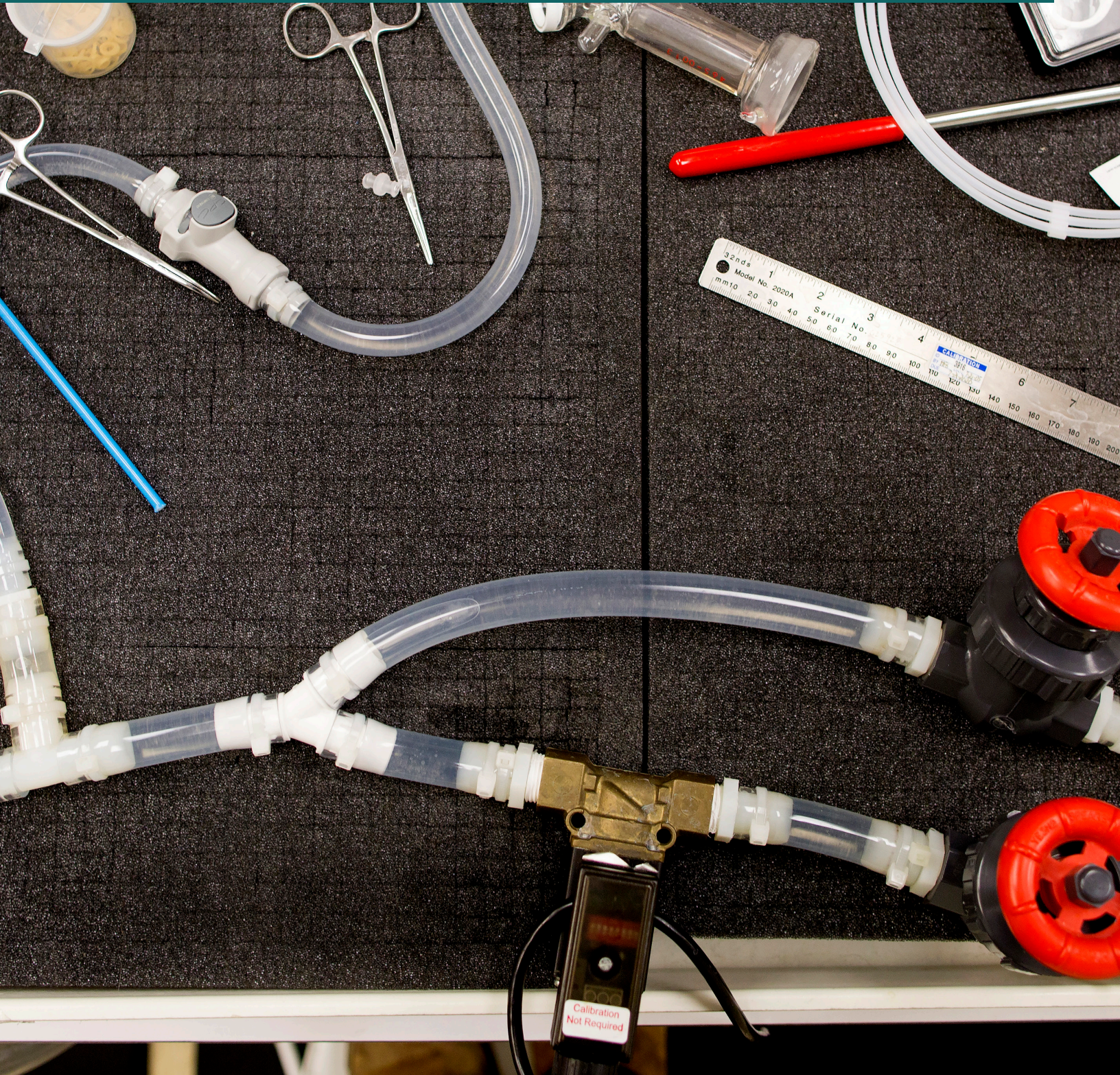




INDUSTRY INSIDER HEALTHCARE

INDUSTRY REPORT

2019



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EXECUTIVE SUMMARY

June 2019

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board (WIB), is pleased to present the *2019 Healthcare Industry Insider* report. Our research partner, Moody's Analytics, provided the research for this report.

