



Management Discussion and Analysis of Results from Operations and Financial Position

For the Nine Months Ended September 30, 2021

**For Public Posting to:
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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 generally accepted accounting principles 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, 2020. 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 Nine Months Ended September 30, 2021

Overview

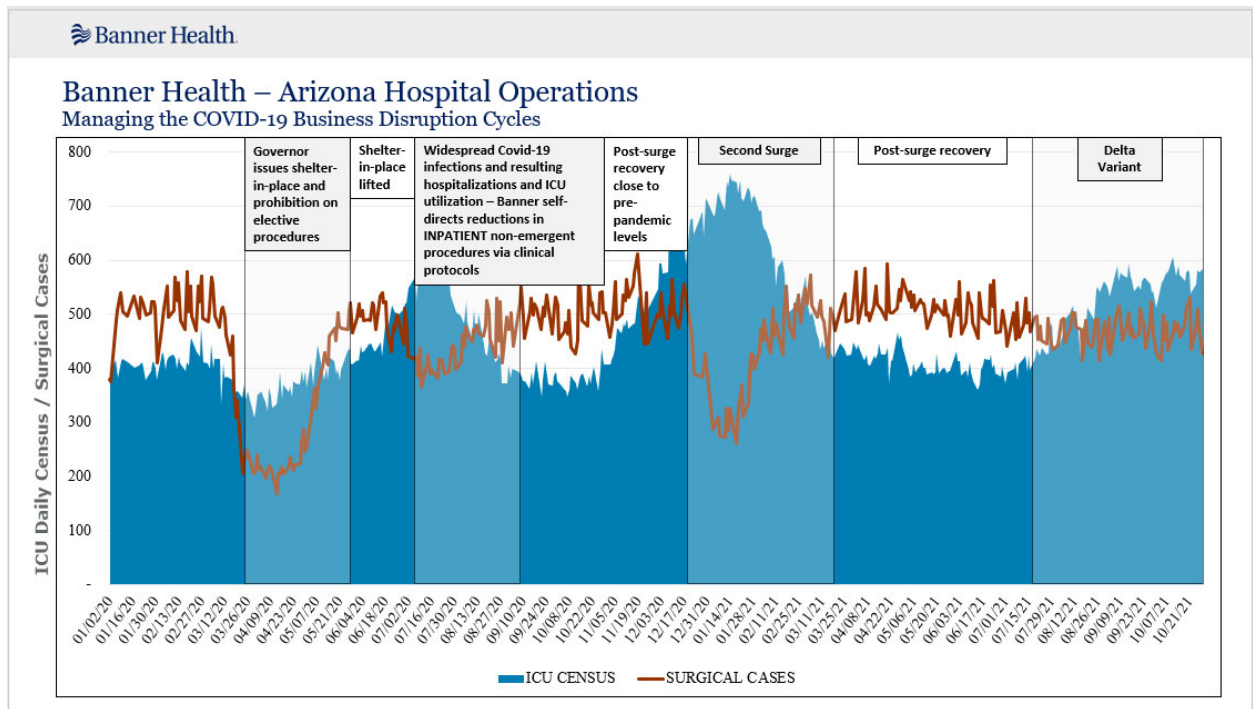
Banner Health (“Banner”) is one of the nation’s largest secular nonprofit healthcare systems, combining a portfolio of hospitals, ambulatory care centers, medical clinics, a comprehensive academic medicine division in partnership with the University of Arizona, and an insurance division operating Banner Health Network (“BHN”), Banner – University Health Plans (“BUHP”) and Banner Medicare Advantage (“MAPD”) 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 thirty-two (32) 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, Chandler and Mesa, Arizona.

For internal management and reporting purposes, Banner has organized itself into two operating divisions, Care Delivery and Insurance Operations: (1) Care Delivery includes all provider operations, including all academic hospitals, community hospitals, academic and non-academic employed physicians, and all ambulatory care services, including its joint ventures; (2) Insurance Operations includes Banner’s accountable care organization, BHN, including CMS MSSP operations and delegated risk contracts from third party MAPD plans, its commercial insurance joint venture, Banner—Aetna, its owned Medicaid/AHCCCS contractor plans and special needs Medicare Advantage plan operating under BUHP, and beginning in 2021, its wholly-owned MAPD plans.

