



# **Management Discussion and Analysis of Results from Operations and Financial Position**

**For the Three Months Ended March 31, 2023**

**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 accounting principles generally accepted in the United States of America 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, 2022. 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, 2023**

#### **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"), Banner Medicare Advantage ("MAPD") plans, and Banner|Aetna commercial health plan (under a joint-venture). 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 operates a broad range of healthcare services, including thirty-three (33) hospitals concentrated in three geographic areas: the greater Phoenix metropolitan area; the greater Tucson metropolitan area; and western state 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 academic medical centers, community hospitals, academic and non-academic employed physicians, and all ambulatory care services, including certain (clinical) joint ventures; (2) Insurance Operations includes Banner's accountable care organization and provider network (BHN) including CMS MSSP operations and delegated risk contracts from third party MAPD plans, its commercial insurance joint venture (Banner—Aetna), its wholly-owned Medicaid/AHCCCS contractor plans and special needs Medicare Advantage plan operating under BUHP, and its wholly-owned MAPD plans.

## Financial Reporting Summary

Banner recognized \$128M of operating income in the first quarter of 2023, resulting in operating and operating EBIDA margins of 3.7% and 8.2%, respectively. Continuing the momentum from the fourth quarter of 2022, most volume indicators trended upward and focused efforts to rebuild core nursing staff continued to progress. The quarter was also bolstered by the recognition of \$58M of FEMA reimbursement for external contract labor costs incurred in prior years as a direct result of the COVID-19 pandemic.

Total surgical volume, including ASC outpatient surgeries, increased 3.0% over the fourth quarter of 2022 and finished 10.0% better than the same quarter in the prior year. The medical/surgical mix climbed to 22.5% on a year-to-date basis compared to 20.9% in 2022. Acute length of stay declined 5.2% year-over-year as the incremental burden created by the pandemic has largely subsided. Coinciding with the decline in length of stay, the overall case mix index ended the quarter at 1.81 versus the prior year's 1.85. Outpatient emergency department registrations, physical therapy visits, and imaging procedures increased 3.3%, 9.0%, and 7.0% over the prior year, respectively.

Total revenue for the quarter was \$3.5B, a 9.8% increase over 2022. Contract labor cost was reduced by \$57M, or 26.0%, through a combination of reduced rate and lower utilization. Supply expense as a percentage of net patient service revenue was 23.1% for the quarter, a 1.8% increase over the prior year primarily driven by inflationary pressures.

Banner's Insurance division generated operating income of \$38M during the quarter on \$896M of total revenue, for an operating margin of 4.2%. The operating income and total revenue were the highest totals recognized in a single quarter since the inception of the division. The total revenue was a 20.1% increase over 2022, while the operating income represented a \$40M year-over-year improvement. Full risk membership increased 16.4% over 2022, highlighted by a 61.4% increase in Banner's commercial insurance joint venture, Banner—Aetna. The division's combined medical loss ratio has improved year-over-year from 91.0% to 86.4%; medical loss ratios for most lines of business declined (improved) as management continues to mature its overall care management and utilization review capabilities. The Insurance division has served as a natural hedge to the pandemic-driven disruption of Care Delivery financial performance as Banner continues to grow its insurance strategy across commercial, Medicare, and Medicaid products. Insurance premium revenue now represents 25.3% of Banner's overall operating revenue stream.

**Financial Highlights**  
(\$000's in millions)

	<b>FY 2021</b>	<b>FY 2022</b>	<b>Q1 2022 YTD</b>	<b>Q1 2023 YTD</b>
Revenue	\$12,359	\$12,656	\$3,195	\$3,508
Operating expenses	12,232	12,639	3,241	3,380
Operating EBIDA	830	712	132	286
Interest, depreciation and amortization	703	695	178	158
<b>Net operating income (loss)</b>	<b>127</b>	<b>17</b>	<b>(46)</b>	<b>128</b>
Nonoperating income (loss)	701	(398)	(96)	184
Excess of revenues over expenses attributable to non-controlling interests	78	66	29	20
Excess (deficiency) of revenues over expenses attributable to Banner Health	\$750	\$(447)	(\$171)	\$292
Operating Margin	1.0%	0.1%	-1.4%	3.7%
Operating EBIDA Margin	6.7%	5.6%	4.1%	8.2%

Net operating income (loss) for the three months ended March 31, 2022 and 2023 are reflected in the tables below, by reporting division:

**For the Three Months Ended March 31, 2023**

(\$ in thousands)	Care Delivery	Insurance Operations	Eliminations/ Other	Sub-total Recurring Operations	PRF/ FEMA	Consolidated
Operating Revenue	\$ 2,756,531	\$ 896,472	\$ (202,832)	\$ 3,450,171	\$ 57,928	\$ 3,508,099
Operating Expense	2,723,462	858,597	(202,074)	3,379,985	0	3,379,985
Operating Income	\$ 33,069	\$ 37,875	\$ 758	\$ 70,186	\$ 57,928	\$ 128,114