HIGHLIGHTS



Hospital care has consistently increased in Sonoma County and California in the last ten years, though it remains less expensive in California than in the nation as a whole. Sonoma County benefits from a number of highly rated hospitals, and new residency programs, as well as partnerships with medical schools in the state, will help ensure a pipeline of talent into the local health care system. Affiliations of hospitals and health care providers like Healdsburg District and St. Joseph's will further help reduce costs and raise efficiency. Overall, over two-thirds of Sonoma County's hospitals have either joined or are in the process of joining regional networks to gain greater leverage in price bargaining.

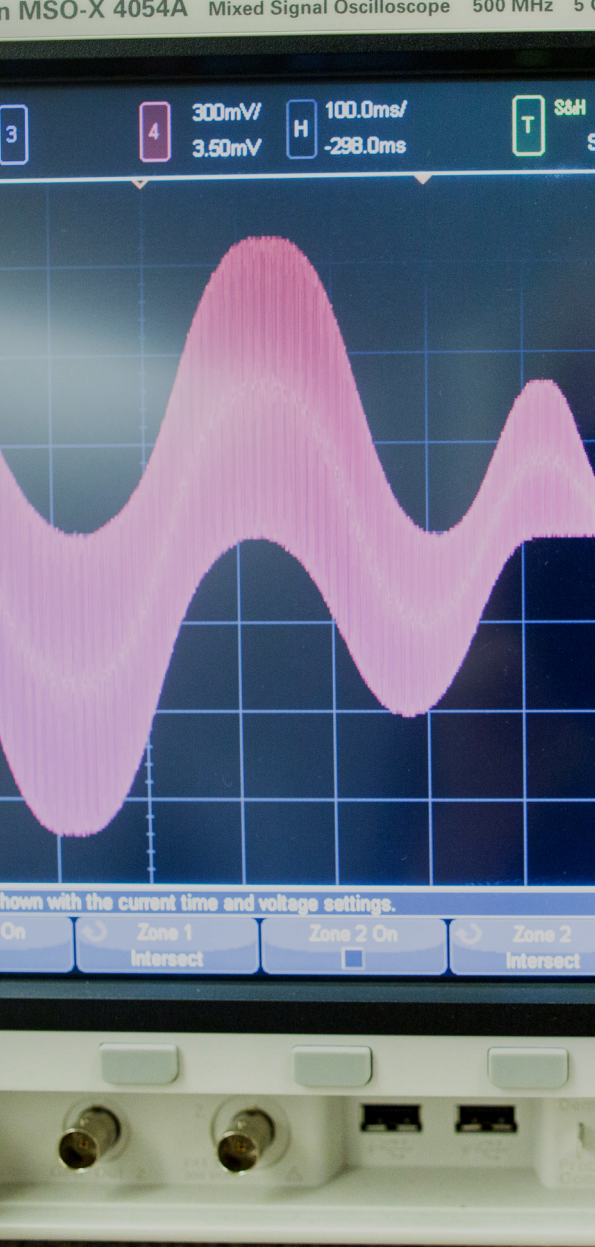


Sonoma County will see moderate growth in the health care industry, even as expansion slows from the last ten years. The combination of record enrollments across the state of California (with Medicaid expansion and the launch of Covered California) and the aging population of the county (one quarter of the county is projected to be over the age of 65 by 2030) will continue to drive demand for health care, and especially home health aids, specialized doctors, and nursing homes. The tightening of the labor pool, however, will constrain worker supply and will continue to drive wages up, especially in holistic care centers that are particularly common in Sonoma County.



Enrollments in coverage across the country have declined, fueled by uncertainty around the future of the Affordable Care Act. For Covered California, the state's federal marketplace for healthcare, overall enrollment dropped by .5%--an improvement of 1.7% from the year before. While policy shifts at the federal level drive enrollment down, and consumer costs up, the state of California has increased subsidies to offset the cost of higher premiums. Robust competition in the California marketplace will further dampen rising costs. Nevertheless, patients will bear much of the cost of employer-provided healthcare, as plans shift costs onto employees.

