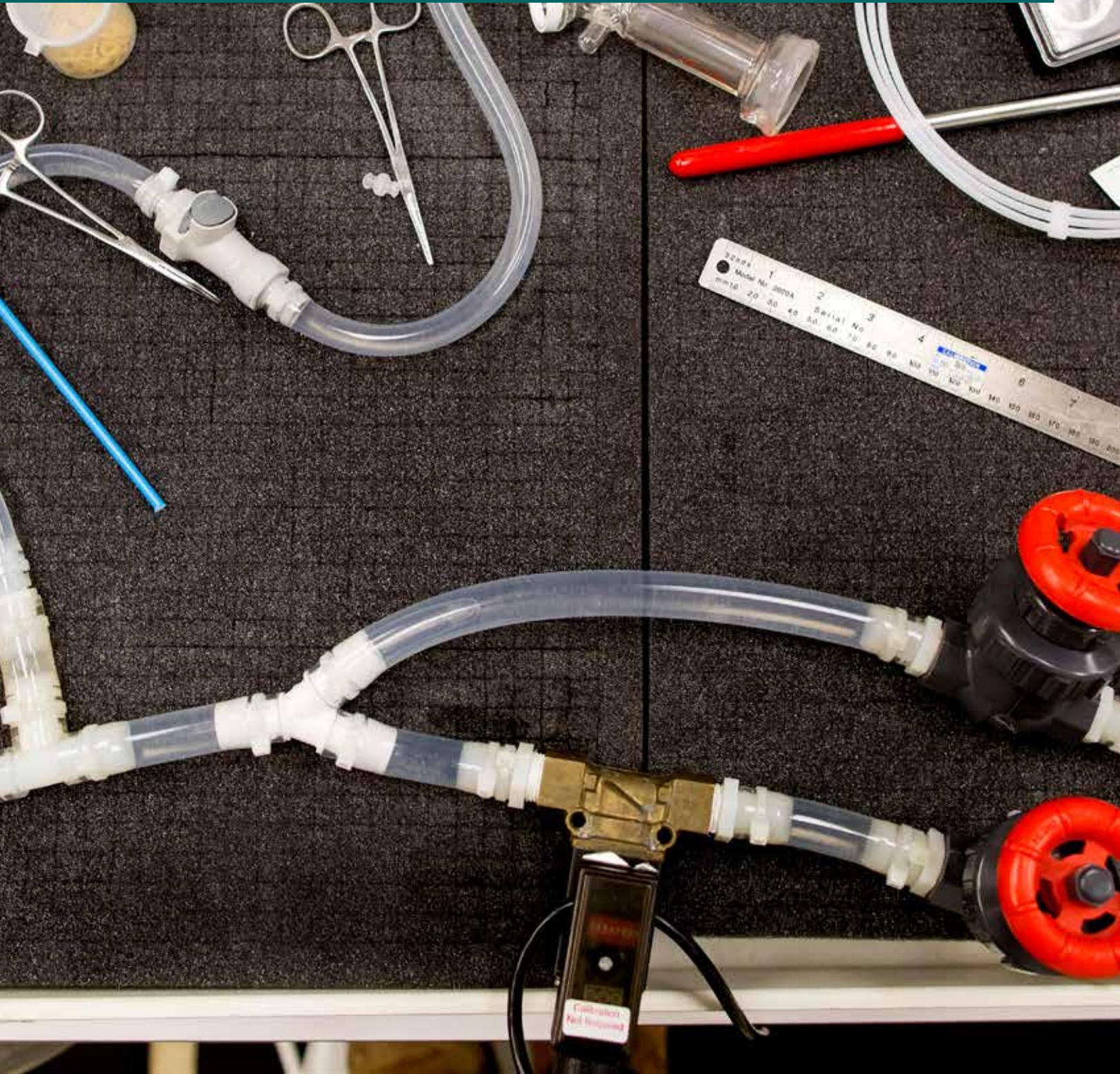




INDUSTRY INSIDER HEALTHCARE

INDUSTRY REPORT

2017



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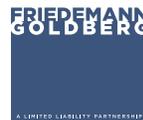
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CONTENTS

- 4. EXECUTIVE SUMMARY
- 6-8. HEALTHCARE: SONOMA COUNTY



EXECUTIVE SUMMARY

June 2017

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

HIGHLIGHTS



Hospitals, health clinics, and wellness establishments are enjoying the benefits of greater demand for medical and preventative care engendered by the increase in the number of seniors as well as the growth in the share of insured residents. Furthermore, health-conscious visitors are frequenting health and wellness establishments within Sonoma County in greater numbers. The long-term success of the industry will be driven by increases in the ranks of newly insured residents as well as the large aging population in the county.



