



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

**For the Three Months Ended March 31, 2020**

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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, 2019. 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, 2020**

#### **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.

For internal management and reporting purposes, Banner has organized itself into two general 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 provider services, including its joint ventures; (2) Insurance Operations includes Banner’s accountable care organization including CMS MSSP operations, BHN health plans including delegated risk contracts from MAPD plans, its minority interest in Banner—Aetna for commercial insurance, and its Medicaid/AHCCCS contractor plans.

#### **COVID-19 Update**

Banner began organizing and preparing for the onset of COVID-19 in late January 2020, establishing an Emergency Operations Command (“EOC”) led by its Chief Clinical Officer (“CCO”). The EOC serves as a multi-disciplinary leadership command center to coordinate national, state and local guidance and information regarding COVID-19, and translate such evolving information across Banner operations. The CCO and leader of the EOC partnered with Banner’s Chief Operating Officer (“COO”), Chief Human Resources Officer (“CHRO”) and clinical leaders across the enterprise to coordinate Banner’s full COVID-19 response for patient safety, workforce safety, and all operating capacity and resource decisions in the face of this pandemic. The EOC established a daily briefing with Banner’s Senior Leadership Team (“SLT”) including Banner’s CEO and the direct reporting executives to the CEO. This structure allowed Banner to remain informed, implement coordinated clinical and operating decisions, and communicate effectively both inside Banner and to the communities and outside agencies engaged in this crisis.

Banner also owns (51%) of and operates Sonora Quest Laboratories, a joint-venture with Quest Diagnostics, which is the region's largest outreach diagnostic lab operation. SQL has been deeply involved in providing capacity for COVID-19 testing for the entire state of Arizona. Banner's Supply Chain operation served to provide continuous patient protective equipment ("PPE") throughout the crisis, maintaining ranges of 10-21 days of PPE inventory at Banner hospitals across six states. Banner's Supply Chain operates under a bulk-purchasing model, with its own supply warehouse and distribution center located in Chandler, Arizona. By purchasing direct from manufacturers and group purchasing organizations, Banner's Supply Chain operation avoids many of the distributors that could interfere with its supply chain. Banner is also an owner / member of Premier, Inc., a group purchasing organization that supports Banner's supply chain. Banner's deep participation with Premier's supply and pharmacy programs have provided invaluable access to products and resources throughout this crisis.

Beginning in mid-March 2020, Banner began incurring impacts from the COVID-19 pandemic, including community shelter in place orders and restrictions around elective health care services immediately impacting patient volumes and corresponding revenues. During the second half of March 2020, Banner experienced declines in both inpatient and outpatient volumes in its hospitals by ranges of 20% - 30% as a result of limited elective services and general public concern about utilizing hospitals. Deeper volume declines were experienced in many of Banner's ambulatory facilities, including ranges of 40% - 60% declines in certain outpatient imaging centers, ambulatory surgery centers, and employed physician clinics. Many of Banner's hospitals include higher levels of care less impacted by community restrictions, including Level I Trauma Centers, tertiary and quaternary programs such as organ transplantation services, open heart programs, and several of its complex surgical programs. These, mainly inpatient, services continue to support Banner's hospitals during the pandemic period.

For the first two months of first quarter 2020, Banner experienced strong growth of patient volumes, including 3.7% growth in adjusted admissions year over year, and posted strong financial results including a 4.4% operating income margin compared to 3.5% in the prior year two months. Both Care Delivery and Insurance divisions were performing well ahead of prior year activity. The onset of the COVID-19 pandemic and many of the community restrictions served to undermine the early 2020 performance, resulting in a 1.3% operating income margin for the first quarter ended March 31, 2020.

