



Industry Sector Report

Health Care Industry Insider

2016
SONOMA
COUNTY

2016 Health Care Industry Insider

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to present the 2016 Health Care Industry Insider for Sonoma County. Our research partner, Moody's Analytics, provided the research for this report.

Highlights of the 2016 Health Care Industry Insider include:

- The large increase in newly insured residents following California's Medicaid expansion, and the county's growing senior population are spurring demand for health services. Hiring has strengthened accordingly.
- The extension of the ACA's employer mandate to businesses with fewer than 100 employees introduces a degree of uncertainty into the outlook. While the mandate could initially raise costs for smaller wineries, bed and breakfast establishments, and smaller craft brewers, it will further drive demand for insurance as employers roll out health plans and more employees shop for insurance.
- Sonoma's aging population, which is also wealthier on average than that in the rest of the state, will increase demand for more lucrative procedures such as knee and hip replacements, bolstering margins at county hospitals.
- Sonoma County hospitals have faced rising costs from emergency care in recent years, but the extension of Medi-Cal to more low-income adults will introduce significant cost savings. For example, Sutter Health reported a 45% decline in costs from uncompensated care last year, and Sutter's Sonoma-based hospitals have shared in the savings.

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,

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Chair
Economic Development Board

Ben Stone
Ben Stone
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Recent Performance

Sonoma County's economy is hitting full stride. The county is adding jobs at a faster pace than the U.S. economy, pulling the unemployment rate a full percentage point lower over the past year even amid strong labor force gains. The tightening labor market is lifting wage growth. Though residential construction has yet to show green shoots, rising home sales are pulling house prices closer to their prerecession peak.

Healthcare is contributing to the economy's vitality. Sonoma's population is aging in step with the national trend. Together with the large increase in newly insured residents following California's Medicaid expansion, the county's growing senior population is spurring demand for health services. Hiring has strengthened accordingly. Although the closure of Palm Drive Hospital dragged on industry payrolls in the first half of 2015, hiring has reaccelerated following its re-opening under new management last fall as Sonoma West Medical Center. In response to a growing patient base, local providers are expanding. Sutter Santa Rosa Medical Center recently opened an urgent care center, while Santa Rosa Community Health Center, the county's largest network of outpatient care centers, will break ground on a \$6 million outpatient clinic this year.

Area hospitals are adjusting to new regulations put in place by the Affordable Care Act and fare better than the state and national averages in limiting unnecessary re-admissions and in curbing hospital-acquired conditions. In fiscal 2016, 762 hospitals across the country, including 88 in California, were fined by the Center for Medicare and Medicaid Services for putting patients at risk, but no Sonoma County hospital was assessed such a fine, marking the county's second consecutive year without a penalty. Nor was any county hospital fined for excessive readmissions of Medicare patients.

County healthcare providers continue to gain recognition for the quality of care and rank favorably compared with other counties in the state and nation. According to the Robert Wood Johnson Foundation's annual health-care rankings, Sonoma County ranks sixth in the state in overall patient health, up from eighth in 2015. Better timeliness of payments to healthcare providers thanks to steady improvement in the labor market and credit quality and the large reduction in outlays for charity care are boosting hospital profit margins.

Not all is sunshine and roses. Sutter Santa Rosa Medical Center, the county's third-largest hospital, was found by the California Department of Health to be in violation of state benchmarks for hospital-acquired conditions stemming from the overuse of antibiotics and will have to ramp up spending as it overhauls guidelines and implements alternative measures to prevent bacterial infections.

Macro Drivers

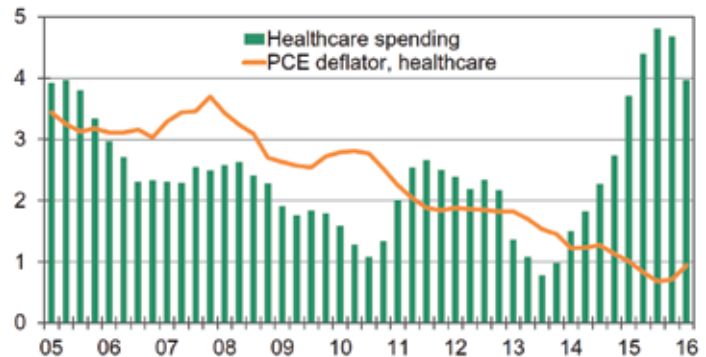
The U.S. economy is performing strongly despite headwinds from declining energy investment and sluggish global expansion. While energy and trade will drag on growth in the near term, consumers are stepping up to the plate and will do more to lift the economy this year. The Moody's Analytics forecast calls for the economy to advance by 2% in 2016, sustained by consumer spending and a stronger recovery in residential construction.

