Months Ended March 2019

(\$ in thousands)	Community Delivery	Academic Medicine	Insurance Operations	Elims/ Other	Consolidated
Operating Revenue	\$ 1,439,711	\$ 584,652	\$ 471,498	\$ (168,101)	\$ 2,327,760
Operating Expense	1,310,569	622,798	491,757	(184,767)	2,240,357
Operating Income	\$ 129,142	\$ (38,146)	\$ (20,259)	\$ 16,666	\$ 87,403

For the Three Months Ended March 2018

(\$ in thousands)	Community Delivery	Academic Medicine	Insurance Operations	Elims/ Other	Consolidated
Operating Revenue	\$ 1,362,016	\$ 550,858	\$ 358,600	\$ (176,408)	\$ 2,095,066
Operating Expense	1,244,516	580,195	392,625	(204,499)	2,012,837
Operating Income	\$ 117,500	\$ (29,337)	\$ (34,025)	\$ 28,091	\$ 82,229

Performance results for Banner's three divisions for the three months ended March 31, 2019 include the following highlights:

Community Delivery

Operating performance of Community Delivery continued to provide Banner with resources to fund growth and turnaround plans for Academic Medicine and Insurance Operations. Contributing factors driving performance for Community Delivery included:

- Growth over the prior year in adjusted admissions and total surgical volume of 2.2% and 7.9%, respectively, despite a milder flu season in 2019
- Improvements in payor-mix supported declines in bad debt and charity as a percentage of net healthcare revenue, dropping to 10.8% compared to 11.4% in 2018
- Emergency department and urgent care visits, combined, held stable from the prior year, despite a milder flu season
- Outpatient registrations increased more than 40% as a result of an increase in outpatient rehabilitation business following the commencement of operations of BHSM, the joint venture between Banner and Select Medical

Academic Medicine

Underlying operating performance improved in Academic Medicine as physician and clinic operations improved efficiency and recovered the productivity lost as the result of prior year electronic medical record system conversions, both serving to source more patients for hospital services.

Volumes were improved from the prior year, despite a milder flu season as compared to the prior year. Adjusted admissions and total surgical volume increased 2.8% and 1.8% over the prior year, while average inpatient length of stay was reduced by nearly 2% year over year. Clinic encounters were 18% higher than the first quarter of 2018 and Emergency Department visits increased 3.1% over the prior year.

A new patient tower at B—UMCP opened in the fourth quarter of 2018, and the new tower at B—UMCT opened in April 2019. Together, these projects represent approximately \$1 billion dollars of investment into Banner's academic medicine strategy and are expected to drive additional volume increases.

Operating expenses increased by \$43 million in first quarter 2019 over the prior year quarter, due primarily to the opening of our new patient tower at B—UMCP adding new operating cost and depreciation expense, the addition of 110 new physicians to support clinical activity and growth strategies for both Phoenix and Tucson campuses, and variable cost increases associated with the growth in patient volumes referenced above. Management remains focused on operational improvement plans for Academic Medicine, including the growth of high-yield surgical services, increasing its primary care physician base in Tucson, implementing labor and supply cost reduction programs, and reducing administrative costs.

Insurance Operations

Insurance Operations includes Banner-Aetna, a commercial insurance offering in partnership with a subsidiary of Aetna, BHN, a financially and clinically integrated provider network with certain delegated Medicare Advantage risk contracts, and UFC and UCA, wholly-owned Arizona Medicaid plan and its associated dual eligible special needs Medicare Advantage plan.

Insurance operations generated an operating loss of \$20.3 million in the first quarter which was a 35.6% improvement over the same quarter prior year. The combined medical loss ratio improved from 101.1% in first quarter 2018 to 94.9% during first quarter 2019. Management remains focused on the accuracy of risk-scoring and quality data reporting to increase risk adjusted revenue.

Membership in commercial insurance plans offered by Banner-Aetna and the Medicaid contractor plans continue to exhibit growth, expanding the number of lives managed by Banner under value-based payment models.

	<u>Q1 2018</u>	<u>Q1 2019</u>
BHN – Full Risk	63,768	57,045
Banner Employee – Full Risk	83,724	83,698
Medicaid Contractor Plans	148,514	213,482
Total Full Risk Lives	296,006	354,225
BHN/Banner-Aetna - Shared Risk	460,938	536,185
Total Lives	756,944	890,410

Banner's balance sheet indicators have continued to improve, as shown below:

	<u>Q1 2019</u>	<u>YE 2018</u>	<u>YE 2017</u>	<u>YE 2016</u>
Long-Term Debt to Capitalization	33.4%	35.3%	35.0%	36.6%
Days Cash on Hand	219	214	246	218
Cash to Long-Term Debt	163%	151%	161%	150%
Maximum Annual Debt Service Coverage	4.6	4.6	4.9	4.5