



HEALTH INDUSTRY REPORT



2007



HEALTH INDUSTRY INSIDER

November 2007

The Sonoma County Economic Development Board (EDB) is pleased to bring you the first Health Industry Insider, a report that reviews the county's health care industry and related health care issues. The report also briefly discusses the effects of the shifting economy and local demographics on the demands for health care facilities and technology. Our research partner, Moody's Economy.com, produced the research for this report.

Highlights from the 2007 Health Industry Insider include:

- The continued rapid development of medical technologies, including recent advances in biotechnology, offers significant potential for providing more efficient care to a larger population.
- The medical services industry in Sonoma County continues to expand. Sonoma County boasts an above-average share of residents aged 65 and older. This elevated share of elderly favors increased demand for medical services, particularly in outpatient centers, nursing homes, and home health settings.
- Local hospitals are expected to continue to benefit from serving residents in neighboring counties, where the public caseload is significantly higher and healthcare facilities are less equipped.

Thank you for your continued interest in the Economic Development Board's research. As always, if you have questions or suggestions, please feel free to contact us at (707) 565-7170. Questions specifically related to this report or to the Sonoma County Employers' Coalition on Health may be directed to SCECH@sonoma-county.org.

Julia Roberts, Project Coordinator for the EDB and the Sonoma County Employers' Coalition on Health (SCECH), compiled and presented this report.

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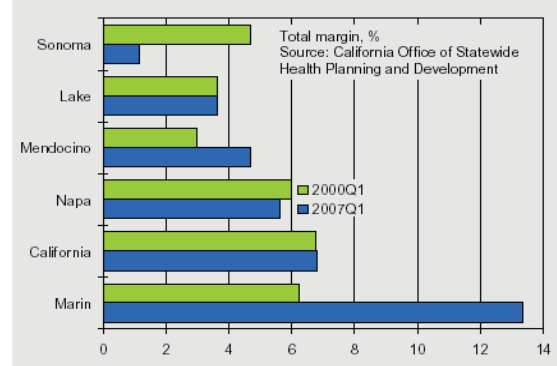
Recent Performance. The medical services industry in Sonoma County is expanding, albeit at a slower pace than it experienced earlier this decade. According to the California Office of Statewide Health Planning and Development (OSHPD), revenues during the first quarter of this year rose 6% relative to one year ago; this comes on the heels of 8% growth the quarter prior. Further, revenues are currently advancing at half the pace they did early in the decade. The medical services industry is facing a growing number of constraints, namely further slowing in U.S. national health expenditures, fading pricing power, low reimbursement levels in Sonoma County and rising insurance premiums. These factors will challenge the industry's financial performance over the next couple of years.

While hospitals in the county are posting slower revenue growth, they are combating rising expenses. In the first quarter, operating expenses rose over 7% on a year-ago basis for Sonoma County hospitals. Rising operating expenses for medical services are common themes across the county, primarily due to rising labor costs. Tight labor markets, combined with a shortage of skilled healthcare workers, have put considerable upward pressure on wages. With growth in operating expenses outpacing revenue growth, net income was down over 60% in the first quarter.

The deceleration in revenue growth suggests that hospitals in Sonoma County are losing a portion of their pricing power. Demand has turned sideways with total outpatient visits up a scant 1.8% in the first quarter, and total patient days were essentially unchanged compared to the same time last year. According to OSHPD data, average staffed beds were up over the past year.

The county's healthcare industry may see a shift in 2008 pending the potential closing of a hospital. In response to financial stress—brought on in part by need for a \$300 million state-mandated seismic retrofit—Sutter Medical Center has proposed closing its 175-bed in-patient hospital in Santa Rosa and putting on hold plans to build a new facility. If the Medical Center closes, some operations would be taken over by Memorial Hospital, which has begun to expand its capacity and would likely take on the indigent and under-insured

Sonoma Bringing Up the Rear



The healthcare industry has moderated nationally and regionally since the beginning of the decade, as indicated by slower profit and revenue growth. The same is true of Sonoma County hospitals, although the moderation locally has been far stronger than in the rest of the state. Total margins for Sonoma County hospitals in aggregate have declined considerably since the beginning of the decade and are now well below the state average. Among other factors, this reflects a higher burden of indigent care that Sonoma County hospitals bear, according to OSHPD, nearly twice the state average in 2006.

patients now assigned to Sutter. Memorial also recently announced its plan to double its emergency facilities on its Santa Rosa campus in 2008. Over the long term, this reduction of capacity may improve profitability for the local healthcare industry with improved economies of scale, although near-term costs will be incurred as other providers continue to undertake moderate expansions.

