Sonoma County Economic Development Board

presents

2005 Medical Services Report

Sonoma County EDB Economic Development Board
www.sonoma-county.org/edb

Sonoma County Workforce Investment Board

With Acknowledgment and Appreciation to the Underwriters of the Economic Development Board Foundation Research Initiatives Program

Sonoma County Permit & Resources Management Dept. ■ Sonoma County Office of Education
Community Development Commission ■ Sonoma County Health Services ■ Codding Foundation
Sonoma County Transportation & Public Works ■ Sonoma County Workforce Investment Board

American AgCredit

Anderson Zeigler Disharoon Gallagher Gray — Attorneys at Law, A Professional Corporation

Christopherson Homes Incorporated

Frank Howard Allen Realtors

Bank of America

Exchange Bank — Since 1890

Ghilotti Construction Company — Since 1914

Matsen Insurance Brokers

Wells Fargo

Luther Burbank Savings

North Coast Bank

SAFE-BIDCO

Law Offices Lanahan & Reilley LLP

National Bank of the Redwoods — www.nbronline.com

North American Title Company — Like Clockwork®

BasinStreet Properties

Westamerica Bank

Summit State Bank

Prudential Santa Rosa | California Realty

Sonoma Valley Bank

Ryan Mortgage Company

North Bay Business Journal — North San Francisco Bay Area: Sonoma, Napa, and Marin Counties

Keegan & Coppin Real Estate

Bank of Marin — Member FDIC

Redwood Credit Union

First American Title

Merrill Arnone & Jones, LLP

North Coast Builders Exchange

Simons & Brecht Inc. — Development • Architecture • Management — Redefining the workplace since 1967

The Press Democrat

Pacific Gas and Electric Company®

REMLA — Redwood Empire Mortgage Lenders Association

April 2005

The Sonoma County Economic Development Board (EDB), in partnership with the Sonoma County Workforce Investment Board, is pleased to bring you the 2005 Medical Services Report. Our research partner, Economy.com, produced this report for the EDB. It includes important information regarding the hospitals, health professionals, managed care organizations and medical technology firms in Sonoma County. This report reviews 2004, and provides a look ahead.

Highlights from the 2005 Medical Services Report include:

- Following three years of weak revenue and profit growth, the health services industry enjoyed one of its best years in 2004. The growth was attributed to improved pricing and successful cost containment.

- Hospitals in Sonoma County posted operating margins of 4% in the year leading up to the third quarter of 2004, a 3.6% increase from the same period last year.

- New investment and expansion activity by Kaiser Permanente, Sutter Medical Center, and Sonoma Valley Hospital is driving industry growth in the near-term.

- The local heath services industry has posted two consecutive quarters of positive employment growth, after contracting for the preceding six quarters. Plans for new hospitals or expansions bolster prospects for ongoing hiring in the coming two years.

- Technology creates the biggest upside potential for the health services industry. The recent space expansion by Medtronic and the continued growth of several small biotech firms, most particularly TriVascular and Endomatrix, bode well for the sector locally.

Thank you for your continued interest in the Economic Development Board's research. As always, if you have any questions please feel free to contact us at 707-565-7170.

Sincerely,

Ben Stone
Director

Recent Performance. The outlook for the health services industry in Sonoma County has improved markedly over the past year. Following three years of weak revenue and profit growth, the health services industry enjoyed one of its best years in 2004. The industry is set to post moderate growth in the coming year as well. Improved pricing and successful cost containment are the most significant drivers behind the improved outlook.

Hospitals in the county posted operating margins of 4.07% in the year leading up to the third quarter of 2004, the last quarter for which data are available. This is up from 3.64% for the same period last year, according to data from the California Office of Statewide Health Planning and Development (OSHPD). The local heath services industry has also started adding jobs through the second half of 2004, after contracting for the preceding six quarters.

