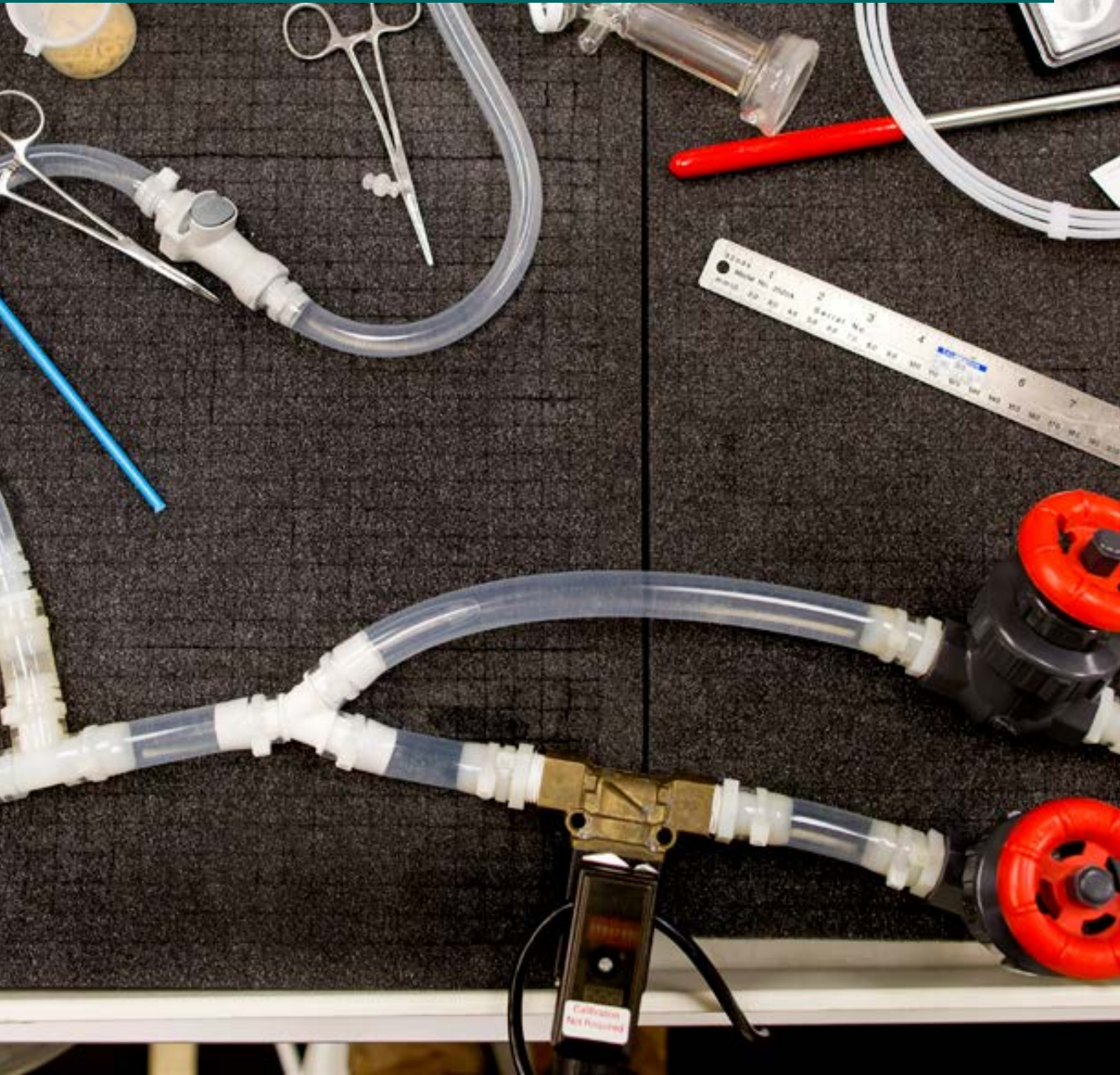




# INDUSTRY INSIDER HEALTHCARE

INDUSTRY REPORT

2018



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# CONTENTS

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- 4. EXECUTIVE SUMMARY
- 6-8. HEALTHCARE ANALYSIS



# EXECUTIVE SUMMARY

June 2018

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to present the *2018 Healthcare Industry Insider* report. Our research partner, Moody's Analytics, provided the research for this report.