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 expanding well, but showing signs that growth is moderating as firms grapple with the supply constraints of a late-cycle expansion. Local payrolls in healthcare have risen more than 3% since the beginning of 2017, outpacing overall employment gains in Sonoma County and reflecting growing demand for medical care among older cohorts and newly insured residents. The launch of the state healthcare exchange and California's expansion of Medicaid have significantly boosted insurance coverage statewide.

After experiencing robust growth in recent years, healthcare employment gains are slowing as providers struggle to fill positions amid an extremely tight labor market. Industry headcounts in the first quarter of 2019 were flat relative to a year ago in Sonoma County. Outpatient facilities and hospitals have outperformed other segments of the local healthcare sector as specialized treatment demand rises and insurance coverage improves.

The quality of the care offered by county healthcare providers is outshining that of peers elsewhere in the state and the nation. Annual healthcare rankings by the Robert Wood Johnson Foundation placed Sonoma County eighth in the state, according to health outcomes, a composite index measure of patient health and well-being. This is down slightly from its seventh place finish in 2018 but higher than the 12th place rank it held from 2011-2014.

Still, there is room for improvement. In fiscal 2019, the Center for Medicare and Medicaid Services penalized 800 hospitals across the country—including 99 in California—for exposing patients to unnecessary risk. Four hospitals in Sonoma County were penalized, compared with three the previous year. CMS flagged both Santa Rosa Memorial Hospital and Sonoma Valley Hospital for the third year in a row. Sonoma West Medical Center received its second consecutive penalty and was flagged separately for excessive hospital readmissions. Patient risk exposure at hospitals has been worsening statewide; the share of California hospitals penalized for high levels of hospital-acquired conditions increased 4 percentage points to 34%, compared with 25% nationally.

Macro drivers. The U.S. economy is making solid gains as it pushes further into its late-cycle expansion. Growth will moderate in 2019 compared with a year prior as the stimulus from deficit-financed tax cuts fades and global

growth softens. Consumer spending will prove key to growth, supported by somewhat lower oil prices and a robust labor market. Payroll gains are forecast to average around 170,000 per month through the remainder of the year, pushing the unemployment rate as low as 3.3% and driving wages higher.

Healthcare is a critical driver in the U.S. economy. The industry makes up about 13% of national employment but has accounted for 20% of net hiring since the beginning of 2018. A large fraction of the industry's progress has been fueled by rising headcounts among ambulatory healthcare facilities, particularly home health services. In-home healthcare providers have expanded payrolls swiftly to meet the demands of a growing senior population. While most of these jobs are lower-paying, the sheer number of additions will generate positive spillovers and give the economy a boost.

An expanding senior population will provide greater demand for healthcare in the years to come, both nationally and in Sonoma County. Residents age 65 or older currently make up an above-average 20% of the local population, and this share is forecast to reach 25% by 2030. Over time, outpatient care and in-home health service providers will need to hire additional doctors, nurses, and support staff to meet the needs of older residents.

Industry drivers. The future of the Affordable Care Act is uncertain following federal policy changes, but the landmark bill will nevertheless support the healthcare industry in the medium term. While the ACA has been less successful at containing surging healthcare costs, it has significantly reduced the share of uninsured people across the country. Covered California, the state's federally facilitated marketplace for healthcare, added around 300,000 new enrollees in its open enrollment period for 2019 coverage, around 25% fewer new participants than the prior year. The decline in new enrollees was partially offset by participants who renewed coverage at higher rates. Overall enrollment in Covered California dropped 0.5% from a year ago, slightly better than the 2.2% decline during the previous coverage year.

Policy shifts at the federal level are likely pushing enrollment lower than it would be otherwise. The removal of the individual mandate penalty, which expired January 1, 2019, is prompting some residents to pass up healthcare coverage. Participation is also

lower due to the Trump administration's decision to substantively scale back efforts to advertise enrollment in the Federally Facilitated Marketplace. The federal government also cut off support for cost-sharing reductions, which lowered patients' out-of-pocket expenses, pushing consumers off federal exchanges. California responded by allowing insurers to create modified off-exchange silver plans that are cost-effective under the new policy setting, and the state is encouraging unsubsidized silver plan enrollees to switch to such off-exchange coverage. Meanwhile, subsidized consumers are still buying insurance through Covered California, where subsidies rise to offset higher premiums.