Notably, all the revenue growth in the local health services industry is coming from improved pricing, since utilization has actually declined. Total hospital discharges for all of the county's hospitals for the four quarters ending in the third quarter of 2004 were down 2.3% from the same period in the previous year. Total outpatient visits were down 2.6% as well for the same period. At the same time, however, operating revenues rose 13.8% for inpatient visits and 17.9% for outpatient visits, according to OSHPD data. This confirms that area hospitals are enjoying healthy growth in pricing for services provided from the major payers—Medicare and private insurers. Indeed, revenues for Sonoma County hospitals from Medicare were up 12%, and private insurer revenues were up 22% for the year ending in the third quarter of 2004, according to OSHPD data. Medi-Cal remains constrained by budget cuts, and Medi-Cal revenues to local hospitals were up a mere 1.4%.

In particular, local hospitals benefited from a reclassification in the Medicare wage-index, which brings Medicare's reimbursements to hospitals in Sonoma County more in line with payments to San Francisco hospitals. Physicians continue to be paid a lower rate though, which remains a drag on the local industry. However, the likelihood that Medicare will fix this formula in the coming year is encouraging.

On the medical technology front, the loss of over 500 jobs at Medtronic Vascular has been a setback to the region's biotech aspirations, although recent space expansions by Medtronic bode well for the industry locally. Several small biotech firms continue to invest and expand locally, most particularly TriVascular and Endomatrix.

Macro Drivers. The broader U.S. economy is expected to post strong but moderating growth into 2005. Fundamental macroeconomic and industry drivers will ensure that the health services industry maintains sturdy job and revenue growth. A pickup in broader income growth is crucial to driving overall medical care consumption trends, especially with increased cost shifting from employers to employees. Demographically, an aging population is expected to support robust consumer health spending over the longer term, particularly in outpatient centers, nursing homes and home-health settings.

In the medium term, an expected pickup in interest rates will weigh on demand for corporate and municipal bonds. This will adversely affect the health provider industry disproportionately, as a majority of hospitals rely on this market for capital acquisition. In addition, hospital boards, and especially non-profit boards, are facing increased accounting and corporate governance pressure in the wake of Sarbanes-Oxley.

Industry Drivers. The improving fortunes of the Sonoma County's healthcare industry are demonstrated by the flush of new investment and expansion activity in the industry locally.

The most dramatic are the three major new hospital expansions that are in the works. Kaiser Permanente, flush with money from rising insurance premiums over the past four years, has committed to spending $180 million to build an 82-bed hospital wing, as well as a medical office building and parking garage over the next three years. Meanwhile, competitor Sutter Medical Center has also announced plans to build a 118-bed, $204 million hospital and medical office building. Finally, Sonoma Valley hospital, deciding that a seismic retrofit will be too expensive, is currently exploring the establishment of a new $100 million hospital instead.

Soaring insurance premiums and new market developments have made the heath insurance industry a lucrative one as well. PacifiCare, for instance, has indicated it will be reentering the Medicare HMO market in the county after quitting the local market two years ago. Medicare reimbursement rates for private managed care organization have been bumped up significantly as part of the Medicare Prescription Drug Bill passed in late 2003, making the Medicare HMO market profitable again. As a result, county residents now have a real alternative to Kaiser, currently the only large HMO in the market.

In addition, the past year has also seen a flurry of smaller companies that offer more consumer-centric health insurance. The creation of Health Savings Accounts (HSAs), also under the Medicare bill of 2003, has encouraged the creation of various small alternative health insurance plans that cost employers significantly less than traditional insurance plans, but transfer a higher burden of health costs to the consumers.

The slew of new potential competitors is good news for local employers and employees, and will help to further moderate health cost gains in the coming year. The expansion of hospitals, however, offers some risks. Sonoma County hospitals already operate under lower occupancy rates than the state average and the county currently has a higher share of hospital employees per capita than the state. New investment and competition between the few existing hospitals create the real possibility of a new medical technology arms race, which will in turn raise overall costs for local healthcare in the medium term.

Pricing. Over 45% of hospital revenues in the county come from public sources, mostly Medicare. Despite growing fiscal deficits that pose a risk to long-term Medicare commitments, Medicare reimbursements are not threatened in the near term, and are expected to remain healthy. Sonoma County hospitals received a healthy boost this year due to their reclassification by Medicare from rural to urban, which garners a higher reimbursement rate. Physicians continue to be paid a lower wage, however, as they are still classified under rural designation. There is a strong possibility that legislation will be introduced this year to fix this, which could generate up to 10% higher Medicare revenues for local physicians.