Management continues to monitor the effect of COVID-19, as Banner is now approaching relaxed restrictions and resumed elective services on or before May 1<sup>st</sup> in Arizona and Colorado. Banner's largest market, Arizona, was less impacted by COVID-19 compared to other markets across the country. The University of Washington Institute of Health Metrics and Evaluation ("IHME") projected as of April 29, 2020, that the peak of COVID-related hospital resource demands in Arizona will have occurred on May 1, 2020, and that Arizona's hospital and ICU bed supply has and will continue to greatly exceed the demand. Banner's experience to date is consistent with this projection. The Arizona projection contrasts with the IHME's projection as to the national shortage of hospital and ICU beds when the national peak of COVID-related resource demands occurred on April 19, 2020. Management believes this suggests that Banner's recovery from the current wave of COVID-19 infection may begin sooner than expected. Federal stimulus support dollars have also been instrumental in mitigating some of the financial burden from this crisis, with more federal funding anticipated from disbursement of funding authorized under the CARES Act and other COVID-19-related legislation. To date, Banner has received approximately \$140 million of deposited funds from first-wave stimulus funds, and also has received more than \$600

million of Medicare Advance and Accelerated Payments to support liquidity needs during the balance of 2020. Management will continue to monitor the COVID-19 crisis, recovery period activities, and various sources of stimulus and grant (FEMA) funding as Banner proceeds forward from peak crisis activity to re-activation of its business operations and strategies.

On April 16, 2020, Banner converted \$300 million of outstanding self-liquidity variable rate demand bonds to Floating Rate Notes. The conversion serves to safeguard these bonds from trading and put risk, for 9 to 12 months. At the end of this period, management currently expects to convert the interest rate mode on these bonds to self-liquidity variable rate bonds and publicly re-offer such bonds. Banner has also obtained a new bank line of credit totaling \$150 million from Bank of America, N.A. Together with Banner's bank syndicate credit facility of \$400 million (which will be available in its entirety after the draw of approximately \$301.6 million related to the NCMC acquisition is repaid with proceeds of the Series 2020A Bonds), Banner will have access to \$550 million in lines of credit to support liquidity needs.

### Three Months Ended March 31, 2020

Banner generated \$30.6 million of operating income and a net loss of \$683.5 million during the first quarter of 2020. These results equate to operating and operating EBIDA margins of 1.3% (\$30.6M) and 7.9% (\$188.3M), respectively, on total operating revenue of \$2.4 billion. As of the end of February 2020, several year-to-date patient volumes reached their highest levels in Banner's history before COVID-19 caused the Governor of Arizona to require Banner to limit elective surgical procedures and mandate a shelter-in-place order for the community beginning in mid-March. Nevertheless, first quarter net operating revenue increased 2.0% over the prior year. Insurance operations posted a \$0.3M profit in the first quarter driven by declining readmissions rates and an improved medical loss ratio as claims slowed amid the pandemic.

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

	2018	2019	Q1 2019	Q1 2020
Revenue	\$8,519.8	\$9,426.6	\$2,327.8	\$2,373.8
Operating Expenses	8,333.5	9,226.2	2,240.4	2,343.2
Operating EBIDA	727.6	800.9	223.7	188.3
Interest, Depreciation and Amortization	541.3	600.5	136.3	157.7
Operating Income	186.3	200.4	87.4	30.6
Nonoperating (Loss) Income	(142.3)	526.4	240.1	(714.1)
Excess (Deficiency) of Revenues over Expenses	44.0	726.8	327.5	(683.5)
Operating Margin	2.2%	2.1%	3.8%	1.3%
Operating EBIDA Margin	8.5%	8.5%	9.6%	7.9%
Total Margin	0.5%	7.3%	12.8%	-41.2%

Unrealized investment losses for the quarter were \$580.7 million, roughly 10% of Banner's more than \$5 billion investment portfolio, as a result of the worldwide economic retreat caused by the COVID-19 pandemic. Banner's fixed-payer interest rate swaps generated a mark-to-market loss of \$133.8 million year to date, as interest rates declined.