Premiums will rise moderately in the near term, though rate hikes in California will be below the U.S. average thanks to robust competition among insurers. The Golden State boasts one of the most competitive ACA marketplaces. All 11 insurers returned for 2019 and 96% of customers have access to at least two providers. Competition will promote consumer choice and hold down premiums. Still, the individual mandate repeal and spending cuts to ACA marketing will adversely affect the healthcare market and put upward pressure on rates. California's program has historically been effective at attracting young people with lower health costs, but cuts to federal policies that help draw low-risk patients leave the coverage pool sicker and costlier, driving premiums up.

Uncertainty still clouds the total impact of ACA policy changes on rates and enrollment. Doubt over the future path of policy could prompt carriers to raise premiums to accommodate the anticipated cost of covering on- and off-exchange risk pools or exit the marketplace entirely. Regardless, the federal exchanges cover a minority of residents since most get health coverage through their work.

As medical costs rise, employer-provided healthcare will grow more burdensome for patients as plans increasingly shift fees onto workers. Employer-based premiums have spiked more than 10% since 2013, and employees in California have shouldered 40% of the increase over that period, compared with 30% nationally. Rising healthcare costs are eating into workers' earnings. In an effort to improve the health of their workers and reduce insurance claims, companies are increasingly investing in workplace wellness programs that promote weight management and health screenings. While such programs

have proven to be effective at advancing diet and exercise habits, the near-term benefits for health outcomes will be limited.

Additionally, local wellness facilities will prosper as holistic care grows ever-popular in the U.S. Sonoma County is home to a constellation of treatment centers, including facilities providing spa treatments, specialized fitness programs, and massage therapy. As holistic care grows more mainstream, county wellness centers will flourish, attracting health-conscious residents and tourists to the area.

Pricing. As hospitals increasingly consolidate, county healthcare providers will gain pricing and bargaining power relative to insurers and medical device manufacturers. More than two-thirds of hospitals in Sonoma County are either members of or have initiated talks to join broader regional networks. Greater leverage in bargaining will help county hospitals bring down operating costs.

Conversely, consumers stand to lose pricing power as healthcare providers form large affiliations. Insurers passing along the costs of a higher-risk patient base are pushing prices higher for their customers. After rates surged from 2016 to 2018, on-exchange premiums through Covered California will fare slightly better in 2019. Average unsubsidized premiums will rise an estimated 8.7% in 2019, lower than the 12% jump the year before but still above the five-year average of 8%. Meanwhile, subsidized consumers will see an above-trend 6% increase. Insurance rates will climb in step with the rising costs of medical services, prescription drugs and hospital staff.

Operating expenses. Operating expenses will increase in the years ahead as a tight labor market pushes wages higher. Lofty salaries will raise costs, as labor reflects one of the largest components of healthcare cost structures. Still, hospitals will reap the financial benefits of technological improvements. Electronic record-keeping and data management systems will enable hospitals to manage greater caseloads, supporting bottom lines. The transition from the traditional fee-for-service model, which can lead to unnecessary procedures, toward value-based care systems will help providers become more cost-conscious. This shift will accelerate in the years ahead as the Department of Health and Human Services begins implementing various value-based care models for primary care providers in 2020.

Profitability. Profit margins at area hospitals will hold steady despite rising operating

costs. Estimated operating margins slipped to 3.3% in 2018, down from 5.3% in 2017 and roughly in line with the 3.8% average over the previous five years. Limiting uncompensated care costs will be crucial to preserving healthy profit margins. Uncompensated care has been declining as a share of overall operating expenses, with the latest estimate at 6.4% in 2017, down from 8.5% in 2013. However, recent progress is at risk following the removal of the individual mandate tax penalty. This policy shift may induce some residents to forgo health insurance, pushing uncompensated care costs higher and crowding emergency rooms.

A proposed rule by CMS could add additional strain to the bottom lines of Sonoma County hospitals. Released in April 2019, the proposal seeks to address inequities in federal rules regarding regional cost-of-living differences that—in some states—favor hospitals in metro areas over those in rural areas. Hospitals in Sonoma County would see federal payouts adjusted down under the new rule, though the CMS would set a limit on funding declines due to the rule change.