## HIGHLIGHTS



Employment in the healthcare industry has outpaced overall employment growth in recent years. This trend is expected to continue towards the medium-to-long-term as Sonoma County continues to age faster than the state and nation. Demand for healthcare will also be buoyed by the county's above-average household incomes. Weakening population growth, near-zero net migration, and an extremely tight labor market will drive up wages in all industries, with healthcare being no exception. Because labor costs make up a more substantial part of the industry's overall operating costs, healthcare profitability will be especially affected by wage pressures.



Sonoma County's healthcare industry will see bifurcated revenue gains from older and younger residents. Most impactful will be the ageing of the county: from 2014-2016, the proportion of residents aged 65+ increased 10%, outpacing cohort growth in California (7.5%) and the United States (6.6%). The ageing population will increase demand for home health services, nursing and residential care, and traditional outpatient facilities. But for younger residents, there is increased interest in holistic and preventative care. These services—which include spa treatments, specialized fitness programs, and alternative medicine—will dovetail with the hospitality industry to create “health and wellness tourism.”



The Affordable Care Act's uncertain future will create upside and downside risks for California's insurance market, and Sonoma County healthcare operators. In recent years, the state's uninsured population has sizably shrunk. County hospitals looking to reduce operating expenses will benefit from reduced instances of uninsured, uncompensated care. But the loss of federal support for cost-sharing subsidies from the federal government and a loss of the individual mandate, insurers may see payouts increase as the patient pool becomes older and sicker. However, Sonoma County's uninsured rate remains below-average, and healthcare operators will be shielded from some rise in uncompensated care costs.

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](http://www.sonomaedb.org).



**Recent Performance.** Sonoma County's healthcare industry is powering forward, with growth in healthcare payrolls extending its lead over that of the rest of the economy. Employment in healthcare has risen more than 11% since the beginning of 2015, about 4 percentage points higher than it has nationally, reflecting the rising demand for medical and preventive care among older cohorts and newly insured residents alike. The launch of the state healthcare exchange, coupled with California's expansion of Medicaid, has greatly reduced the share of residents lacking health insurance. Although hiring in healthcare has cooled from last year's breakneck pace, growth in industry employment and wage disbursements is outpacing that of the rest of the economy. Recent job gains have been largely concentrated in outpatient care facilities as demand for specialized treatments rises.

Meanwhile, wellness establishments are flourishing as health-conscious visitors frequent the county's spas and outdoor retreats in greater numbers. Many health and wellness centers have shifted their focus from fitness activities to programs that promote a healthy lifestyle 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 that of peers elsewhere in the state and the nation. The Robert Wood Johnson Foundation's annual healthcare rankings placed Sonoma County seventh in the state, according to health outcomes, a composite index measure of patient health and well-being. This is down from its fifth place finish in 2017, but a marked increase from its 12th place rank in 2011. Area hospitals have clearly made significant strides in improving care quality over the years.

Still, there is room for improvement. In fiscal 2018, the Center for Medicare and Medicaid Services penalized 749 hospitals across the country, including 88 in California—three of which were 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 for the second year in a row. Sonoma West Medical Center was also penalized. Only Sonoma Valley Hospital was assessed a penalty from Medicare for excessive readmissions.

**Macro drivers.** The U.S. economy is operating at full tilt, and growth will accelerate further as deficit-financed tax cuts and additional fiscal spending take hold. Consumer spending will expand at a healthy pace as the combination of tax cuts and tight labor markets drive up wage rates and raise sentiment. The synchronized global expansion, sturdy domestic demand, and expansionary fiscal policy will enable the labor market to perform well in its ninth year of growth. Unemployment, which has been hovering just over 4% in recent months, will fall further this year.