Operating income (loss) for the quarters ended March 31, 2020 and 2019 are reflected in the tables below:

**For the Period Ended March 31, 2020**

<i>(\$ in thousands)</i>	<u>Care Delivery</u>	<u>Insurance Operations</u>	<u>Eliminations/ Other</u>	<u>Consolidated</u>
Operating Revenue	\$ 2,080,361	\$ 444,691	\$ (151,224)	\$ 2,373,828
Operating Expense	<u>2,037,343</u>	<u>444,427</u>	<u>(138,586)</u>	<u>2,343,184</u>
Operating Income	<u>\$ 43,018</u>	<u>\$ 264</u>	<u>\$ (12,638)</u>	<u>\$ 30,644</u>

**For the Period Ended March 31, 2019**

<i>(\$ in thousands)</i>	<u>Care Delivery</u>	<u>Insurance Operations</u>	<u>Eliminations/ Other</u>	<u>Consolidated</u>
Operating Revenue	\$ 2,024,364	\$ 474,502	\$ (171,106)	\$ 2,327,760
Operating Expense	<u>1,933,369</u>	<u>495,634</u>	<u>(188,646)</u>	<u>2,240,357</u>
Operating Income (Loss)	<u>\$ 90,995</u>	<u>\$ (21,132)</u>	<u>\$ 17,540</u>	<u>\$ 87,403</u>

Performance results for Banner's Delivery and Insurance Operating Divisions for the three months ended March 31, 2020 include the highlights that follow:

Care Delivery Operations

- Acute cases and emergency department registrations ended the quarter lower than prior year after being at record levels through February, as patient volumes continued to exhibit growth in Banner's core markets pre-COVID-19
- Net healthcare revenue per adjusted admission increased 4.7% year over year, reflecting modest increases in reimbursement rates and strong performance in revenue cycle operations
- Expanded telehealth program from roughly 300 providers to nearly 7,000 providers over the course of ten days to support the evolving pandemic crisis
- 19.4% growth in urgent care visits and 121.9K free-standing imaging procedures, help to provide lower cost points of care in support of Banner's insurance strategy
- Employed physicians have increased 4.3% year over year as Banner continues to invest in new (employed) providers to expand its care delivery footprint – with a particular emphasis on primary care services
- Premium labor as a percentage of worked hours declined 4.0%, reflecting Banner's ongoing attention to effective cost management

## Insurance Operations

- Insurance premium revenue represented 18.3% of total system revenue for the quarter, a slight decline over 2019 as Banner no longer has delegated risk from the Blue Advantage MA plan
- Combined medical loss ratio improved from 95.1% to 91.2% year over year, as Banner continues to improve care management, concurrent review, and overall risk strategies to effectively operate within Medicare Advantage and Medicaid programs
- Insurance plan joint ventures contributed \$4.5M of operating income during the quarter, driven primarily by Banner’s joint venture with Aetna for commercial insurance offerings in Arizona
- Significant growth in Banner—University Health Plans (Medicaid) membership (15.8% over last twelve months), driven by contract expansion to Maricopa County
- Membership in Banner—Aetna commercial insurance plans continues to exhibit rapid growth in Arizona, now with nearly 350,000 members, a 10.9% increase over first quarter of the prior year
- Management has continued to develop risk-scoring and quality (Star-ratings) data procedures to drive corresponding premium revenue and margin opportunities

	<b>Q1 2019</b>	<b>Q1 2020</b>
BHN – Full Risk*	57,045	17,891
Banner Employee – Full Risk	83,698	85,252
Medicaid Contractor Plans	213,482	247,180
<b>Total Full Risk Lives</b>	<b>354,225</b>	<b>350,323</b>
BHN/Banner—Aetna - Shared Risk	544,844	542,018
<b>Total Lives</b>	<b>899,069</b>	<b>892,341</b>

\*Note: decline in full risk lives reflects the termination of the Blue Advantage risk delegation contract to BHN, as Banner sold its 50% interest in Blue Advantage to BCBSAZ in December 2018. 2019 was the final year of the risk contract. Banner expects to backfill this MAPD strategy with its new stand-alone plan offering later this year for coverage effective January 1, 2021.

Banner’s balance sheet indicators have remained strong through 2019, being negatively impacted by the COVID-19 pandemic in the first quarter of 2020, as shown below:

	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>Q1 2020</b>
Long-Term Debt to Capitalization	35.0%	35.3%	33.7%	35.7%
Days Cash on Hand	246	214	225	192
Cash to Long-Term Debt	161%	151%	167%	146%
Maximum Annual Debt Service Coverage	4.9	4.6	4.0	4.0