Sonoma Specialty Hospital—formerly the Sonoma West Medical Center—is on better financial footing following the transition to a new management group. Mired in fraud and controversy, the previous administrator filed bankruptcy in late 2018 and discontinued its toxicology testing services. The new management group is transitioning the facility into a long-term acute care center with an urgent care operation. If progress continues, the hospital's fiscal turnaround will be a boon to county healthcare employment.

Long-term outlook. Sonoma County's healthcare industry is on solid ground and is set to capitalize as older residents boost consumption of medical services. The area's position as a hub for holistic wellness facilities gives the local industry a leg up as residents and visitors increasingly focus on holistic health and treatment.

Even though below-average population growth in the years to come will hamper healthcare's progress, the industry will benefit greatly as the share of senior citizens in Sonoma County rises faster than the U.S. average. The local population of residents age 65 or older has expanded by 30% since 2012, compared with the 23% in California and 22% nationwide. This pace also far exceeds the 2% increase in Sonoma's total population over the same period. By 2030, one in four individuals in Sonoma

County will be at least 65 years old. Longer term, health services will expand at a moderate pace to meet the medical demands of an aging population and broader patient base.

Upside risks. The affiliation between Sonoma Valley Hospital and The University of California, San Francisco Medical Center may provide a valuable talent pipeline between the Bay Area and Sonoma County. Finding skilled labor to fill positions will be a hurdle as demand for health services grows, and drawing workers from San Francisco, where costs of living are sky-high, will be important. New residency programs at Sutter Medical Center and Kaiser Permanente Santa Rosa Medical Center could also help ease the labor shortage that is feeding higher patient costs.

A formal partnership between Healdsburg District Hospital and St. Joseph Health would greatly benefit the public hospital, which has had its share of fiscal woes. The two parties officially began talks last year and are exploring the potential for a management or lease agreement. Affiliating with St. Joseph Health would bring down costs for Healdsburg, raise efficiency, and ensure the hospital remains financially viable in the years ahead.

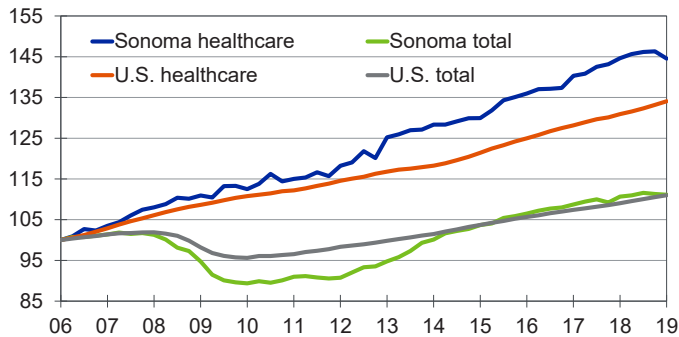
Stronger-than-expected household formation would provide county healthcare providers with a windfall of new patients. In particular, adding more young, low-risk patients to the insurance pool would soften premium hikes across the board and increase demand at Sonoma County's wellness facilities.

Downside risks. Uncertainty over the future of the ACA and federal healthcare policy is weighing heavily on the long-term outlook for Sonoma County's healthcare industry. California's insurance market remains in flux and will suffer without the ACA's individual mandate or federal support for cost-sharing subsidies that help low-income patients with out-of-pocket expenses. If insurers become convinced that these policies will persist in the long term, the marketplace may destabilize further and lead to higher premiums, fewer insured residents, and healthy people exiting the insurance pool. This would leave a sicker group of consumers with even higher premiums that could perpetuate a vicious cycle. More uninsured residents would hamper demand for healthcare as fewer low-income residents seek preventive care and raise uncompensated care costs, damaging the profitability and fiscal health of hospitals.

*Evan Karson
June 2019*

Robust Net Hiring in Healthcare...