Sonoma County is near full-employment, putting upward pressure on wages and salaries. This is particularly evident in healthcare where employers are finding it increasingly difficult to fill openings. As a result, new healthcare workers will earn higher wages as employers compete for available talent. Higher incomes for healthcare workers will benefit the local economy. Income from healthcare accounts for more than one-sixth of total county income and thus any increases support elevated demand for consumer services and housing.



Risks to the healthcare industry stem from uncertainty surrounding the Affordable Care Act and the potential for repeal. California benefits from the individual mandate and federal support for cost-sharing subsidies for low-income residents. A greater number of uninsured residents would reduce overall demand for healthcare as fewer low-income residents seek preventative care. Furthermore, the use of uncompensated care would increase, which would raise operating costs for hospitals and cut into profitability.

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.



Recent Performance. Sonoma County's healthcare industry is on solid footing. Hospitals, health clinics and wellness establishments are reaping the benefits of greater demand for medical and preventive care among older cohorts and newly insured residents alike. Meanwhile, wellness establishments are flourishing as health-conscious visitors frequent the county's spas and outdoor retreats in greater numbers. Though hiring in healthcare has cooled from the breakneck pace set over the past two years, growth in healthcare payrolls and wage disbursements is outpacing that of the rest of the economy. Improving consumer fundamentals, including better wage growth and sturdier balance sheets, have aided the timeliness of payments to healthcare providers, safeguarding margins at hospitals and health clinics.

Rising consumption of health services, especially among seniors, combined with a rising share of insured residents following California's Medicaid expansion has provided regional medical centers with a steady influx of new residents in need of medical care. This has spurred investment in new medical facilities, including by Kaiser Permanente and Sutter Health, which has increased its footprint in Sonoma with the opening of a new walk-in clinic. Local wellness centers are also expanding thanks to increasing demand for holistic health experiences. Many health and wellness clubs have shifted their focus from fitness activities to programs that promote a healthy lifestyle in an attempt to appeal to a larger share of the population and raise the county's prestige as a premier destination for preventive care and holistic health treatments.

The quality of the care provided by county healthcare providers is outshining peers elsewhere in the state and the nation. The Robert Wood Johnson Foundation's annual healthcare rankings placed Sonoma County fifth in the state according to health outcomes, a composite index measure of patient health and well-being. This is up from its sixth place finish in 2016, and a marked increase from its 12th place ranking in 2011. Area hospitals have clearly made significant strides in improving care quality in recent years.

There are some growing pains as local providers adjust to new regulation standards put in place by the Affordable Care Act. In fiscal 2017, the Center for Medicare and Medicaid Services penalized 96 hospitals in California, as well as two in Sonoma County, for exposing patients to unnecessary risk. Santa

Rosa Memorial Hospital and Sonoma Valley Hospital were both identified for their excessive levels of hospital-acquired conditions, breaking the county's two-year streak without a penalty. However, Sonoma County hospitals continue to set the gold standard for long-term care. No hospitals were fined for excessive readmission rates. This is the best outcome in the past five years and emphasizes the improvements being made overall.

Macro drivers. The U.S. economy has returned to full employment, and with it will come mounting upward wage pressures. Plentiful jobs, rising corporate investment, and manageable inflation will act together to support the U.S. economy's broad-based expansion. Full employment will naturally lead to a more subdued pace of hiring, but the U.S. job engine will hum along through the end of 2017. Monthly job additions will average 180,000 this year, with gains tracking closer to 140,000 per month in 2018. The tight labor market will boost wages, which will facilitate further balance sheet repair and enable more households to take the plunge into homeownership.

Healthcare is a standout industry in the U.S. labor market even as broader job growth moderates. Health services employ just over 13% of the national workforce, but has accounted for nearly 16% of jobs created since the beginning of the year. This is a slower pace than in previous years, but hiring in healthcare is still outpacing that in the rest of the economy as it has for most of the past decade. Rising hospital payrolls coupled with a growing need for home health aides to help the swelling senior cohort have underpinned industry additions in recent years. While most of these jobs are in the lower-wage service category, limiting their contribution on a per-job basis, they have lifted the economy through the sheer number of additions.

