



Industry Sector Report

Health Care Industry Insider

2014
SONOMA COUNTY

SONOMA COUNTY
EDB
ECONOMIC DEVELOPMENT BOARD

SONOMA COUNTY
WORKFORCE INVESTMENT BOARD

2014 Health Care Industry Insider

July 2014

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2014 Health Care Industry Insider for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the 2014 Health Care Industry Insider include:

- Sonoma County's healthcare industry will experience greater demand in coming years, stemming from faster than average growth in the county's share of senior population.

- Sonoma County hospitals will utilize a smaller share of their beds than the state average. This will result partly from a continued shift toward home care services for retirees and partly from new facilities such as the Sutter Medical Center in Santa Rosa, which elevate competition.

- Implementation of the Affordable Care Act will remain the main driver of health care industry in the next several years. In Sonoma County, it has the potential to generate significant savings in the large Medicare program, which will make the use of advanced medical technology related products more affordable to many health-care providers.

- Sonoma County's consumer credit quality has continually improved in the last four years, and better private balance sheets will help the timeliness of compensation paid by consumers to healthcare providers.

Thank you for your interest in the Economic Development Board's research. For additional information, questions, comments, or suggestions please contact us at (707) 565-7170 or visit www.sonomaedb.org.

Sincerely,

Pamela Chanter
Chair
Economic Development Board

Ben Stone
Executive Director
Economic Development Board

Recent Performance

Sonoma County's recovery shifted to a higher gear toward the end of 2013 as considerable gains in consumer-driven industries such as leisure/hospitality led the way. Unfortunately, healthcare failed to post similar gains. Healthcare payroll growth outpaced California's in 2012, but weakness took hold in 2013, when Sonoma County experienced the same tepid healthcare employment gains as occurred in the state and nation. Most of the softening came from hospital hiring, which in the last quarter of 2013 fell by nearly 4% compared with the same quarter of 2012. Even ambulatory services employment growth, which has been stronger than hospital payroll increases nationally, has been moribund since the end of 2012.

Consumers' balance sheets have improved significantly, and delinquency rates, including those for mortgages, autos and bankcards, have reached post-recession lows and stand below state and national averages.

California's acute-care hospitals may lose up to $17 billion in Medicare reimbursement cuts for the period from 2010 to 2020, according to the California Hospital Association. The healthcare law also reduces Medicare-related payments to hospitals that report readmissions within 30 days of discharge following a patient's treatment for a major illness.

Sonoma County hospitals are better prepared to deal with such problems than most hospitals in the state, however. The opening of Sutter Medical Center in Santa Rosa later this year indicates that competition through innovation will drive the industry for years to come. More important, recognizing the needs that come with a growing senior population, Sonoma County hospitals have created a tradition in home health services, as a shift from hospital care to home services began nearly two decades ago, but the Affordable Care Act has triggered an acceleration in such trends as hospitals contend with reduced Medicare payments and penalties from excessive readmissions. The latest example of such a shift is the Sonoma Valley Hospital's initiative to expand its home health services by rebranding its Healing at Home program. The rebranded program counts nearly 1,000 weekly home visits and has grown 28% in the last five years, according to program administrators, who see a window of opportunity in the expansion of outpatient services in the valley.

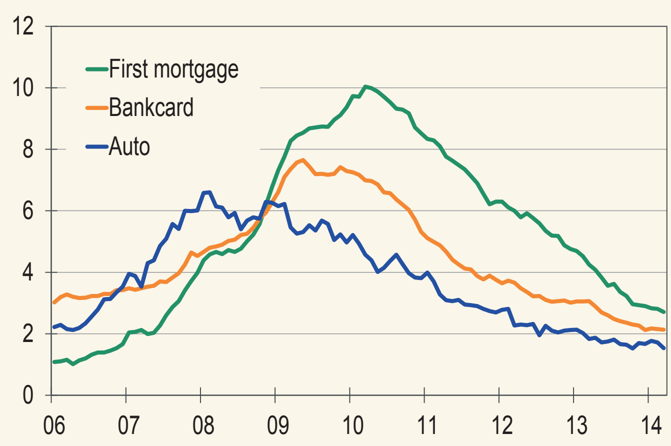
Macro Drivers

The U.S. economy is expected to grow at a faster rate this year, bringing the recovery closer to completion. Economic growth amounted to 1.9% in 2013, but with several challenges left behind, including the fiscal drag and weather-related adversities, stronger broadbased gains should soon take hold. Despite a weaker than expected first quarter, mainly because of weather and weaker than anticipated housing market gains, U.S. economic activity is projected to accelerate to 3.9% in the second quarter, amounting to 3% growth by year's end. The pace should accelerate to 4% by 2015 but, given the delay, full employment should be achieved only by fall 2016. Such predictions, however, are subject to downside geopolitical and natural disaster-related risks.