The modest outlook for output growth stands in contrast to the white-hot labor market. The economy is adding jobs at a break-neck pace, pulling the unemployment rate down to 5% even amid strengthening labor force growth. On average, employers have added more than 200,000 jobs in each of the last six months, and at the current rate of job gains, any remaining slack in the labor market will be absorbed by summer.

Healthcare continues to stand at the forefront of U.S. job gains, accounting for more than one-fifth of jobs created in the first quarter despite making up just over 13% of total employment. Hiring in healthcare has outpaced that in the rest of the economy in all but one year since the national recovery began in 2009, and while lower-paid laboratory technicians and administrative positions have accounted for many new positions, healthcare has also contributed to the recovery in mid- and high-wage jobs. An aging U.S. population, coupled with the large increase in health insurance coverage, will drive industry expansion over the next few years.

ACA Has Reined In Healthcare Costs...

% change yr ago, 4-qtr MA



Sources: BEA, Moody's Analytics

Chart: The Affordable Care Act has helped slow growth in healthcare expenses even as overall spending reaccelerates. Cost containment will prove increasingly difficult as private insurers hike premiums to make up for lower returns on public exchanges. Premium hikes will do little to deter demand from Sonoma's greying population, which is wealthier than its state and national counterparts. While rising premiums will undermine affordability for lower-income residents, Accountable Care Organizations such as Redwood Community Health will ensure access to affordable, high-quality care.

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The aging baby boomer cohort will further drive demand for healthcare, as this generation of older workers is healthier, on average, than the previous generation, and is choosing to remain in the workforce longer. Thus, demand for a variety of medical procedures will increase, spurring growth in not only traditional outpatient care settings such as physicians' and specialists' offices but also re-habilitation programs and in general wellness services such as nutrition counseling.

Sonoma County's population is expected to expand at a slightly lower rate than that of the U.S. over the next five years, and growth in the retiree cohort is expected to mirror the outlook for the nation as a whole. The expanding population of retirees is both a challenge and an opportunity, as it poses long-term labor force hurdles but will also prop up demand for health services. The county's population of residents aged 65 and over increased by 5.4% from 2013 to 2014, well ahead of the 4% rate for California and 3.4% for the U.S.

Industry Drivers

The Affordable Care Act will remain the main driver of the healthcare industry in the next several years. The law has led to broader insurance coverage and stronger outpatient services demand, although success in broadening coverage has been more noticeable than other reform goals such as curbing costs. Although enrollment in California's state-run healthcare exchange fell short of expectations in fiscal 2015, increased marketing and outreach efforts boosted 2016 enrollment numbers. Nearly 1.5 million Californians signed up for health insurance via the state-run insurance exchange in 2016, a figure that includes more than half of the 700,000 Californians estimated to be eligible for subsidies but that did not purchase insurance the year before. Most will use their insurance in outpatient settings, spurring the expansion of ambulatory care.

Despite stronger enrollment in California's health insurance marketplace, efforts to curb costs will hinge on improvements to Medicare. The national experiment in coordinated care, in which provider networks receive incentive payments from the government in exchange for meeting cost-savings targets, has enjoyed modest success, saving Medicare upwards of \$400 million over the past four years. Sonoma providers are among those leading the charge: The county's three largest outpatient clinics have joined together as a government-sponsored Accountable Care Organization to receive federal cost-savings payments, and Sutter Health Center will soon make a decision on whether to form its own ACO. Accountable Care Organizations are at the heart of the ACA's effort to transition from a fee-for-service model to a bundled, or per-visit payment system, although providers with a below-average share of Medicare patients have reported less success in meeting savings goals.

Local providers will also contend with less uncertainty following the passage of the "doc fix" bill that tied Medicare reimbursements to the rate of inflation, which often led to hospitals receiving lower reimbursements than planned for.

The passage of the doc fix together with the extension of the Children's Health Insurance Program will expand coverage among the county's most vulnerable residents.