The outlook is not so sanguine for the Medicaid portion of public reimbursements. Although Medi-Cal only accounts for about 11% of total revenues for the county's hospitals, persistent budget deficits leave the program open for serious cutbacks. The California health industry dodged a bullet last year when the governor's proposed 10%

cutback in provider rates in Medi-Cal for FY2004-2005 was rescinded in May. Still, growth in Medi-Cal revenue for hospitals has been muted over the past year. In January 2005, Governor Schwarzenegger has proposed an ambitious overhaul of the system, pushing for a shift from the current fee-for-service to a managed care system with new user fees for beneficiaries. Most providers are relieved that the proposal includes no cuts in reimbursement rates, muting the direct impact of the proposed overhaul. Still, a shift to greater managed care participation could further limit pricing gains in Medi-Cal.

Private insurers account for nearly 40% of local hospital revenues. The outlook calls for healthy but slower growth in reimbursements from private insurers in the coming year. Hospitals are coming off two years of steady accelerating private reimbursements. Increasing pressure from public groups to limit health insurance premiums growth, as well as increased competition in the local health insurance market, will help temper premium growth. However, this also means a moderation in prices private insurers pay to local hospitals.

Operating Expenses. Labor and technology continue to be the biggest drivers of operating expenses for health service providers nationally, and Sonoma County is no different. Local hospitals suffer higher patient-adjusted operating expenses than the state average, according to OSHPD data. Whereas patient-adjusted operating expenses averaged $1,919 for the state for the four quarters ending in the third quarter of 2004, Sonoma County hospitals averaged $2,006, 4.5% higher.

Although local hospitals did a good job cutting expenses over the past two years, there are signs now that most efficiencies have been wrung out of the system; operating expenses rose over 9% between the third quarter of 2003 and 2004. This exemplifies some of the persistent labor and technology pressures that the county is facing. Although the national and regional nursing shortage has eased some over the past two years, hospitals remain pressured to pay higher wages to attract and retain trained staff. California's mandated minimum-nurse staffing ratio is also exacerbating the situation, although it is likely having a positive impact on outcomes.

Increased competition among local hospitals and an improvement in revenues have also led to the resurgence of technology competition between local hospitals. This is in turn putting upward pressure on technology expenses. Capital expenditure is up over 40% between the third quarter of 2003 and third quarter of 2004. Expansion of building space and new technologies will drive expenses in the coming year, especially as interest rates rise, making borrowing more expensive.

Finally, bad debt remains a growing problem for hospitals, nationally and regionally. Despite the economic recovery, the number of uninsured remains notably high, and this has increased the pressure on hospitals that provide uncompensated care.

Profitability. Profit margins are now moderating after improving markedly in late 2003 and into early 2004. Improved reimbursements from public and private sources, combined with effective cost containment, have put local hospitals, in aggregate, in the black. Operating margins rose from 1.71% in the third quarter of 2003 to 1.96% in the third quarter of 2004.

Managed care companies are enjoying strong profit margins due to hikes in insurance premiums and reduced operating expenses. Successful attempts to bolster private industry participation in Medi-Cal will also further boost profitability in managed care plans. That said, the best times have likely passed, and increasing competition and pressure from employers will lead to healthy but weaker profit margins in the coming year for the local health insurer industry.

Long-Term Outlook. Despite some downside risks on the horizon, the long-term outlook for the health service industry in Sonoma is positive. The county's demographics provide room for optimism for local healthcare demand. Sonoma residents are generally wealthier and older than the average Californian and the average American. Further, the public health caseload in Sonoma County is below average, with a lower share of the population eligible for the state's low-income Medi-Cal program than the state average. The aging of the baby boomers, concurrent with a boom in healthcare technology and a growing life expectancy, will support consumer demand. Local hospitals should also continue to benefit from serving residents in neighboring counties, where the public caseload is significantly higher and healthcare facilities are less well-equipped.