Healthcare is a top-performing industry in the U.S. Healthcare employs about a 10th of the national workforce, but account for nearly 13% of jobs created over the past year. This is a smaller share than in prior years, but hiring in healthcare is still outpacing that in the rest of the economy as it has for the last three years. Rising hospital payrolls coupled with an increasing need for home health aides to help a growing senior cohort will underpin industry additions. 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 their additions.

In the coming years, a large and expanding baby boomer population will generate greater demand for healthcare in Sonoma County and across the nation. In addition to traditional outpatient care settings and health services provided in homes, nursing and residential care facilities will need to expand staff and capacity to meet the increase in demand that will come from a growing cohort of older residents.

**Industry drivers.** With the removal of the individual mandate and some cost-sharing subsidies, the future of the Affordable Care Act is uncertain, but the landmark bill will nonetheless support the healthcare industry in the near term. The legislation has been more effective at increasing insurance coverage than keeping surging healthcare costs in check. Covered California, California's state-run healthcare exchange, added more than 400,000 new enrollees during the open enrollment period for 2018 coverage, about 3% more than the previous year. An additional 1.1 million renewed their coverage, bringing total state enrollment to around 1.5 million.

Total enrollment in the program was about 35,000 below the year before likely because of the state's response to the Trump administration's decision to end federal fund-

ing for cost-sharing reductions, which lower the cost of patients' deductibles. This year, the state allowed insurers to create slightly different off-exchange silver plans that do not include the cost of the reductions and encouraged unsubsidized silver plan enrollees to switch to off-exchange coverage. This protected those consumers from having to pay the higher premiums that were necessary to cover the cost of the reductions. Consumers that received subsidies continued to shop in the exchange, where subsidies were increased to offset higher premiums.

Thanks to cost savings at the state level, average premium increases in California will be lower than the national average but still exceed the cost of medical care as insurers respond to uncertainty. In addition to setting the individual mandate tax penalty to zero, cuts to spending on marketing for the federal marketplace and the implementation of association health plans and short-term, limited-duration insurance plans will affect the market as well. Over the past several years the state program has been effective at bringing a greater number of young people under coverage to lower the overall health risk of those insured. However, the repeal of the individual mandate may cause younger cohorts to drop coverage. This would make the remaining pool of customers sicker and costlier as a whole.

Although the effects of changes to the ACA on enrollment are not clear yet, large premium increases in 2019 are almost a guarantee. Continued policy and rate uncertainty may result in carriers either leaving the marketplace or raising premiums to accommodate the anticipated cost of covering both their on- and off-exchange individual market risk pools. However, the individual marketplace covers only a small share of the population since most people get health coverage through their work.

Employers have responded to rising healthcare costs by adopting high-deductible health plans and shifting a greater share of plan premiums to employees. This year, U.S. employers expect their healthcare costs to increase more than 5%, up from a 4.6% increase in 2017. Rising healthcare costs are eating into employees' paychecks as they are forced to shoulder more of the burden. In an attempt to reduce costs, California has proposed a bill that would set prices for health services. However, this proposal could create a variety of new problems for state residents

and healthcare providers as price controls could prompt doctors to move out of state as well as force some hospitals to reduce staff or close.

At the same time, an 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 in relation to insurers and medical device firms. Nonetheless, insurers will still increase prices as they adjust premiums to better reflect expectations about enrollment and the risk pool composition. Covered California premiums experienced a slightly smaller increase than last year, rising an average of 12.5% in 2018. However, because of the end of federal funding for cost-sharing reductions, ACA silver plans accrued an additional 12.5% surcharge, causing base rates in Sonoma County to increase. Premiums will rise further in 2019 as a result of the ever-increasing costs of medical services and prescription drugs, as well as changes to the ACA and the resulting risk pool. Covered California estimates the total hike to premiums in 2019 will be between 15% and 30%. Though most state residents obtain coverage through work, rising healthcare costs will push insurers to raise premiums for employer-based coverage as well.