Macro Drivers. The primary macroeconomic drivers for Sonoma's medical service industry are demographic trends, interest rates, labor markets and income growth. As such, macroeconomic conditions are gradually turning less favorable for the medical services industry.

The ongoing drags on the consumer due to high energy prices and mortgage payments bode ill for the medical services industry, as industry revenues are becoming more dependent on household finances. This stems from the ongoing shift of health insurance costs from employers to employees. Job and income growth will therefore become increasingly important drivers for the medical services industry going forward.

Sonoma County's labor market is tight with job growth at its fastest rate since the 2001 recession. Hiring has surged ahead of California and U.S. growth rates with gains evenly distributed across most major industries.

The acceleration in job growth will be a positive for the medical services industry as it will help support spending on medical care. Sonoma County's tight labor markets are the key to supporting healthy income growth. Steady income gains will increase households' ability and willingness to pay for medical services. Therefore, as long as the economy continues to add jobs, we expect demand for medical services to grow.

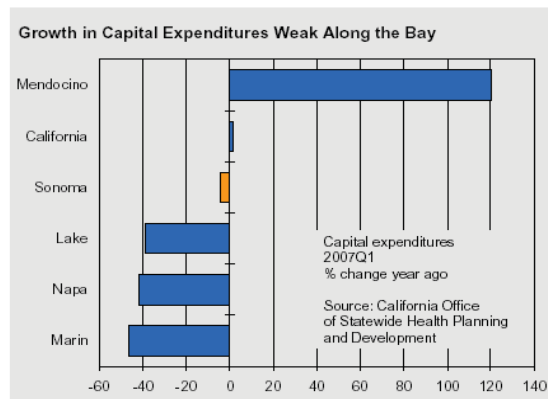
Despite the rapid improvement in labor market conditions in Sonoma County, population growth remains tepid at best. According to the Census Bureau's midyear 2006 population figures, Sonoma County once again lagged both the California and U.S. averages. On a brighter note, Sonoma County boasts an above average share of residents aged 65 and older. This elevated share of elderly favors increased demand for medical services, particularly in outpatient centers, nursing homes and home health settings.

The Fed has lowered its target Fed funds rate since last summer, despite original expectations that it would remain steady. In fact, though Q3 data shows that the economy expanded more quickly than projected at 3.9%, the Fed rate fell from 5.25% to 4.50% in October. Also, while long-term interest rates have increased, they remain low by historical standards. Risk premiums and bond spreads are low, reflecting the buoyant state of financial markets. Market conditions, therefore, remain highly favorable for corporate and municipal bond issuers, including hospitals. The prospective slowdown in health services capital spending is, therefore, more a matter of exhausting investment opportunities than of a shortage of available financing.

Industry Drivers. The most significant expansion in Medicare in the last two decades took effect in January 2006, and Medicare spending has increased significantly as a result of this reform. According to the Treasury Bulletin, federal outlays on Medicare are up by roughly 10% compared to what they would have been without the prescription drug program. The program is expected to add over \$500 billion to the Medicare bill over the first five years. The increase in Medicare spending will have a marginal impact on the medical services industry in Sonoma County.

Because Sonoma County is technically considered a "rural county" by Medicare, Sonoma County physicians get reimbursed at a lower rate than in neighboring Napa. Furthermore, in early 2006 there were cuts to physician reimbursement rates for doctors treating Medicare and Medi-Cal beneficiaries. Sonoma County physicians are reimbursed at the lowest level in California, and 60% of doctors in the area do not accept new Medicare patients, according to the Sonoma County Medical Association. Also, because of the low reimbursement level, Sonoma County is at a comparative disadvantage when attempting to attract new physicians to the area. The low reimbursement level also hurts the medical services' bottom lines.

Medicaid cuts passed over the past year provide some insight into the pressure that is building on the fiscal side. Federal grants for Medicaid have stagnated after several years of robust growth, thus shifting the cost of providing healthcare to program recipients to state governments. The Medicaid cuts are coming at a time when states are enjoying a surge in tax revenues, which has caused many of them to reverse their own previous cuts to Medicaid.