**For the Three Months Ended March 31, 2022**

(\$ in thousands)	Care Delivery	Insurance Operations	Eliminations/ Other	Sub-total Recurring Operations	PRF/ FEMA	Consolidated
Operating Revenue	\$ 2,607,285	\$ 746,569	\$ (193,686)	\$ 3,160,168	\$ 34,626	\$ 3,194,794
Operating Expense	2,677,752	748,838	(185,723)	3,240,867	0	3,240,867
Operating (Loss) Income	\$ (70,467)	\$ (2,269)	\$ (7,963)	\$ (80,699)	\$ 34,626	\$ (46,073)

Performance results for Banner's Care Delivery and Insurance Operations Divisions for the three months ended March 31, 2023 include the following highlights:

**Care Delivery** recognized an operating income of \$91M in the first quarter of 2023, including FEMA reimbursement. Banner's hospitals continue to recover from the impact of crisis-level stress on clinical workers over two plus years that contributed to the 'great resignation' experienced broadly across the U.S. healthcare landscape, requiring unprecedented utilization of external contract labor at hyper-inflated rates. The academic medicine segment of Banner's Care Delivery division saw a 16.3% increase in total revenue and a \$82M improvement in operating income over the prior year. Banner's commercial lab joint venture - Sonora Quest Laboratories (SQL) contributed operating income of \$17M for the quarter which was a \$43M decline from 2022 as the volume of lab testing has stabilized close to historical norms.

Year-to-date net healthcare revenue of \$2.5B (before eliminations) was 4.9% higher than 2022 with strong increases in hospital net healthcare revenue being reduced partially by the decline in commercial lab revenue. Continued same store and de novo growth in free-standing surgery centers resulted in a 35.5% increase in net healthcare revenue. Additionally, there was modest growth across several other ambulatory business lines.

The shortage of core labor contributed to constrained hospital capacity throughout mid-2022 however, Banner has since experienced a net gain in core nurse staff and has supplemented that staff with contract labor to accommodate the increased volume. Management remains vigorously focused on recovery of its core business and realignment of staffing practices and labor costs.

The **Insurance Division** produced a \$38M operating gain in the first quarter of 2023, compared to \$2M loss in the prior year. Insurance Operations are organized in three sub-divisions: commercial insurance plan joint venture (Banner|Aetna); Banner Health Network (BHN) plans; and Banner University Health Plans (BUHP).

1. **Banner|Aetna (joint venture)** recognized a \$11M year-to-date operating gain, rebounding from a \$4M operating loss in 2022. Full risk membership has increased 61.4% over the prior year. Banner|Aetna covers roughly 425,000 commercial member lives in Arizona with roughly 75% of those members covered under self-funded (ASO) contracts. Note — Banner records full financial consolidation for the Banner|Aetna joint venture.
2. **BHN plans (primarily Medicare Advantage risk contracts and Banner's stand-alone MAPD)** contributed a \$1M operating gain in the first quarter; a \$16M improvement over the prior year. The improvement was driven by increases in MSSP and other commercial insurance shared savings arrangements. Now in their third year of operation, Banner Medicare Advantage Plans have experienced significant membership growth and currently cover nearly 14,000 members.
3. The **BUHP (Medicaid) plans** posted a year-to-date operating gain of \$26M versus the prior year gain of \$18M. Membership has grown 8.0% year-over-year while the medical loss ratio improved from 87.3% to 84.9%. Higher administrative investments have resulted in improving care coordination activities to reduce avoidable utilization which has produced sustained profitability. BUHP combined is the 3<sup>rd</sup> largest Medicaid plan in Arizona.

### **Non-Operating Performance**

First quarter investment performance was positive, resulting in investment income of \$205M as investment markets withstood short-lived turbulence in the banking sector and additional policy rate increases by the Federal Reserve to slow inflation. Interest rate swaps yielded a \$17M unrealized loss in the first quarter of the year versus a \$79M unrealized gain at the same point in 2022. 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**

CMS recoupment of Medicare Advanced Payments and downward pressures on investment markets, resulting in primarily unrealized losses, had an adverse impact on the indicators in 2022 but performance in the first quarter of 2023 has provided stabilization as shown below:

	<u>2021</u>	<u>2022</u>	<u>Q1 2023</u>
Long-Term Debt to Capitalization	35.5%	36.0%	34.9%
Days Cash on Hand	256	218	225
Cash to Long-Term Debt	190%	173%	183%
Historical Annual Debt Service Coverage	5.9	3.7	N/A