



Industry Sector Report

Health Care Industry Insider

2015
SONOMA COUNTY

SONOMA COUNTY
EDB
ECONOMIC DEVELOPMENT BOARD

Sonoma County
Workforce Investment Board

2015 Health Care Industry Insider

June 2015

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2015 Health Care Industry Insider for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the 2015 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, the law has led to broader health insurance coverage and stronger outpatient services demand. Success in broadening coverage has been more noticeable than other reform goals such as curbing costs.

- Sonoma County's consumer credit quality has continually improved in the last five years. Consumer balance sheets and the delinquency rates, including mortgage, auto and bankcards, have reached new post-recession lows and stand below state and national averages.

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

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Recent Performance

The Sonoma County economy is charging forward. Employment growth has fallen below the California average in recent months but is keeping pace with hiring nationally. Healthcare is also making progress, but the industry is running behind the overall economy because it is still adjusting to an array of Affordable Care Act and state regulations. Such adjustments
have suppressed hiring in recent months. While both California and U.S. healthcare hiring picked up in late 2014, the industry
shed jobs in Sonoma County. Hospitals remain the main source of this weakness. Job losses there started in early 2013, and worsened in 2014 when Palm Drive Hospital
in Sebastopol closed its doors after filing for bankruptcy in 2007. However, area hospitals are faring better than state and national averages in limiting the number of unnecessary
readmissions of Medicare patients. Excessive readmissions are one of the main sources of U.S. healthcare spending growth in recent years. Palm Drive Hospital was the only hospital that was assessed a fine for its readmission rate in fiscal 2015. Now the hospital is reopening under new management as Sonoma West Medical Center and is better
prepared to meet ACA regulations.

Petaluma Health Care District was chosen recently by the Association of California Healthcare Districts as the best-performing district for the year in the state, evidence of the high quality care delivered there. Sonoma County hospitals are also performing well generally in delivering quality care. Medicare officials are cracking down on "hospital-acquired conditions," but no such cases have been reported at Sonoma County hospitals. In fiscal 2015, 721 hospitals across the country, 79 of which are in California, were fined for putting patients at risk, but all six Sonoma County hospitals avoided such fines.

Employment growth in ambulatory care services has modera ed, but the subsector is still hiring as it absorbs some of the ACAaugmented demand. Outpatient services are growing in importance and ambulatory care will remain an important industry driver. The bulk of the newly insured Sonoma County residents, especially the young and healthy, will use the services offered under their plans in outpatient settings.

Consumers' balance sheets have further improved and the delinquency rates, including mortgage, auto and ban cards,have reached new post-recession lows and stand below state and national averages.

Macro Drivers

After experiencing a setback in the first quarter, the U.S. econ my is expected to expand at a faster clip later this year. The bad winter weather, combined with disruptions from the now-settled strike at West Coast ports and cutbacks in energy-related investment due to lower oil prices, may have taken a conside able bite out of first quarter growth. Moody's Analy ics estimates that such factors combined have taken 1.5 percentage points out of GDP growth for the quarter, leaving annual increases around 3%.

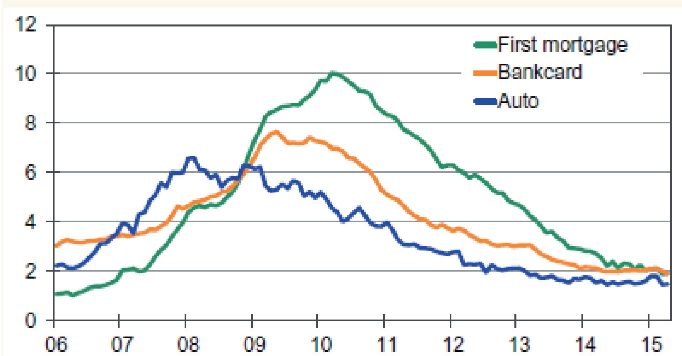
The pace should further accelerate and be somewhere north of 3% in 2016. Given the drop in the unemployment rate, full employment should be achieved by summer 2016. The main threat to this outlook is the surging value of the U.S. dollar.

The U.S. labor market is tightening, as the economy is creating, on average, more than 200,000 jobs a month. Despite the fact that better employment prospects have drawn more workers into the labor force, the unemployment rate dropped to 5.4% in April, the lowest in seven years. Sonoma County's unemployment rate has also been falling and reached a seven-year low of 4.5% in March, well below the state and the national rates.