COVID-19 Update

The delta variant, being spread mostly amongst the unvaccinated, has created a third surge of COVID-19 volumes. Although not as pronounced as the first two surges, the delta variant surge has been, and continues to be, more prolonged. Aside from the shelter in place executive order at the onset of the pandemic (March 2020), Banner has been able to effectively manage combined operations for both COVID and non-COVID populations incurring less onerous reductions in (elective) patient volumes.

The below illustration serves to contrast the shelter in place mandate to the surge disruption cycles, comparing inpatient ICU census with surgical volumes, and supports management’s effective operating results during the crisis:



CARES Act Provider Relief Funds (“PRF”) have been instrumental in mitigating the financial burden from this crisis. As of September 30, 2021, Banner has received approximately \$466M in general, targeted, high impact, academic, and safety-net CARES Act stimulus funds, and also received approximately \$654M of Medicare Advance and Accelerated Payments to support liquidity needs in the short term. \$316M of PRF was recognized in other operating revenue during 2020 while another \$24M was recognized in net assets as reimbursement for emergency capital spending. \$103M of the PRF funds have been recognized as other operating revenue in the first half of 2021. The remaining \$23M was recorded as a current liability as of September 30, 2021. The Medicare advanced payments began to be recouped in April of 2021 and approximately \$513M remained as a current liability as of September 30, 2021.

Management will be submitting claims to FEMA to help offset incremental cost being incurred, not covered by PRF and other grants, in order to support our delivery of comprehensive and safe care during the pandemic.

Financial Reporting Summary

Banner posted \$164M of operating income through the first nine months of 2021, resulting in operating and operating EBIDA margins of 1.8% and 7.7%, respectively. Total revenue for the first nine months of 2021 was \$9.0B, a 21% increase over the prior year which was hampered by the shelter in place period. 2021 operations were disrupted by the second and most significant COVID-19 surge, which peaked in January, and more recently (beginning in Q3) the steady surge driven by the delta variant. Management was able to commence recovery of elective services mid-way through the first quarter and continued to experience normalized operations through Q2 and the first half of Q3 before the delta surge dampened expected surgical volume. Banner recognized \$103M of PRF dollars into operating revenue during the first nine months of 2021 to support the most recent business disruption and extraneous costs associated with caring for the COVID population. Year-to-date net income through September 30, 2021 was \$667M for a 7.4% total margin, compared to a \$57M net loss in the prior year due primarily to the shelter-in-place mandates, volatility in the investment markets, and unrealized losses on interest rate swaps.

While working through the COVID-19 crisis and managing the volatile demand and business disruptions in Care Delivery, Banner's Insurance division continued its journey of improving performance by generating a 0.8% operating margin on premium revenue of \$2B through Q3 2021. Premium revenues have increased 19% year-over-year, as Banner continues to mature its insurance strategy and operating performance for commercial, Medicare, and Medicaid products.

Financial Highlights (\$000's in millions)

	FY 2019	FY 2020	Q3 2020 YTD	Q3 2021 YTD
Revenue	\$9,427	\$10,397	\$7,471	\$9,029
Operating expenses	9,227	10,086	7,317	8,865
Operating EBIDA	801	957	631	691
Interest, depreciation and amortization	601	646	477	527
Net operating income	200	311	154	164
Nonoperating (loss) income	553	320	(185)	561
Excess of revenues over expenses attributable to non-controlling interests	26	44	26	58
Excess (deficiency) of revenues over expenses attributable to Banner Health	\$727	\$587	\$(57)	\$667
Operating Margin	2.1%	3.0%	2.1%	1.8%
Operating EBIDA Margin	8.5%	9.2%	8.4%	7.7%

Net operating income (loss) for the nine months ended September 30, 2021 and 2020 are reflected in the tables below, by reporting division:

For the Nine Months Ended September 30, 2021

<i>(\$ in thousands)</i>	Care Delivery	Insurance Operations	Eliminations/ Other	Sub-total Recurring Operations	Cares Act Stimulus	Consolidated
Operating Revenue	\$ 7,590,020	\$ 1,997,516	\$ (660,951)	\$ 8,926,585	\$ 102,591	\$ 9,029,176
Operating Expense	7,396,632	1,981,166	(512,706)	8,865,092	0	8,865,092
Operating Income	<u>\$ 193,388</u>	<u>\$ 16,350</u>	<u>\$ (148,245)</u>	<u>\$ 61,493</u>	<u>\$ 102,591</u>	<u>\$ 164,084</u>