Recently, budget concerns have kept capital investment under wraps in and around Sonoma County. The potential closure of Sutter Medical Center would result in a realignment of medical care to other facilities. Unless capacity becomes an issue, local hospitals will continue to work on shoring up their financial conditions before expanding or building new facilities. However, the recent decrease in interest rates will boost demand for corporate and municipal bonds. This will positively affect the healthcare industry, as a majority of hospitals rely on this market for capital acquisition.

Low real borrowing costs have not been enough to spark a sharp runup in capital spending in Sonoma County. In the first quarter, total capital expenditures dropped 4% on a year-ago basis. Rather than expanding operations, businesses are choosing to consolidate within the industry in an effort to boost revenues and lower costs. Nevertheless, there are some expansion projects in the works. With the assistance of the Kaiser Permanente and other community partners, Southwest Health Clinic has plans to complete a centralized, multi-service health and wellness campus in west Santa Rosa. Still, the lack of capital spending is a long-term hurdle for the local industry. Sonoma County must strive to attract more providers and either upgrade or build new facilities to help attract physicians and specialists.

Pricing. Over the past several years, hospitals and health insurers alike have been able to continuously mark up their prices. However, hospitals and health insurers will have a more difficult time improving their pricing position. Insurers are already seeing significant resistance to price increases, both in the form of substitution to cheaper plans and in the form of politically induced moves to curb price growth through legislation and industry regulation.

Strong demand for managed care is translating into strong pricing growth, which is bolstering its revenues, although all indications point to a moderation in this trend. Rising competitive pressures among insurers, coupled with a moderation in medical spending growth and a pushback from employers and consumers, will work to moderate premium growth.

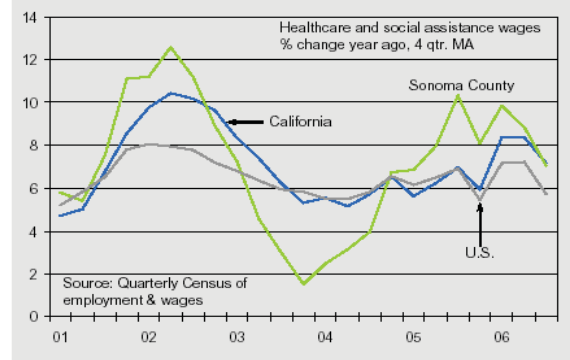
Operating Expenses. The key drivers of operating expenses for health service providers are costs of labor and technology. Labor costs are undeniably the biggest sore spot for the medical services industry. Tight labor markets and a shortage in skilled workers have put upward pressure on compensation for healthcare and social assistance. Further, healthcare and social assistance compensation is advancing well above the average for all workers. Local hospitals suffer high patient-adjusted operating expenses relative to the state, according to OSHPD data. Whereas patient-

adjusted operating expenses averaged \$2,260 for the state for the four quarters ending in the first quarter of 2007, Sonoma County hospitals averaged over \$2,450, 11% higher. A year ago, Sonoma County operating expenses per patient-adjusted day were only 4.5% above the state level.

The lack of new entrants into the local hospital and healthcare industry, combined with slower revenue growth, has led to declines in capital expenditures. The lack of expansion of building space and new technologies will help keep expenses under wraps in the coming year, though this may change with falling interest rates, which make borrowing less expensive.

Finally, bad debt remains a growing problem for hospitals, nationally and regionally. Despite the economy being in its sixth year of expansion, the number of uninsured remains notably high, increasing the pressure on hospitals that provide uncompensated care. In the second quarter of this year, provisions for bad debt were up over 20% on a year-ago basis, according to data from OSHPD. The cost of uncollected debt is a strain on hospitals' bottom lines in Sonoma County.

Wage Growth Bodes Ill for Healthcare Industry



Sonoma County's tight labor market is supporting healthy growth in wage and salary income across a broad number of industries. Wage growth in healthcare and social assistance in Sonoma County is on par with the state average and outstripping the national pace. This bodes ill for the overall healthcare industry as it increases operating expenses while hurting businesses bottom lines. Going forward, we expect the Sonoma County economy to add enough jobs to prevent the labor market from loosening significantly. The tight labor market will help keep a floor under wage growth in healthcare.