The U.S. labor market received encouraging news from the Bureau of Labor Statistics jobs report for April, as the U.S. economy created 288,000 positions in the nonfarm private sector and upward revisions were made to previous months. A lower than expected influx of labor force entrants, however, is concerning and drove the unemployment rate down from 6.7% to 6.3%. Sonoma County's unemployment rate has also been falling, and it stood at 5.7% in March, well below the state and the national rates. More important, the decline has been happening as many are returning to the labor force, which has reached an all-time high. The recovery is incomplete, however, as Sonoma County has recovered only about three-quarters of all the jobs lost to the Great Recession.

Equifax data show that credit quality has improved significantly post-recession, which bodes well for Sonoma County's healthcare industry. All types of consumer delinquency rates are nearing post-recession lows and are well below the U.S. average.

Improved Credit Quality Bodes Well for Sonoma
Delinquency rate, % by $ volume, NSA



Sources: Equifax, Moody's Analytics

Chart: *Sonoma County's consumer credit quality has continually improved in the last four years, and better private balance sheets will help the timeliness of compensation paid by consumers to healthcare providers. Auto loan, bankcard and mortgage delinquencies have reached post-recession lows. The county and the state experienced more housing woes than the U.S., and with that drag almost entirely in the past, the state and county economies are poised to grow faster than the nation's in the coming years. Despite short-term adjustments, healthcare will benefit.*

The foreclosure rate had been above the national average for a lengthy period following the recession, but that changed in early 2013 when the county's foreclosure rate inched lower than that of the state and U.S., according to RealtyTrac data. This depleting supply of distress properties will soon help house prices tick up.

Sonoma County's population outlook remains positive despite the weak 2010 decennial population. The county's population growth will remain slightly ahead of that of California and the U.S., according to Moody's Analytics estimates. The expanding population of retirees is both a challenge and an opportunity, as it poses long-term labor force hurdles but also will support the demand for health services. The county's elderly population increased 5.7% in 2012 from 2011, faster than the 3.5% rate for California and the U.S., according to the same estimates.

California's budget outlook has improved substantially recently, mainly because of healthy gains in local property tax growth, and the improved outlook will support Sonoma County's economic activity as well. The state is projected to have $5.6 billion in reserves at the end of fiscal 2014-2015, according to the Legislative Analyst's Office, which suggests that the budget for the fiscal year that begins in July will pose no major obstacles to the state funded insurance programs. The medium-term outlook seems even brighter, as the state is projected to generate surpluses and put many fiscal woes in the past.

Meanwhile, the national healthcare reform combined with an improved fiscal outlook has triggered some action in the state. For instance, the Assembly's Committee on Health unanimously voted to bring the Medi-Cal primary care provider rates at par with Medicare, as the ACA requires.

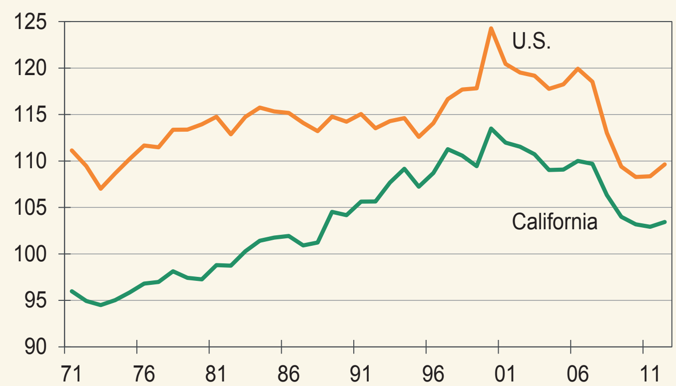
Industry Drivers

Implementation of the ACA will remain the main driver of the healthcare industry in the next several years. The law has led to broader health insurance coverage and significant ongoing changes in the industry. The end of the marketplace open enrollment period found nearly 1.4 million Californians enrolled in a health insurance plan through the Covered California exchange and a total of 3 million, including those enrolled through Medi-Cal, have health insurance coverage. In an effort to address rising healthcare costs, the ACA uses a carrot-and-stick approach to reward providers for quality coordinated care and punish providers engaged in malfeasance, waste and inefficient practices.

The creation of more than 360 Medicare Shared Savings entities coined as Accountable Care Organizations-organizations of various stakeholders interested in being better stewards of people's time and money—marks a significant step toward controlling costs by coordinating care through better record-sharing, while introducing other innovations such as new payment methods aimed at shifting the industry away from fee-for-service and adopting an outcome-based approach to delivering healthcare. Though early, the first results are encouraging, according to the Center for Medicare and Medicaid Services. Some of the pioneer ACOs, a few of which are located in California, have managed to reduce cost growth, while maintaining or improving the quality of care they deliver. Among the concerns that have arisen are the cost burden of revamping the technology that allows record-sharing and the likelihood that unrestricted patient choice could prove challenging to some ACOs.