Over the next few years, the large baby boomer cohort will increase demand for healthcare across the nation. In addition to traditional outpatient care settings and home-based healthcare, nursing and residential care facilities will need to expand staff and capacity to meet the surge in demand from more elderly residents. Although growth in the retiree cohort will increase on par with the nation as a whole, slower population growth will apply restraint. 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 reduced in-

migration will make for slower growth in the patient base.

Industry drivers. The future of the Affordable Care Act remains uncertain, but it will still support the healthcare industry in the near term. The legislation has arguably been more effective at increasing the breadth of insurance coverage than keeping surging healthcare costs in check. Indeed, Covered California, California's state-run healthcare exchange, added over 400,000 new sign-ups in its fourth open enrollment period in January. An additional 1.2 million renewed their coverage, bringing total state enrollment to around 1.5 million. Furthermore, many of those who are currently signed up are expected to enroll again next year. The state program has also been effective at bringing a greater number of young people under coverage to lower the overall risk of those insured.

However, while the greater number of enrollees, especially among lower-income cohorts, has made for a low-risk profile relative to other states, health premiums still increased at a double-digit rate in 2017 as insurers recalibrated risk expectations and as some federal subsidies expired. Nonetheless, California's marketplace, which has generally been one of the most stable, will retain all of its largest private insurers next year. Kaiser Permanente, Blue Shield of California, and Health Net, which collectively cover the bulk of the Covered California enrollees, are committed to selling plans on exchanges in 2018. Moreover, the California Insurance Commissioner will allow insurers to file for two sets of rates depending on how the health reform debate plays out, providing flexibility to carriers.

A growing number of insured residents is good news for healthcare demand throughout the state, but efforts to mitigate rapid cost inflation in the industry will depend on how healthcare reform is handled under the Trump administration. Given reduced state funding for Medi-Cal, the state's Medicaid program, any reduction in federal subsidies could take a toll on the state's most vulnerable residents, who rely on the program for care. The California state budget for fiscal 2017-2018 is not the most favorable for Medi-Cal, and General Fund spending is projected to decline by 2% in fiscal 2017. However, overall funding will still increase thanks to funding from local governments and health plan and provider fees. In particular, a new excise tax on tobacco, called Proposi-

tion 56, will help to increase state funding for Medi-Cal.

Increased focus on overall health outcomes will be a boon for Sonoma County wellness establishments. Holistic care, including but not limited to spa treatments, specialized fitness programs, and alternative medicine, will expand vigorously as U.S. consumers focus on improving all aspects of health and in particular, preventive care. Wellness centers are sprouting in scenic areas not necessarily associated with Wine Country and will complement growth in healthcare.

Pricing. Pricing power for healthcare providers will strengthen in the coming years as large provider networks increase bargaining power vis-à-vis insurers and medical device firms. Insurers will also notch price gains as they adjust premiums to better reflect expectations about enrollment and the risk pool composition. Covered California premiums increased an average of 13.2% in 2017 and will increase further in 2018 due to the ever-increasing costs of medical services and prescription drugs. However, how much premiums will ultimately rise will depend on the future of the ACA. If the individual mandate is not enforced and the cost-sharing subsidies are discontinued, premiums will increase significantly more. While most state residents obtain coverage through work, rising healthcare costs will push insurers to raise premiums for employer-based coverage as well.

Operating expenses. New healthcare workers will pull in higher wages because of the tighter job market, causing operating expenses to rise over the next several years. Higher wages will increase costs for Sonoma County hospitals and ambulatory care centers since labor is the largest share of total expenses. A reduction in per-patient costs will help hospitals manage higher caseloads over the next couple of years. This will prove critical to managing expenses given a growing pool of elderly residents in need of more medical attention. A transition from the traditional fee-for-service model, which can lead to repeat testing and other duplicate procedures, toward per-procedure payments will help on this front by making consumers and hospitals more cost-conscious.

Profitability. Despite rising business costs, county healthcare providers should manage to keep profit margins positive and stable through 2017 and 2018. Operating margins were estimated at 4.3% in 2016, safely above the four-year average of 3.4%. A

reduction in uncompensated care since 2013 and going forward will be key in maintaining healthy profit margins even as hospitals and outpatient centers provide fewer services per patient. Profitability has also benefited from the federal Medicaid expansion, which has gone a long way in reducing the uncompensated care costs incurred by healthcare providers. Secure funding for Medi-Cal should help reduce emergency care costs by extending coverage to lower-income adults and children, enabling more and less expensive preventive care.