**Operating expenses.** Operating expenses will rise over the coming years as the tight labor market pushes wages higher. Higher salaries and wages will increase costs particularly for Sonoma County hospitals and ambulatory care centers because labor is the biggest piece of their cost structure. Efficiency gains will provide relief as the transition to electronic record-keeping helps hospitals manage more caseloads. Additionally, the transition from the traditional fee-for-service model, which can lead to unnecessary testing and other services, toward per-procedure payments will help on this front by making consumers and hospitals more cost-conscious.

**Profitability.** Profit margins at regional healthcare centers will stay positive and stable this year and next, despite rising operating costs. Operating margins were estimated at 5.3% in 2017, well above the five-year average of 3.3%. A reduction in uncompensated care will be key to 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 preventative care at lower cost. However, the removal of the tax penalty for the individual mandate may push uncompensated care costs higher as some residents forgo insurance coverage.

Sonoma West Medical Center is struggling even after reopening under new management. The hospital has discontinued its toxicology testing services after Anthem Blue Cross accused the hospital and healthcare district of business fraud earlier this year. Without the revenue provided by its laboratory facilities, in addition to persistent debt and potential legal liabilities, Sonoma West's financial viability is at risk. In 2017 the hospital's operating margin was -1.2%, underperforming the state and other Sonoma County hospitals by a wide margin.

**Long-term outlook.** Sonoma County's healthcare industry is well-positioned for gains as both younger residents and older cohorts increase spending on healthcare. The county's reputation as a haven for innovative wellness centers enhances prospects as residents and visitors alike prioritize holistic health and wellness treatments.

Sonoma County's population will expand at a below-average pace through the end of the current decade. At the same time, the share of senior citizens is expected to make up a larger portion of the population over the coming decades, in line with the national outlook. The county's population of residents aged 65 and older increased by 10% from 2014 to 2016, compared with the 7.5% increase in California and the 6.6% rise in the U.S. This pace also easily exceeds the 0.9% uptick in Sonoma's total population experienced in 2016. Longer term, an expanding healthcare industry will support the economy as an aging population broadens the county's patient base.

**Upside risks.** Greater demand for specialized treatments such as joint replacements and gene-based therapies would translate into stronger growth in Sonoma County's healthcare industry and would pay dividends for the economy as a whole. A newly formed affiliation between Sonoma Valley Hospital and The University of California, San Francisco Medical Center will create an integrated healthcare network to better serve the needs of Sonoma Valley residents and support research in biotechnology, pharmacological treatments and medical devices. UCSF is ranked among the best hospitals in the country and its expanded memory care and aging program and infusion center could drive further growth in health services.

The affiliation may help Sonoma Valley attract more doctors and develop specialty programs. In addition, residency programs, such as the ones at Sutter Medical Center and 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 contributed to rising costs.

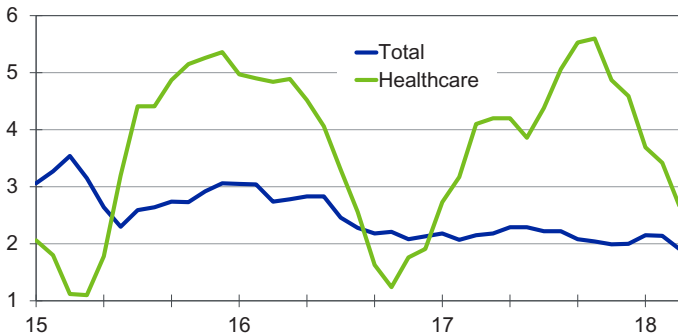
Faster population growth would also spur increased demand for health services, while greater in-migration among younger cohorts would broaden the coverage pool and contribute to lower premiums.

**Downside risks.** The long-term future of Sonoma County's seven hospitals and network of healthcare providers is clouded by the uncertainty surrounding the future of the Affordable Care Act. California's individual insurance market will 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. An increase in uninsured residents would increase the cost of uncompensated care for hospitals and reduce overall demand for healthcare as fewer low-income residents seek preventive care. Reduction of uncompensated care has been key in improving financial health of healthcare providers. As these costs rise, profitability of hospitals and other providers would be threatened, slowing industry growth and investment.