Sonoma County Income Growth Still Stronger

Per capita income indexed to...



Sources: BEA, Moody's Analytics

Chart: *Despite losing some ground during the last decade, Sonoma County residents' above-average incomes have helped the county weather past and current difficulties. Some of the most problematic hospital care costs not related to the Affordable Care Act are related to bad credit and uncompensated care. Fortunately, Sonoma County's share of low income residents in need of charity care is relatively small, allowing hospitals to focus on aspects of delivering care. Health exchanges with subsidies and the Medi-Cal program have combined to bring the pool of the uninsured to a new low.*

The low rates to Medicaid providers are the reason why California providers have the second lowest rate in the nation when it comes to accepting new Medicaid patients, according to the co-sponsor of the bill, Assemblyman Richard Pan (D-Sacramento). More than a fourth of the state's population is on Medi-Cal, and the refusal of providers to take new Medi-Cal patients has been a problem for years; for some Californians health insurance has been almost useless because no doctor has been willing to accept them as patients. Now that the fiscal outlook has improved, the state is easing any previously imposed tightening on healthcare. For example, the Assembly's Committee on Health has also passed a bill to undo a 10% cut imposed on Medi-Cal providers in 2011.

Improvements in healthcare to comply with state and federal regulations, including the ACA, are costly but necessary and will help the industry in the long term. For instance, the Sonoma County Department of Health Services is replacing the current pre-hospital electronic patient care records with a reliable and customizable web-based system that will make the EMS Agency more responsive in meeting the growing demand for healthcare.

Pricing

Health insurance premiums will increase in the near term in California. The rise, however, will take place at a slower pace by 2015 than previously thought. More important, for many recently enrolled Californians, subsidies will help reduce the actual out-of-pocket cost. According to the California Healthcare Foundation, health insurance premiums have risen 185% since 2002 and the premiums paid by workers in 2013 were 22% of the total premium for single coverage and 33% for family coverage, significantly higher than a year earlier. Meanwhile, fewer employers are offering health insurance: only 61% in 2013 compared with 69% in 2000. A growing number of employers nationally are offering their employees a high-deductible plan combined with a health savings account, according to the Employee Benefit Research Institute.

Operating Expenses

Now that some of the most important Medicare provisions of the ACA have been implemented and several others will take effect by the end of the year, the focus of Sonoma County's healthcare providers will be on cost-containment. Hospital wage and salary disbursements were growing quickly before the Great Recession until financial difficulties forced significant cuts. Hospitals have been relatively conservative in their spending ever since; thus wage and salary expenses have grown more slowly recently.

The healthcare law is aiming to cut costs by lowering the number of hospital readmissions within 30 days of discharge. Despite the fines for the excessive number of readmissions imposed on 2,225 hospitals in 2012, some 384 hospitals nationally still have high readmission rates and are facing steep penalties.

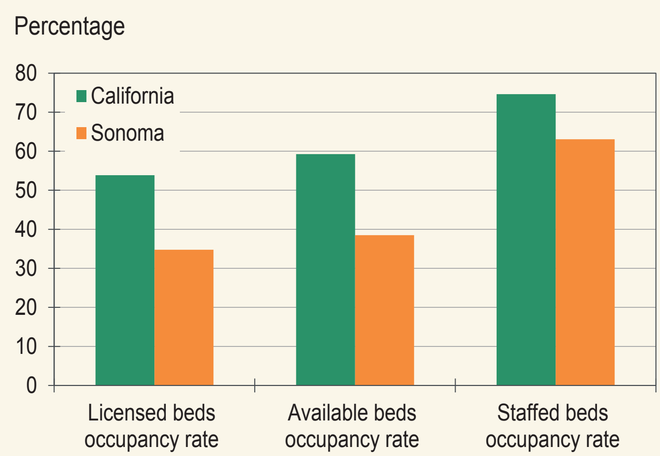
Fortunately, most California hospitals are below the national average and are focusing on improving record-sharing and the quality of care. Most California hospitals either outperform or match the national averages in readmissions because of all-cause hospital-wide readmissions, according to recent Center for Medicare and Medicaid Services data.

Profitability

Sonoma County will face near-term headwinds as cuts to reimbursement rates and a relatively fluid regulatory environment will undermine profitability. Operating expenses grew faster than operating revenues last year, reducing net income from $20.7 million in 2012 to $5.3 million in 2013, according to data from the Office of Statewide Health Planning and Development.