Payroll employment, 2006Q1=100, SA

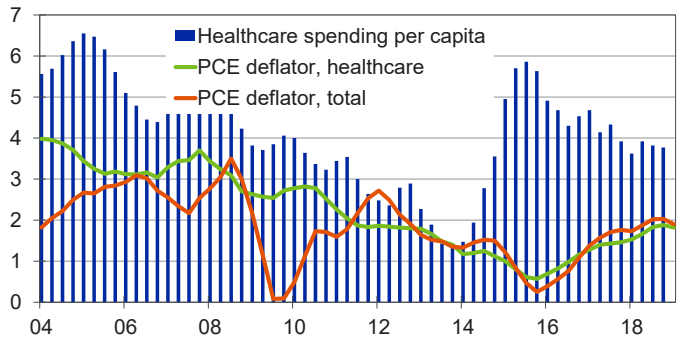


Sources: BLS, Moody's Analytics

Healthcare has been one of the best-performing industries in the U.S. and Sonoma County over the past decade. Rapid growth in the population of seniors has fed strong growth in demand for health services and medical treatments. The ACA has provided another tailwind to industry employment; the sweeping healthcare law has significantly improved insurance coverage in the U.S. and broadened the overall patient base. Slowing population growth in the years ahead will begin to take the edge off payroll growth, but the overall outlook remains positive.

...Alongside Higher Spending and Costs

% change yr ago, 4-qtr MA

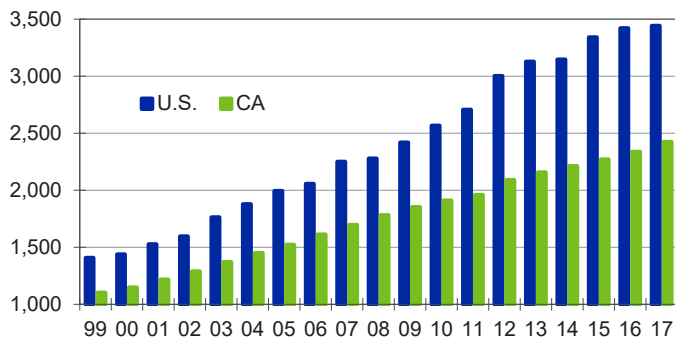


Sources: BEA, Moody's Analytics

Healthcare costs have been accelerating steadily in recent years, with the pace of growth reaching 2% in early 2019. Insurance premiums will see solid increases in the near term as carriers recalibrate on- and off-exchange plans to align with anticipated healthcare expenses. Fortunately, California's insurance pool covers most of the state's residents, and consumers in California and Sonoma County are healthier than average, which will help limit premium hikes in the upcoming years. Even though premiums in Sonoma County may fare better than in the U.S., healthcare spending per capita will expand quickly as the county's senior population swells.

Hospital Expenses Rising in California...

Expenses per inpatient hospital day, \$

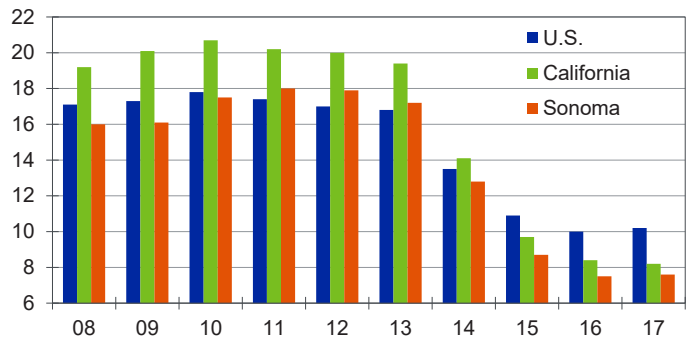


Sources: American Hospital Association, Moody's Analytics

The surging cost of hospital care remains the defining feature of healthcare's performance. One day of inpatient hospital care has become 34% more expensive in California since 2010, compared with 27% nationally. U.S. median household income rose 25% over the same period. Rising wages account for a significant fraction of increasing costs and weigh heavily on the sector's outlook, as labor reflects a major component of hospitals' cost structure. Care providers are also under fiscal pressure from increasing prescription drug costs and malpractice insurance premiums.

...But With Greater Insurance Coverage

Uninsured, % of total population



Sources: Census Bureau, Moody's Analytics

Health insurance coverage has expanded significantly over the last five years. In 2013, an above-average 17% of non-elderly residents in Sonoma County lacked health insurance. This figure fell to 8% by 2017, outperforming the U.S. and California. Even though healthcare costs are rising swiftly, many patients have managed to retain their insurance coverage with support from ACA premium subsidies, which increase over time in proportion to health insurance premiums. Broadening coverage has been critical to limiting uncompensated care costs at state hospitals and keeping care facilities financially viable.



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