Sonoma West Medical Center remains mired in financial duress even after closing and switching management. Utilizing more of its laboratory facilities could bring in revenue and help soften its fiscal woes, but a sustained turnaround is a ways off. The future is even less bright for the Sonoma Developmental Center, which is slated for closure by the end of 2018 following years of hemorrhaging cash flows. A \$2.5 million grant to build a new regional healthcare hub specializing in services for individuals with developmental disabilities will provide residents with specialized care after being transitioned into community-based housing where many will be left without in-house medical, dental, mental and adaptive services.

Long-term outlook. Sonoma County's healthcare base is on sure ground and well-poised for continued, albeit more modest, growth over the long term. An older population along with sustained increases in the ranks of newly insured residents will be paramount to the industry's success. Additionally, the county's reputation as a haven for innovative wellness centers will enhance growth prospects as residents and visitors alike prioritize holistic health and wellness treatments.

Sonoma County's population will expand at a pace below the national average through the end of the current decade. While this will apply restraint, senior citizens are expected to make up a larger share of the population over the coming decades, in line with the national outlook. The county's population of residents age 65 and older increased by 5.3% from 2014 to 2015, easily ahead of the 4.1% increase in California and the 3.4% rise in the U.S. This pace also dwarfs the 0.5% uptick in Sonoma's total population experienced in 2015. Longer term, an expanding healthcare industry will support the economy as an aging population and greater insurance coverage broaden the county's patient base.

Upside risks. The large share of total output and employment produced by Sonoma County's healthcare network means the industry's even more favorable performance would pay greater dividends for the economy as a whole. Residency programs like the one at Sutter Medical Center and the newly accredited program at Kaiser Permanente Santa Rosa Medical Center could help bring more new doctors to Sonoma County, easing the shortage of workers in the healthcare industry that has propelled rising costs.

Better population gains would also spur greater demand for health services. The deterioration of housing affordability has weighed on net in-migration over the past few years. An increase in affordable housing would not only help retain current residents, but also encourage new residents to move to the area, spurring faster population growth. This would, in turn, increase the pool of residents potentially seeking medical services. In addition to benefiting medical device producers like Medtronic, an increase in aggregate incomes would spill over to retailers as well as to spending on wellness establishments, which has outpaced total tourism spending over the past decade.

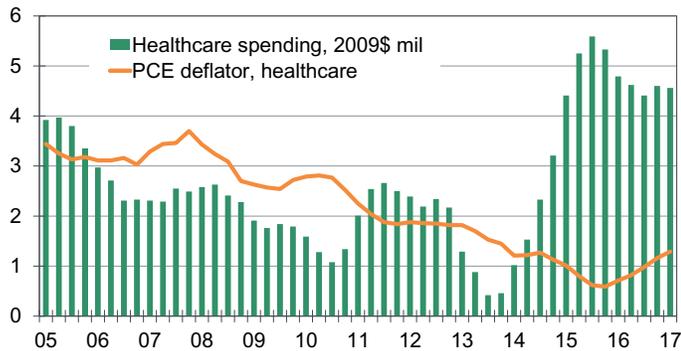
Downside risks. The long-term future of Sonoma County's seven hospitals and extensive network of healthcare providers is clouded by the uncertainty surrounding the Trump administration's promise to repeal and replace the Affordable Care Act. California's individual insurance market would suffer without the ACA's individual mandate and loss of federal support for cost-sharing subsidies that help low-income residents pay for medical costs. Destabilization of the marketplace would result in rising premiums, larger numbers of uninsured residents, and healthy people exiting the insurance market, leaving a sicker group of consumers with even higher premiums.

A greater number of uninsured residents would also reduce overall demand for healthcare as fewer low-income residents seek preventive care. Meanwhile, lower insurance coverage would increase the cost of uncompensated care for hospitals. Reduction of uncompensated care has been key in improving the financial health of healthcare providers. Should these costs rise, profitability of hospitals and other providers would be threatened, slowing industry growth and investment.