Credit quality has improved significantly in the post-recession period, according to credit bureau Equifax, and is helping support spending in Sonoma County's healthcare industry. All types of consumer delinquency rates are now near post-recession lows and are well below U.S. averages. The foreclosure rate had been above the national average throughout the recession and early recovery, but that changed in 2013 when the county's foreclosure rate inched lower than the state and the U.S. rates, according to RealtyTrac.

The county's population gains will remain slightly ahead of those of California and the U.S., according to Moody's Analytics. The expanding population of retirees is both a challenge and an oppo tunity, as it poses long-term labor force hurdles but also will conti ue propping up the demand for health services. The county's population of 65 and over residents increased 5.8% in 2013 from 2012, stronger than the 4.3% rate for California and the U.S., according to the same estimates.

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



Sources: Equifax, Moody's Analytics

Chart: *Healthier household balance sheets, as evidenced by Sonoma County's consumer credit quality, will help the timeliness of conpensation paid by consumers to healthcare providers. Auto loan, bankcard and mortgage delinquencies have advanced to new post-recession lows. The county and the state experienced more housing woes than the U.S, and with that drag almost entirely left behind, the state and county economies are poised to expand faster thant he nation"s in the coming years. Despite short-term adjustments, healthcare will benefit and grow stronger.*

Industry Drivers

The implementation of the Affordable Care Act will remain the main driver of the healthcare industry in the next several years. The healthcare law has led to broader health insurance coverage and stronger outpatient services demand. Success in broadening coverage has been more noticeable than other reform goals such as curbing costs. Further, despite the broader coverage, California has fallen short in meeting its targets. Covered California, the state marketplace for purchasing health insurance, has announced that it will cut both spending and enrollment expectations for 2016. The 2015 enrollment fell short of the 1.7 million goal and barely exceeded the 2014 tally of 1.4 million. This could lead to less marketing and outreach, making it harder to reach particular low- and moderate-income demographics. Further, lower than expected ACA-induced demand for inpatient and outpatient services could weigh on the financial situation of healthcare providers.

Meanwhile, the national experiment of accountable care aimed at curbing costs by coordinating care is gaining more traction. The Obama administration reported recently that the pioneer accountable care organizations saved Medicare nearly $385 million in the first two years of their existence. Some of the pioneer ACOs, a few of which are located in California, have managed to reduce cost growth while mai taining 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 the unrestricted patient choice could prove challenging to some ACOs.

Medicare, the program serving seniors and the disabled, received more good news, which helps put the program on a more stable path. Medicare providers face less uncertainty now that Congress decided to repeal the "doc fix" formula, a rule passed in 1997 that tied physician reimbursement to healthcare spending increases and GDP growth. Congress averted reimbursement cuts by amending the rule, with an annual stopgap measure. The repeal will provide for more stabilityand better Medicare services.

Further, the passage of the bill that repealed the "doc fix" also brought good news for the Children's Health Insurance Program. Doing away with "doc fix" was linked to a two-year extension of the funding for the Children's Health Insurance Program. The continuation of the funding for CHIP will ensure that 1.6 million children and pregnant woman in California continue to receive the care they need, providing a steady demand for healthcare providers in the state.

Thanks to healthy gains in local property tax growth, Califo nia's budget outlook has recently improved substantially and the state is running a surplus. An improved statewide outlook will support Sonoma County's economic activity as well. The state is projected to have nearly $4.6 billion in reserves at the end of fiscal 2015-2016, 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 statefunded insurance programs. The mediumterm outlook seems even brighter; the state is projected to generate surpluses and put many fiscal woes behind.

A revised version of the state budget for fiscal 2015-2016 that Governor Jerry Brown unveiled recently represents a mixed bag for healthcare. The budget allocated for Medi- Cal is $91.8 billion, down by $18.6 billion budgeted in an earlier proposal. Further, the revised budget provides $125 million for rate increases to Medi-Cal managed care plans, but does not address the issue of low reimbursement rates for providers, according to California Health Care Foundation. Despite the broader health insurance coverage, some covered Californians, especially those under Medi-Cal, cannot find a provider. More than half of Medi-Cal patients have trouble finding a doctor, according to California Medical Association. The low rates to Medicaid providers are the reason why California providers have one of the lowest rates in the nation when it comes to accepting new Medicaid patients. As a result, pent-up demand for healthcare services is undermining the gains in the industry.