The outlook for managed care is less optimistic due to its decreasing efficacy in stemming rising healthcare costs. Continued growth in prescription drug spending will complement the ever-increasing costs of implementing new medical technologies. That said, new forms of managed care that take advantage of the internet to improve consumer ownership of healthcare could lead to renewed growth in the industry. Over the long term, hospitals and unionized physician groups with more negotiating clout on one side, and the public and political forces demanding lower health costs on the other, will squeeze managed care profits.

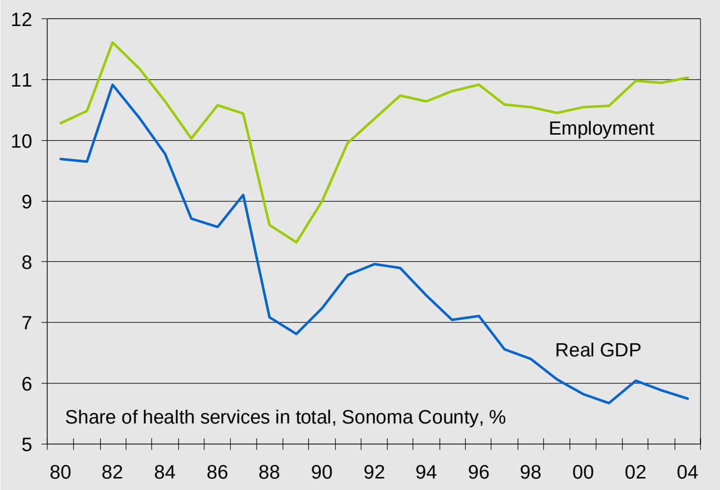
Upside Risks. Technology creates the biggest upside potential for the health services industry. Greater use of the internet and budding wireless technologies could provide significant operational and cost efficiencies. More accurate, accessible and standardized information would cut waste and increase consumer choices. Similarly, the continued rapid development of medical technologies offers significant potential for providing more efficient care to a larger population. Any unforeseen leap from the drawing board to the marketplace of even one of the many promising new technologies is a significant upside risk. Research done at the Buck Institute, as well as ongoing research and development at the many budding local biotech companies, bodes well for the nascent biotech cluster in Sonoma County.

Downside Risks. The greatest downside risk to providers nationwide is extremely high state deficits. Medi-Cal reimbursement cuts remain a real risk, even though they are off the table for now. Further, an imposition of Medi-Cal user fees could lead to a further increase in the rolls of the uninsured and put further pressure on hospitals through bad debt.

Demographic trends also bear watching. Healthcare providers in SON are building capacity anticipating a spurt in demand as baby boomers retire. However, with baby boomers living healthier lives, the demand for healthcare might not increase as much as expected, and might be focused on medical devices and drugs than on health services. Persistent physician woes are also a downside risk; anecdotal evidence suggests an ongoing physician shortage in the county, which could intensify and affect local health outcomes if it is not addressed.