District hospitals will get a break now, as they may no longer need to treat a large number of uninsured residents. Recent enrollment through healthcare exchanges and the Medicaid program have considerably reduced the number of uninsured in the county.

Sonoma County Has More Beds to Fill



Sources: State of California, Moody's Analytics

Chart: *Sonoma County hospitals will utilize a smaller share of their beds than the state average. This will result partly from a continued shift toward home care services for retirees and partly from new facilities such as the Sutter Medical Center in Santa Rosa, which elevate competition. Increased competition will lead to winners and losers, as some hospitals will thrive, while others such as Palm Drive Hospital in Sebastopol will end their operations. The county's low utilization rates of hospital beds raise questions about whether more beds are needed.*

Moody's Analytics Health Care Report

The finances of some noncompliant healthcare institutions will be squeezed by a key provision of the American Recovery and Reinvestment Act of 2009 that has recently gone into effect. Incentives for adopting electronic records were introduced as a way to stimulate the economy and their use was initially optional, but that is about to change as the healthcare reform mandates the adoption of such records. Starting in 2015, the government will penalize, by reducing Medicare reimbursement rates, providers that fail to show they are adopting an electronic medical records system.

Long Term Outlook

The uncertainty stemming from various provisions of the healthcare reform will fade over time. Increasing demand for health services due to a greying population, which is also wealthier than average compared with the state and nation, will strengthen Sonoma County's healthcare over the long term. The recent slowdown in healthcare spending growth combined with the ACA's crackdown on inefficiency, fraud and abuse will provide healthier ground for the national healthcare system. The life of an optimally funded Medicare trust fund, the time until Medicare begins to pay out more than it takes in, has been extended to at least 2029, according to the most recent trust report, and Sonoma County retirees will benefit. Some uncertainty about the program's future remains, however.

Sonoma County's healthcare industry is also poised to benefit from a recent shift toward outpatient services as providers have been gearing up for a while now and the county is well-positioned to facilitate the rising demand for health services among its retirees.

Upside Risks

The healthcare reform has the potential to generate significant savings in Sonoma County's large Medicare program and across the nation. Such savings will make the use of advanced medical-related technology more affordable to many healthcare providers. Being home to many such products, Sonoma County will immensely benefit, as growth in healthcare will spill over to other sectors as demand for medical products design and manufacturing increases.

Downside Risks

The uncertainty that comes with the implementation of the remaining provisions of the ACA is a potential downside risk to the economic outlook in general and the healthcare industry in particular. The penalties for 30-day readmissions related to joint replacement surgeries, emphysema, and chronic obstructive pulmonary disease set to take effect in October could place significant strains on hospital financials, undermining industry growth.

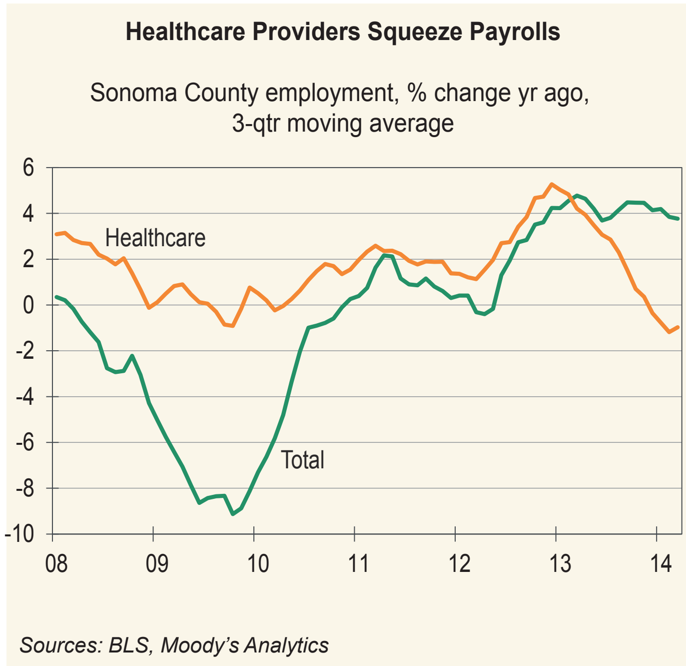


Chart: *Sonoma County's healthcare industry will experience greater demand in coming years, stemming from faster than average growth in the county's share of senior population. Necessary adjustments to facilitate the implementation of the healthcare reform, including record-sharing and readmission reductions, will be a near-term drag, as law-compliant healthcare facilities will sometimes need to make tough choices, including adjusting payrolls. Sonoma County hospital payrolls have been shrinking since late 2012 and will remain weak in the near term.*

Ilir Hysa
Moody's Analytics

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