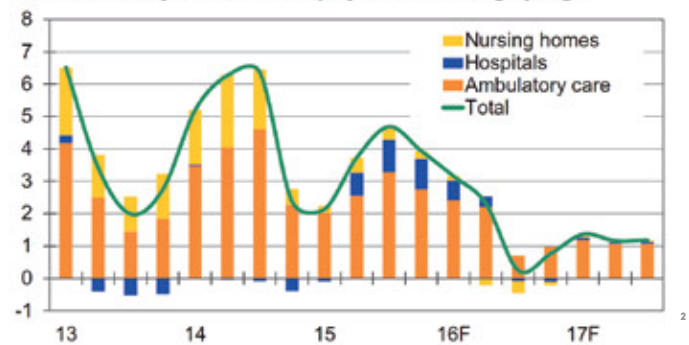
The outlook for the California state bud-get, and with it, funding for state insurance programs, continues to be strong. Although Governor Jerry Brown's revised May budget proposal for fiscal 2016-2017 is modestly lower than the budget proposed in January, the 8% funding increase for Medi-Cal, the state Medicaid program, remains intact. Most of the additional funds will go to-ward the extension of benefits for children of undocumented immigrants. Additional funding for multilingual outreach could help boost enrollment among Sonoma County's underserved communities.

The extension of the ACA's employer mandate to businesses with fewer than 100 employees introduces a degree of uncertainty into the outlook. While the mandate could initially raise costs for smaller wineries, bed and breakfast establishments, and smaller craft brewers, it will further drive demand for insurance as employers roll out health plans and more employees shop for insurance.

The potential pullout of several large insurers from the public healthcare marketplace presents a more pressing concern. Citing losses stemming from a more risky pool of policy holders, United Healthcare, the nation's largest health insurer, has ceased offering health plans via public exchanges. The ex-changes account for only a small share of the insurance market, but insurers that remain in the public marketplace could raise premiums across the board to offset lower revenues from the exchanges.

...And Will Accelerate Shift to Outpatient Care

Sonoma County healthcare employment, % change yr ago



Sources: BLS, Moody's Analytics

Chart: Ambulatory care providers such as primary care physicians, specialists, and home care professionals will be the greatest beneficiaries of broader health insurance coverage, as most new patients will use their insurance in outpatient settings. Aging workers are healthier, on average, than the previous generation, and more choose to remain in the workforce longer. Demand for a variety of medical procedures will increase nonetheless. The increasing cost effectiveness of hip replacement surgeries and other common procedures for aging patients will further shift demand to outpatient centers.

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Pricing

Pricing power for Sonoma County hospitals will strengthen, as their membership in larger provider networks will enhance bar-gaining power vis-à-vis pharmaceutical, medical supply and equipment manufacturers, and insurance companies. More than half of the county's hospitals belong to larger regional networks, and ACA incentives to coordinate care will drive further consolidation. This trend will extend to Sonoma's outpatient care centers as health clinics such as Santa Rosa Community Health, Petaluma Health Center, and West County Health Centers capitalize on their shared buying power to lower costs.

Pricing power for consumers will move in the opposite direction in the near term, as healthcare premiums are expected to increase significantly in 2016 after more moderate rises in the past two years. Insurers are already filing for significant hikes next year, citing the high cost of pharmaceuticals and riskier pools, which they are mandated by law to insure. Although the largest increases will be borne by the public insurance marketplace, insurers will likely raise premiums for employer-based coverage also.

Operating Expenses

Despite significant savings from medical equipment and pharmaceuticals, operating expenses will rise as the tightening local labor market increases competition for healthcare workers. Labor costs make up the largest share of operating costs for hospitals and ambulatory care centers, and higher compensation for staff will lift overall costs. Nonetheless, the healthcare industry in general and hospitals in particular have become more cost-conscious. The shift away from the traditional fee-for-service model and toward bundled, or per-procedure payments will encourage hospitals to cut down on unnecessary services. Thus, while overall patient visits will rise over the next few years, hospitals will benefit from lower per-patient costs.

Profitability

Profit margins will firm as Sonoma County hospitals and outpatient centers make further inroads in coordinating patient care. While not part of the ACA, the federal mandate instituting electronic record sharing will go far in facilitating the coordination of care beyond the examination room, helping to cut down on excessive readmissions and lengthy hospital stays. Progress in reducing hospital readmissions will lower per-patient costs and bolster profit margins even as hospitals and outpatient centers render fewer services per patient. The federal Medicaid expansion will also help profitability by reducing outlays for uncompensated care. Sonoma County hospitals have faced rising costs from emergency care in recent years, but the extension of Medi-Cal to more low-income adults will introduce significant cost savings.