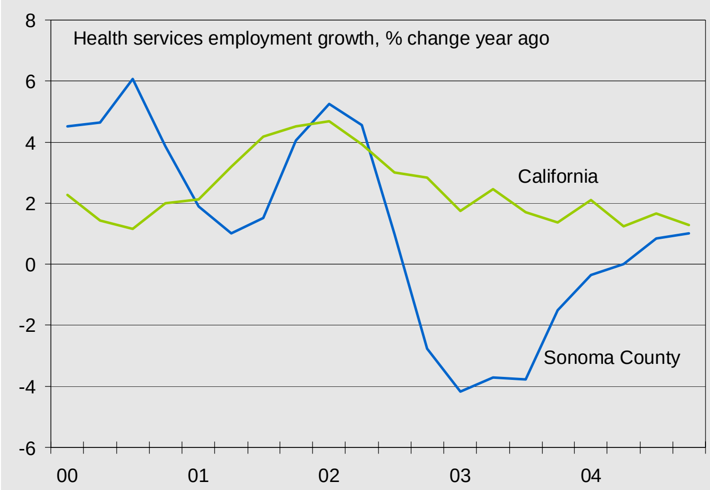
Rakesh Shankar
April 2005

Healthcare Matters in Sonoma County, but More So for Jobs



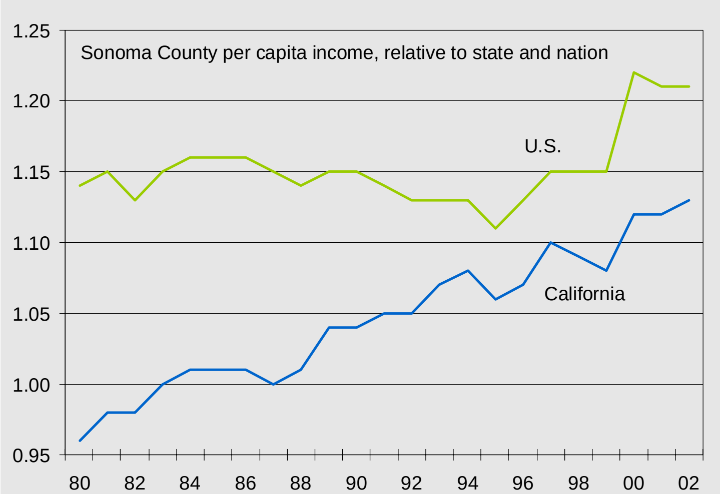
Healthcare is one of the largest employers in Sonoma County and contributes a significant share of personal and wage income, nearly 10% in 2004 by Economy.com estimates. Stronger than average growth in non-healthcare industries in the late 1990s helped temper the role of healthcare in the local economy, but this has reversed following the 2001 recession. That healthcare's share of output has declined speaks more to the stronger increase in output for non-healthcare industries due to productivity gains that were largely absent in healthcare in the 1990s. This reflects national trends.

A Recovery in the Works



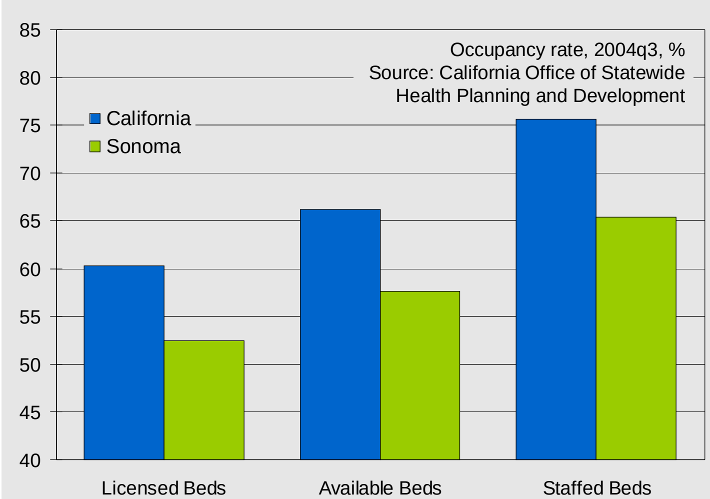
After over two years of persistent weakness, local hospitals are finally seeing enough of an improvement in their financials to resume hiring again. The industry has now posted two consecutive quarters of tentative but positive employment growth. Anecdotal reports indicate that Kaiser Permanente has added over 700 jobs in the past year, while Sutter has added over 200 jobs. Nursing shortages are easing a bit, and mandatory nursing staffing ratios are helping bolster employment. Plans for new hospitals bode well for ongoing new hiring in the coming two years.

Richer Is Better



One of the fundamental drivers of the positive long-term outlook for healthcare in Sonoma County is its wealthier base. Macroeconomic studies indicate a positive relationship between wealth and spending on health services, especially elective procedures that tend to be more lucrative for the local health service industry. A wealthier base also suggests a smaller uninsured and dependent base, which minimizes the demand for uncompensated care from local health providers. The county's income advantage with the state and the nation has steadily improved.

More Empty Beds to Fill



There is some cause for trepidation from the recent announcements of new hospital construction in the county. Although local hospitals enjoy healthy revenue growth, there is plenty of data to question whether Sonoma County really needs more hospital beds. Hospitals are already suffering from lower utilization rates, both on an outpatient and inpatient basis. Further, local hospitals suffer a far lower bed occupancy rate than the state, despite having lost bed capacity in the past few years. Thus, new construction might actually spur higher health costs.