



Management Discussion and Analysis of Results from Operations and Financial Position

For the Six Months Ended June 30, 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 Six Months Ended June 30, 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 Six Months Ended June 30, 2019

Banner generated \$111.8 million in operating income and \$430.9 million in net income during the first half of 2019. These results equate to operating and total margins of 2.4% and 8.6%, respectively, on total operating revenue of \$4.7 billion. Operating revenue increased 11.6% 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. Year-to-date operating and EBIDA margins are in line with 2018 results, even as Banner has made significant short-term investments in Academic Medicine that will provide for future growth.

Operating margins continue to be supported by strong performance in overall Care Delivery operations, with inpatient admissions increasing nearly 4% over the prior period, and adjusted admissions (inclusive of outpatient activity) increasing 3.3% year over year. Banner experienced 6.6% growth in surgical cases, with inpatient cases exhibiting slower growth of 2.4% year over year, reflecting a continued shift to outpatient surgery. Operating margins softened from 3.0% during the six-months period in 2018, to 2.4% in 2019, due largely to investments being made in the growth and turnaround of new businesses across Banner Health: a 36% growth in premium revenues in Banner’s insurance division is being met with start-up (temporary) losses in our Banner—University Health Plans (Medicaid) operation; start-up losses in newly developed and acquired ambulatory care operations (imaging, ambulatory surgery, and urgent care); investments in over 100 newly employed physicians in Banner Medical Group and Banner--University Medical Group include start-up losses to grow our care delivery footprint and key service-lines; recent opening of new patient towers at Banner—University Medicine medical centers in both Phoenix and Tucson, at a value of nearly \$1 billion, include (temporary) transition costs and start-up losses as operating teams relocate into the new patient care space. Banner expects to mature these investments and new assets in our Insurance and Care Delivery divisions as we move through the balance of 2019.

Investment income of \$411.8 million, a 9.8% return from our comprehensive investment program (CIP) year to date, helped to bring the fair value of Banner's cash and investment portfolio over \$5 billion. Fixed interest rate swaps generated a mark-to-market loss of \$74.0 million year to date, as bond yields have declined due to money supply flowing into US markets. As a result, the required collateral posting of unrestricted cash and securities has increased \$44.1 million during the first half of 2019.

Financial Highlights
(\$000's in millions)

	2019 YTD	2018 YTD	2018	2017
Revenue	\$4,670.0	\$4,184.7	\$8,519.8	\$7,835.3
Operating Expenses	4,558.2	4,057.4	8,333.4	7,564.6
Operating EBIDA	395.8	393.8	727.6	795.4
Interest, Depreciation and Amortization	284.0	266.5	541.3	524.8
Operating Income	111.8	127.3	186.3	270.7
Nonoperating Income	319.1	70.9	(142.4)	438.7
Revenue over Expenses	430.9	198.2	44.0	709.4
Operating Margin	2.4%	3.0%	2.2%	3.5%
Operating EBIDA Margin	8.5%	9.4%	8.5%	10.2%
Total Margin	8.6%	4.7%	0.5%	8.6%

For the Six Months Ended June 2019

<i>(\$ in thousands)</i>	<u>Delivery Operations</u>	<u>Insurance Operations</u>	<u>Elims/ Other</u>	<u>Consolidated</u>
Operating Revenue	\$ 4,037,509	\$ 976,628	\$ (341,101)	\$ 4,670,036
Operating Expense	3,915,053	1,013,147	(369,966)	4,558,234
Operating Income	\$ 122,456	\$ (39,519)	\$ 28,865	\$ 111,802

For the Six Months Ended June 2018

<i>(\$ in thousands)</i>	<u>Delivery Operations</u>	<u>Insurance Operations</u>	<u>Elims/ Other</u>	<u>Consolidated</u>
Operating Revenue	\$ 3,794,263	\$ 727,983	\$ (337,582)	\$ 4,184,664
Operating Expense	3,657,020	781,510	(381,132)	4,057,398
Operating Income	\$ 137,243	\$ (53,527)	\$ 43,550	\$ 127,266

Performance results for Banner’s two divisions for the six months ended June 30, 2019 include the following highlights:

Delivery Operations

- Adjusted admissions and total surgical volume increased 3.3% and 6.6%, respectively, as patient volumes continue to exhibit growth in Banner’s core markets
- Net healthcare revenue per adjusted admission was 2.7% higher, as rates of payment and service-mix increased year-over-year
- YTD Hospital FTE’s per adjusted occupied bed declined 1.2%, an indication of improved labor productivity
- Urgent care visits have increased 13.0%, while Emergency Department visits remained relatively flat, supporting lower cost points of care for our Insurance strategy
- Employed physicians have increased 5% year over year, while clinic encounters increased 7.3%, as Banner continues to invest in new (employed) providers to expand its care delivery footprint
- Outpatient registrations increased more than 20.0% as a result of new outpatient rehabilitation business following the commencement of the Banner Health\Select Medical joint venture in mid-2018

Insurance Operations

- Insurance premium revenue now represents over 20.0% of total system revenue, as premium revenues increased 36% year over year
- Combined medical loss ratio improved from 100.4% to 95.9%, as Banner continues to improve on managing risk within Medicare Advantage and Medicaid programs
- Significant growth in Banner—University Health Plans (Medicaid) membership, driven by expansion to Maricopa County
- Membership in Banner|Aetna commercial insurance plans continues to exhibit rapid growth in Arizona, now with over 315,000 members after only 2-years of operation
- Banner Health Network now managing over 900K lives covered by value-based payment models
- Management focused on accuracy of risk-scoring and quality data to ensure correct risk adjusted revenue is realized

	2019	2018
	YTD	YTD
BHN – Full Risk	56,501	63,054
Banner Employee – Full Risk	83,242	82,188
Medicaid Contractor Plans	220,972	151,438
Total Full Risk Lives	360,715	296,680
BHN/Banner-Aetna - Shared Risk	545,439	477,037
Total Lives	906,154	773,717

Banner's balance sheet indicators remain solid in 2019, as shown below:

	<u>Q2</u> <u>2019</u>	<u>YE</u> <u>2018</u>	<u>YE</u> <u>2017</u>
Long-Term Debt to Capitalization	34.6%	35.3%	35.0%
Days Cash on Hand	231	214	246
Cash to Long-Term Debt	165%	151%	161%
Maximum Annual Debt Service Coverage	4.1	4.7	4.9