For the Nine Months Ended September 30, 2020

<i>(\$ in thousands)</i>	Care Delivery	Insurance Operations	Eliminations/ Other	Sub-total Recurring Operations	Cares Act Stimulus	Consolidated
Operating Revenue	\$ 6,316,460	\$ 1,603,774	\$ (707,019)	\$ 7,213,215	\$ 258,361	\$ 7,471,576
Operating Expense	6,135,995	1,583,422	(402,032)	7,317,385	0	7,317,385
Operating (Loss) Income	<u>\$ 180,465</u>	<u>\$ 20,352</u>	<u>\$ (304,987)</u>	<u>\$ (104,170)</u>	<u>\$ 258,361</u>	<u>\$ 154,191</u>

Performance results for Banner's Care Delivery and Insurance Operations Divisions for the nine months ended September 30, 2021 include the following highlights:

Care Delivery recognized a year-to-date operating gain of \$296M as of September 30, 2021, aided by the previously mentioned \$103M of PRF revenue recognition. Operating revenue of approximately \$8B (before eliminations) was 17% higher than 2020 driven by a recovery of elective volumes and an increase in Medicaid reimbursement from the implementation of a new federal-matching program for Arizona hospitals (HEALTHII) which began October 1, 2020. Also contributing to the revenue growth was the acquisition of Wyoming Medical Center (October 2020) and opening of newly constructed Banner Ocotillo Medical Center in the last quarter of 2020.

The delta variant surge, coupled with an unprecedented shortage of core labor, has created significant (temporary) turbulence to the financial performance of the division. Premium labor was 125% or \$334M higher than the prior year on a year-to-date basis. The strained labor market has driven contract labor rates to exorbitant levels, applying extreme cost pressure to operations beginning in late Q3. These operating disruptions and extraneous costs supported the recognition of \$103M of PRF revenue and will also serve as the basis for a claim to FEMA. Management expects short-term volatility in operating performance during the intermittent COVID-19 surge events, and corresponding impact on labor costs, core staffing, and use of contract labor.

The **Insurance Division** recognized a \$16M operating gain over the first nine months of 2021, continuing to reflect performance stability when compared to the pandemic aided \$20M gain from the prior year. Insurance Operations are organized in three sub-divisions: commercial insurance plan joint ventures; Banner Health Network (BHN) plans; and Banner University Health Plans (BUHP).

1. **Insurance plan joint ventures** contributed \$7M of operating income to the division, roughly \$2M above the prior year. The Banner|Aetna (B|A) commercial insurance joint venture covers nearly 350,000 member lives in Arizona and represented all of the gain. Roughly 85% of those members are covered under self-funded (ASO) contracts with B|A.
2. **BHN plans (primarily Medicare Advantage contracts)** lost \$15M for the nine months ended September 30, 2021 which was a decline of \$4M compared to the prior year. The Banner Medicare Advantage Plans, that began operations in 2021, represent \$5M (during the start-up period) of the year-to-date loss.
3. In total, the **BUHP (Medicaid) plans** posted an operating gain of \$24M versus the prior year gain of \$26M. Membership has grown 13.7% year-over-year. Increased premium rates resulting from management’s actuary-based appeals and improving care coordination activities to reduce avoidable utilization have translated to profitability. All BUHP plans and contracts were profitable in 2020 and have continued as such in 2021; BUHP combined is the 3rd largest Medicaid plan in Arizona.

Non-Operating Performance

Investment performance has been strong over the first three quarters of 2021, resulting in year-to-date gains of \$500M versus a \$5M loss at the same point in 2020. Interest rate swaps yielded a \$73M unrealized gain compared to a \$128M unrealized loss in the prior year, as interest rates moved higher but still remain low from a long-term historical perspective. Banner remains committed to a long-term investment and financing strategy that anticipates short-term volatility managed under defined risk tolerance guidelines.

Balance Sheet Ratios

Banner’s balance sheet indicators have been supported by the CARES Act stimulus funds, Medicare Advanced Payments, and 2020 capital markets activities as shown below:

	<u>2019</u>	<u>2020</u>	<u>Q3 2021</u>
Long-Term Debt to Capitalization	33.7%	37.7%	34.7%
Days Cash on Hand	225	284	271
Cash to Long-Term Debt	167%	174%	200%
Historical Annual Debt Service Coverage	4.5	4.8	NA