Sonoma County Income Growth Still Stronger

Per capita income indexed to...

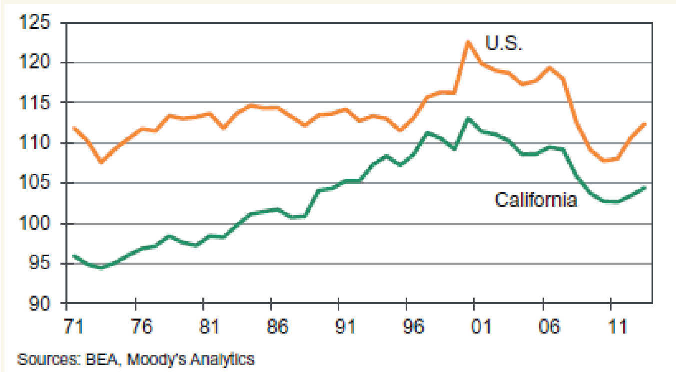


Chart: *Sonoma County residents' above-average incomes have helped the county to weather recessions and will conti ue to do so. Some of the most problematic hospital care costs not related to the Affordable Care Act are related to bad credit and uncompensated care. Fortunately, Sonoma County's share of low-income residents in need of charity care has dropped to new lows, allowing hospitals to focus on aspects of delivering care. Broader coverage has helped bring the pool of the uninsured to a new low, but high-deductible plans are emerging as a significant problem.*

Pricing

Health insurance premiums in California are likely to increase at a faster clip in 2016 than in 2015 and 2014, mirroring the national trend. Insurers are already filing for significant hikes for next year, citing the high costs of pharmaceuticals and unfavorable risk pools, which they are mandated by law to insure. For many recently enrolled Californians, subsidies will help reduce the actual out-of pocket cost, though higher deductibles are an increasing problem, undermining affor ability— the cornerstone feature of healthcare reform. The fast growth of plans with high deductibles is, in part, attributable to a rising number of employers offering their employees a high-deductible plan combined with a health-savings account, according to Employee Benefit Research Institute.

Operating Expenses

The healthcare industry generally and hospitals in particular have become more cost-conscious in recent years, causing them to be relatively more conservative in their spending. As a result, wages and salary expenses have increased more slowly recently. Another way area hospitals have managed to avoid unnecessary spending has been preventing penalties associated with federal reform impleme tation. One important costcutting area the healthcare law is aiming to reform is to lower the number of hospital readmissions within 30 days of discharge. Despite the fines on excessive readmissions assessed on 2,610 hospitals nationally in fiscal 2015, some hospitals still have relatively high readmission rates and are facing steep penalties. Fortunately, the Sonoma County hosp tals were spared such penalties, according to recent Centers for Medicare and Medicaid Services data.

Profitability

Sonoma County healthcare providers will capitalize on stronger demand,

but a fluid regulatory environment will remain a challenge. Operating revenues grew faster than operating expenses last year, allowing net income to increase $10.2 million in 2014 from 2013, according to California Office of Statewide Planning and Development data. Sonoma County hospitals will get a break now as they treat a smaller number of uninsured residents. Recent enrollment through healthcare exchanges and the Medi-Cal program have considerably reduced the number of the uninsured in the county. More importantly, health outcomes in the county are among the best in the state. Sonoma County ranks eighth in that regard, according to Robert Wood Johnson Foundation's County Health Rankings & Roadmaps. Healthcare in the county will continue to experience lots of scrutiny by federal officials, however. For instance, Santa Rosa Medical Center is among the 16 hospitals that agreed to collectively pay Medicare nearly $15.7 million for rendering unnecessary services to Medicare patients. Such payments will weigh on profitability and put downward pressure on the number of inpatient visits.

Long Term Outlook

Sonoma County healthcare will strengt en, as uncertainty stemming from various ACA provisions fades over time. Increasing demand for health services due to a graying population, which is also on average wealthier than state and national averages, will strengthen 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 grounds for the national healthcare system. Such measures have extended the life of an optimally funded Medicare trust fund, the time until Med care begins to pay out more than it takes in, 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 indu try is also poised to benefit from a recent shift toward outp tient services as providers have been gearing up for a while now and it is wellpositioned to facilitate the growing demand for health services among its retirees.