*Emily Fazio  
June 2018*

### Healthcare Payrolls Quick to Expand...

Sonoma County employment, % change yr ago, 3-mo MA

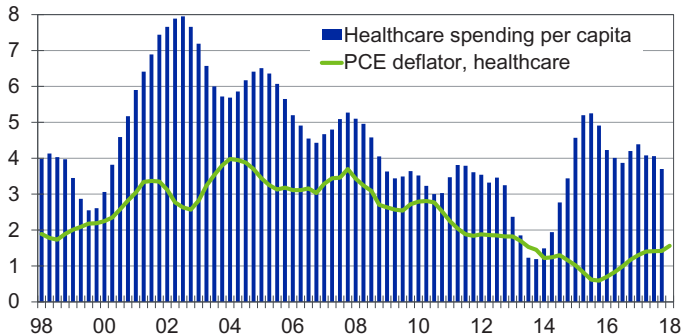


Sources: BLS, Moody's Analytics

Healthcare employment has increased dramatically over the last several years as an expanding senior population and greater insurance coverage drives up demand for medical services. In addition, the ACA encourages prevention and the use of outpatient services, which has 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 support better health outcomes.

### ...But Costs Are Back on the Rise

% change yr ago, 4-qtr MA

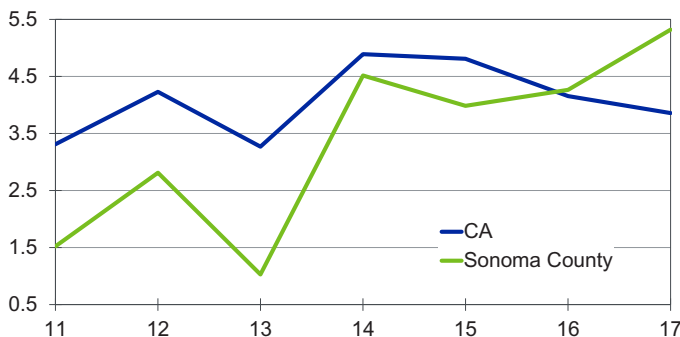


Sources: BEA, Moody's Analytics

The ACA proved to be a temporary salve for increasing healthcare costs. Healthcare costs are on the 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 expanding retiree cohort.

### Hospital Margins Are Much Improved...

Operating margin, %

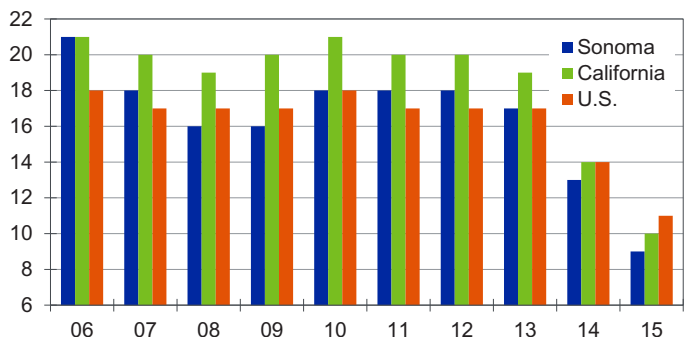


Sources: CA Office of Statewide Health Planning and Development, Moody's Analytics

Hospital operating margins in Sonoma County have risen above the state average. The ACA individual mandate and California's Medicaid expansion were key in reducing the uninsured rate and in turn, uncompensated care, which has been vital to improving profit margins. Profit margins at regional healthcare centers will stay positive and stable this year, but changes to the ACA threaten hospitals' financial well-being. The removal of the individual mandate may push uncompensated care costs higher as some people choose to forgo insurance coverage.

### ...As Uninsured Rates Fall

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 and the ACA's individual mandate. In 2015, the most recent year of data, the share of uninsured residents in Sonoma County fell to 9%, 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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