*Emily Fazio
June 2017*

Healthcare Costs Back on the Rise

% change yr ago, 4-qtr MA

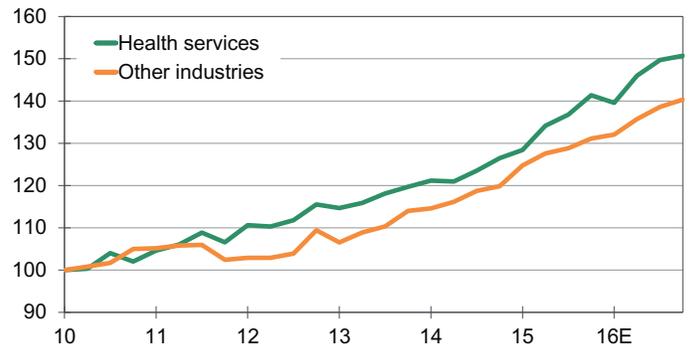


Sources: BEA, Moody's Analytics

Spending on healthcare continues to rise as price pressures intensify and cost containment proves increasingly difficult. Health insurance premiums are rising for both the individual market and employer-based coverage as insurers align premiums with expected costs amid rising outlays for medical services and prescription drugs. However, higher premiums will do little to dent healthcare demand in Sonoma thanks to above-average household incomes and its large and growing retiree cohort.

Healthcare Compensation Maintains Lead

Sonoma County wage and salary disbursements, 2010Q1=100

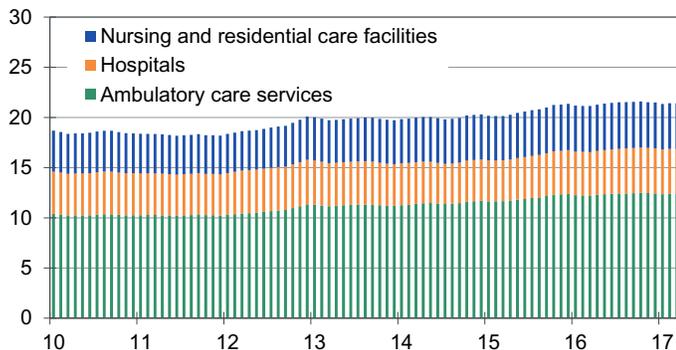


Sources: BLS, BEA, Moody's Analytics

With Sonoma County near full employment, upward pressure on wages is mounting. This is particularly evident in healthcare where employers are finding it increasingly difficult to fill open positions. While higher negotiated salaries and wages will increase costs for health centers, higher incomes will be a boon for the rest of the economy. Wage and salary income from healthcare accounts for more than one-sixth of total county income and will support demand for consumer services and housing in Sonoma County.

Outpatient Care Drives Industry Growth

Sonoma County employment, 3-mo MA

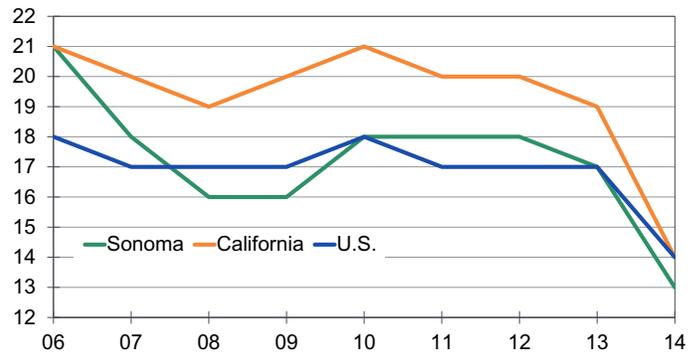


Sources: BLS, Moody's Analytics

Employment in ambulatory care services increased dramatically over the last several years, in part because the ACA encourages prevention and the use of outpatient services instead of costly hospitalizations. This has also led to growth in wellness centers focusing on programs that promote a healthy lifestyle such as weight management and rehabilitation programs for those coming off physical therapy. These courses have natural synergy with hospitals and medical centers and help support better health outcomes.

Fewer Uninsured Residents in Sonoma County

Uninsured, % of total population



Sources: Census Bureau, Moody's Analytics

The share of uninsured residents has fallen to an all-time low thanks to the expansion of California's Medicaid program. In 2014, the most recent year of data, the share of uninsured residents in Sonoma County fell to 13%, below the state and U.S. averages. The increase in insured residents has boosted demand for medical services and will be vital to the industry's long-term success. However, changes to the ACA may undermine the progress that has been made in this area, especially in reducing increasing uncompensated care costs at county hospitals and health clinics.



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