Profitability. The medical services industry in Sonoma County has had a difficult time boosting profitability. Over the past year, the industry's operating margin has crept lower, chiming in at 1.2% in the first quarter, down from 3.1% in the same period last year. Further, the industry's operating margin will be tested over the next several years as reduced pricing power will limit firms' ability to recover costs. Also, mounting unpaid hospital bills and other bad debt will challenge the industry's profitability.

Managed care companies have been doing very well over the past several years, but are facing a number of challenges going forward. In particular, employers and employees alike have increased their efforts to reduce high insurance premiums. One source of saving is the gradual shift toward consumer-driven health plans, which carry significantly lower premiums than the traditional HMO model. The lower medical cost of these plans helps to counteract the impact of lower premiums, and therefore cushions insurer profitability.

California healthcare reform plans may prove beneficial to Sonoma County. Currently, California has made considerable progress in recent years in providing healthcare to children. However, an estimated 8,000 still lack coverage as more families lose workplace medical insurance or give it up because of rising premiums. With help from federal funding, the Governor's proposal plans on expanding Medi-Cal, which currently covers over three million children. This will cost between \$4 billion and \$6 billion over the next five years.

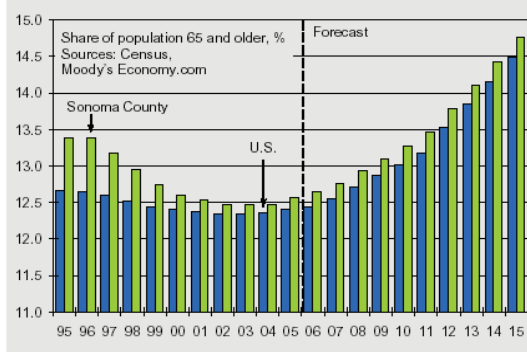
Long-Term Outlook. Despite some downside risks on the horizon, the long-term outlook for the health service industry in Sonoma County is generally positive. The county's demographics provide room for optimism for local healthcare demand. Sonoma residents are generally wealthier and older than the average Californian and the average American. The aging of 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 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.

Upside Risks. Technology remains the foremost upside risk for the health services industry. Greater use of the internet and budding wireless technologies could provide significant operational and cost efficiencies. Similarly, the continued rapid development of medical technologies, including recent advances in biotechnology, offers significant potential for providing more efficient care to a larger population.

Downside Risks. The long-term future of Medicare remains a serious concern for the healthcare industry. The Hospital Insurance Fund, which pays for in-patient hospital spending, started to run cash flow deficits in 2005, and will be exhausted by 2018, according to the 2006 Medicare Trustees Report. The only way to address this is through cutting benefits, raising premiums, raising taxes, or some combination of the three.

Baby Boomers Are Key to Long-Term Growth in Medical Services



Sonoma County's population growth is below average, recording sub 1% year-over-year growth since 2002, according to the California State Department of Finance. More importantly for the healthcare industry, the share of its population 65 and older has declined over the past ten years. This trend is slowing, which is important, as the aging of the baby boomers will boost consumer demand for health services in Sonoma County. Looking ahead, the county's share of elderly in the population will increase, surpassing its most recent peak. An aging population will boost demand for outpatient centers, nursing homes and other healthcare services.

Most of these measures will result in fewer payments to hospitals.

Consumer credit quality poses another downside risk to the medical services industry. Currently, consumer finances are being stretched by a number of factors, including weakening housing markets, high-energy prices and little saving. The risk to spending is mounting as consumers are not as well positioned to absorb unexpected expenses as they were in 2005 and 2006. According to CreditForecast.com, the overall consumer credit delinquency rate in Sonoma County is at its highest level in ten years. Further, conditions are expected to get worse before they improve. The second leg of the housing downturn continues to play out and house prices are falling in Sonoma County, reducing mortgage equity withdrawal and the positive wealth effect. Deteriorating credit quality leaves consumers with little alternative but to reduce spending growth in the face of additional financial constraints. Therefore, consumers may be forced to reduce their spending on medical services at a time when the industry is becoming more dependent on discretionary consumer spending.

Ryan Sweet
November 2007



WITH ACKNOWLEDGMENT AND APPRECIATION TO LOCAL KEY BUSINESSES
SUPPORTING SONOMA COUNTY ECONOMIC DEVELOPMENT:

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EXECUTIVE TIER:



ASSOCIATE TIER:



- Sonoma County Permit & Resources Management
- Community Development Commission
- Sonoma County Health Services
- Sonoma County Transportation & Public Works