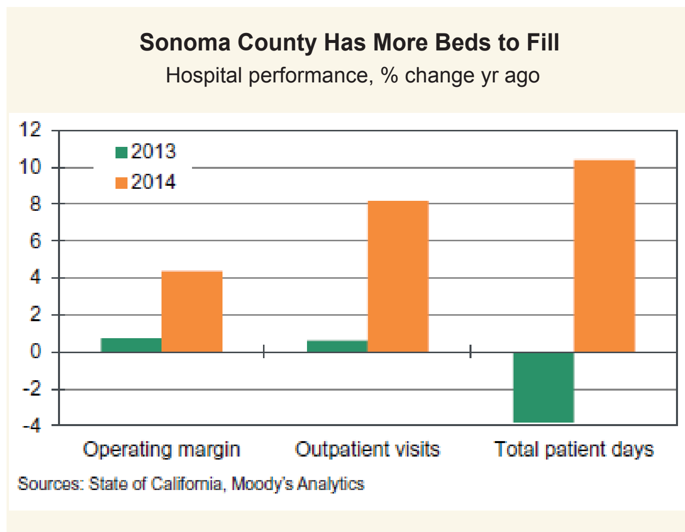


Chart: *Sonoma County hospitals will benefit from a large and growing senior population. Hospitals' 2014 performance shows that, though difficult, it is possible to meet all regul tions and do well financially. The increasing demand for services has prompted the opening of Sonoma West Medical Center in Sebastopol, formerly known as Palm Drive Hosp tal, and will provide for a steady stream of income for healt care providers. The 2014 growth in both inpatient and outp tient services suggests that, as providers learn to comply with regulations, performance will strengthen.*

Upside Risks

The ACA has the potential to generate significant savings in Sonoma County’s large Medicare program and across the nation. Such savings may 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 companies such as Medtronic, the Santa Rosa-based medical device manufactu er, as demand for medical products design and manufacturing rises.

Downside Risks

The uncertainty associated with the ACA implementation is a potential downside risk to the outlook for Sonoma County’s economy in general and the healthcare industry in particular. A pending U.S. Supreme Court decision on exchange subsidies has the potential to undo the financial assistance provision for moderate-income Americans in 34 states, undermining affordability and coverage. This in turn could cause insurers operating in multiple states to lose business, which would drive operating costs up and drive premiums to new highs. This would be more pronounced in states that use the federal marketplace, but would also weigh on states running their own exchanges, including California.

Healthcare Providers Squeeze Payrolls

Sonoma County employment, % change yr ago,
3-qtr moving average

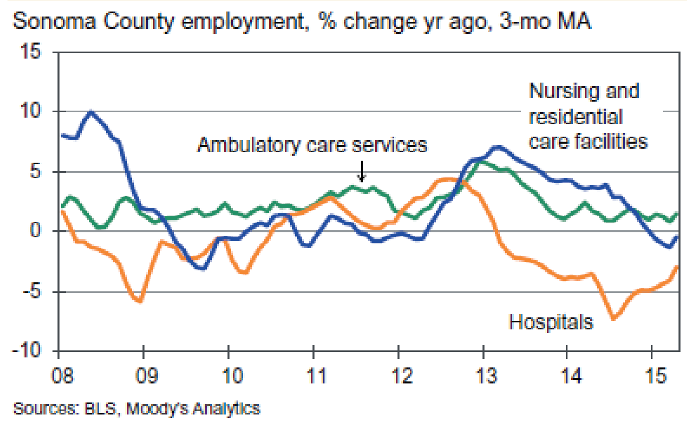


Chart: *Thanks to broader insurance coverage and seniors’ increasing share of the overall population, Sonoma County’s healthcare industry will experience greater demand in coming years. Such augmented demand is already helping to ease job losses at area hospitals. Sonoma County hospital payrolls have been shrinking since early 2013 and will remain weak in the near term. But once the regulatory environment becomes less burdensome, hospitals will be better-positioned to ride the steady growth wave in ambulatory care services in Sonoma County and across the country.*

Ilir Hysa
Moody’s Analytics

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