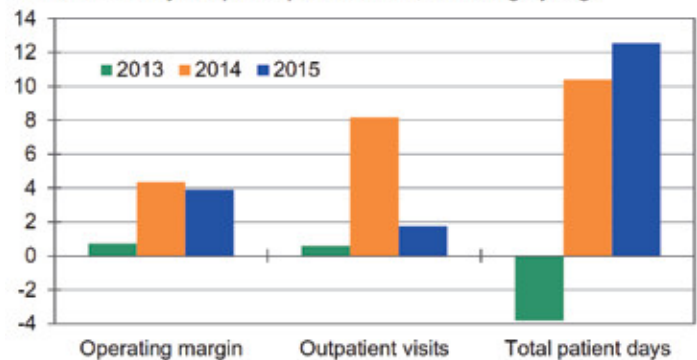
For example, Sutter Health reported a 45% decline in costs from uncompensated care last year, and Sutter's Sonoma-based hospitals have shared in the savings.

Long Term Outlook

Sonoma County's healthcare industry is on a firm footing and will benefit in the long run as an aging population and a large increase in the newly insured ramp up demand for healthcare. Sonoma's aging population, which is also wealthier on average than that in the rest of the state, will increase demand for more lucrative procedures such as knee and hip replacements, bolstering margins at county hospitals. Efforts to coordinate care beyond the examination room, pioneered by Kaiser Permanente at its Sonoma County facilities, will help improve health outcomes by following up hospital stays with home visits and other personalized care. However, there is still more work to be done in meeting ACA mandates. For example, Santa Rosa Medical Center is among the 16 hospitals fined by Medicare for administering unnecessary services and has collectively agreed to pay nearly \$15.7 million in fines. Greater progress in meeting ACA provisions will strengthen healthcare in the long run.

Hospital Finances on a Stronger Footing...

Sonoma County hospitals' performance, % change yr ago



Sources: State of California, Moody's Analytics

Chart: Hospitals' 2015 performance shows that, though difficult, it is possible to meet all regulations and do well financially. Sonoma County hospitals were among the few state-wide that were not assessed fines for excessive readmissions or hospital-acquired conditions. Meanwhile, growth in both in- and outpatient services suggests that, as providers learn to comply with regulations, performance will strengthen. Local hospitals will also benefit from membership in large provider networks, which will enhance pricing power vis-à-vis medical suppliers.

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Upside Risks

The ACA has the potential to generate significant savings for Sonoma County hospitals. The participation of the county's larger hospitals in Accountable Care Organizations would help realize this potential. If Sutter Health's plans to join an ACO come to fruition, its two Santa Rosa hospitals would likely benefit from federal incentive payments given their progress in curbing read-missions for Medicare patients and in avoiding hospital-acquired conditions.

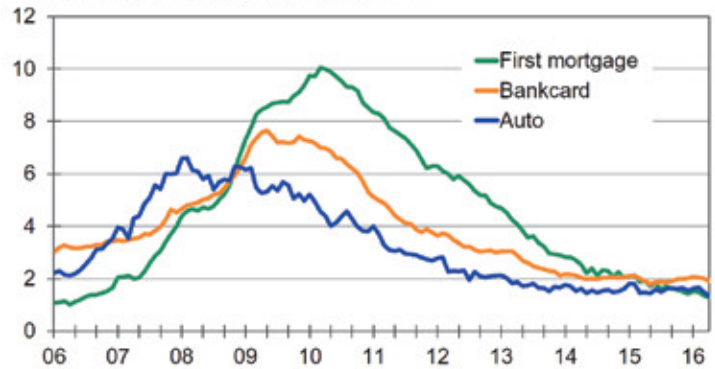
Spillover growth from healthcare would also benefit the economy in general, as county hospitals count residents from surrounding counties among their patient base. Greater than expected demand for healthcare would also benefit Sonoma's medical device manufacturers, spurring greater sales at firms such as Medtronic.

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 for healthcare in particular. Though recent challenges to the ACA's basic provisions have been struck down by the Supreme Court, opposition to the law remains elevated. New court cases aimed at the constitutionality of the law's affordability mandates, such as its provision for 80 cents of every insurance dollar to be spent on medical care, could curb affordability and the law's overall effectiveness if successful. Churn in the large healthcare exchanges is another source of downside risk, as the exit of large insurance providers such as United Healthcare could lessen competition and give insurers greater leeway to raise premiums.

...As Household Delinquencies Ebb

Delinquency rate, % by \$ volume, NSA



Sources: Equifax, Moody's Analytics

Chart: Some of the most problematic hospital care costs not related to the Affordable Care Act are related to bad credit and uncompensated care. Fortunately, broader coverage will reduce healthcare-related bankruptcies. Meanwhile, sturdier balance sheets will improve the timeliness of payments to healthcare providers. 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. With fewer outlays for emergency care, hospital and outpatient clinics' finances will strengthen.

Jesse Rogers
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