DEPARTMENT OF FINANCE

Isiah Leggett
County Executive

Jennifer E. Barrett
Director

April 6, 2011

Honorable County Executive, and
Members of the Montgomery County Council

Ladies and Gentlemen:

I am pleased to present the findings of the Twelfth Annual Business Advisory Panel that was convened on February 17, 2011. The enclosed revised report was prepared by the County's Department of Finance pursuant to Article XI, Section 20-61 of the Montgomery County Code.

The revised report consists of a summary of the panel's advice, a list of the panelists, and the information package that the Department of Finance sent to the panelists in advance of the meeting. The information package includes the agenda for the meeting, concise statements by the Department on the economic outlook, and a framework for discussion.

I believe that the accompanying material accurately reflects the economic advice given by the Business Advisory Panel.

Sincerely,

Jennifer E Barrett

Jennifer E. Barrett
Director of Finance

Enclosures

Office of the Director

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FINDINGS OF THE TWELFTH ANNUAL
BUSINESS ADVISORY PANEL
FEBRUARY 17, 2011

Pursuant to Article XI, Section 20-61 of the Montgomery County Code, the Department of Finance (Department) convened a meeting of the Business Advisory Panel (BAP) on February 17, 2011. The County Council of Montgomery County established the BAP in 1999 to seek the advice of industry experts in key sectors of the County's business community concerning the current and future state of the County's economy. The law requires that the Director of the Department of Finance convene the panel annually and relay the panel's advice to the County Executive and the County Council. This report provides such advice.

The BAP consisted of members representing real estate, finance, health services, academia, and government and trade associations. The meeting was structured to allow participants to brief the panel on the local economic trends and to share their insights about future economic prospects in the County. The participants also discussed the Department's economic assumptions for the next six fiscal years. For purposes of this report, the results of the discussions are presented in two parts. The first part discusses the participants' professional judgments about the County's economy and the Department's economic assumptions. The second section discusses the participants' points about their respective industry sectors.

I. Current Economic Condition and Future Economic Assumptions

The participants were asked to provide comments to a paper prepared by the Department that analyzed the County's economy and provided assumptions about the economic outlook for the next six years. The paper analyzed a number of economic indicators including employment, personal income, real estate, inflation, construction, and interest rates. Because of the current national and regional economic climate, a majority of the discussion by the participants focused on the outlook for the region's economy.

The Center for Regional Analysis (CRA), George Mason University, presented a perspective on the national, regional, and Montgomery County economy. CRA stated that the U.S. economy has been in a recovery for the past twenty months and GDP reached its pre-recession level during the fourth quarter of last year. CRA cautioned that the risk of forecasting the national economy is to underestimate or be too pessimistic about the economy. The current recovery has been on a trend that is consistent with the past two recovery cycles, and as experienced with the 2001 recession/recovery cycle, this recovery may also be a jobless recovery. The region's GDP is about 0.4 to 0.5 percentage points above the nation's rate. CRA estimates that the national unemployment rate will reach 7 percent by 2014 while the normal/natural unemployment rate is 5.7 percent..

Federal spending totaled $144 billion in the local economy. Department of Defense (DoD) procurement was down in 2004 and 2008 although the amount of procurement for 2010 is not yet known. CRA suggests that Montgomery County should focus of non-federal procurement and on those business sectors that are outperforming other business sectors. The

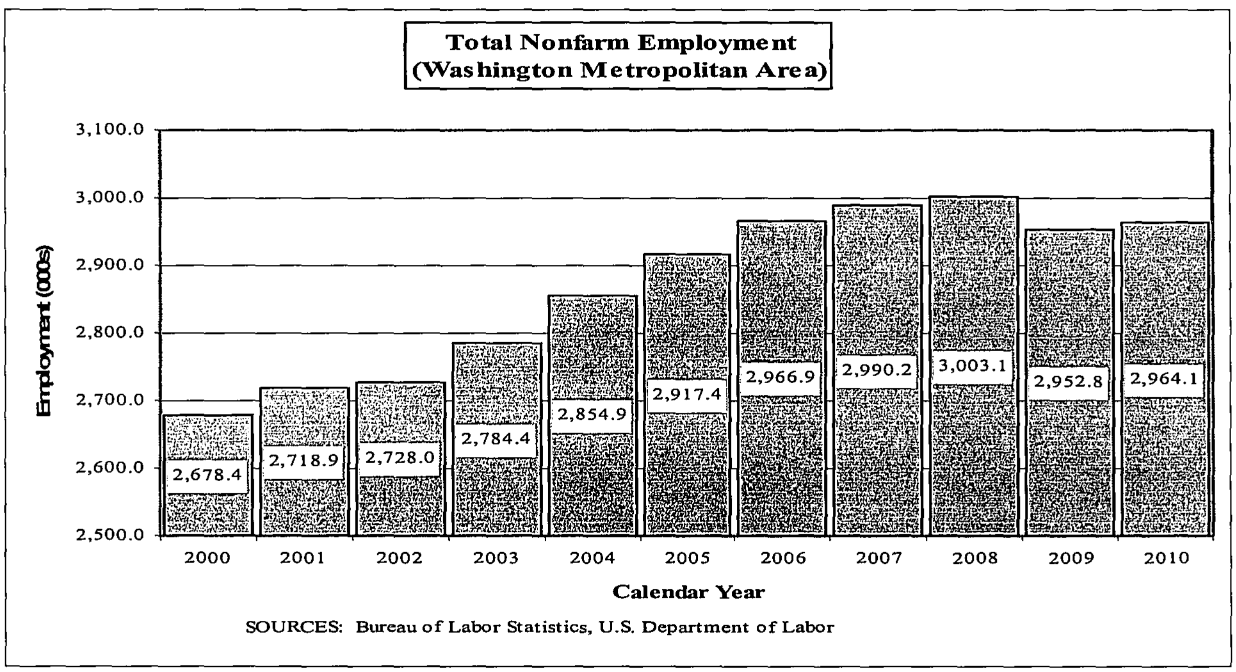
County needs to be cost competitive because business growth will come from companies that want to be here and provide goods and services beyond the County. Montgomery County is in a better position to grow the non-DoD sector than Fairfax County, which has built its infrastructure around DoD spending. The County's life science industry provides a unique attraction for future growth. CRA also noted that there is a serious labor shortage both in quantity and quality.

Post-meeting Update

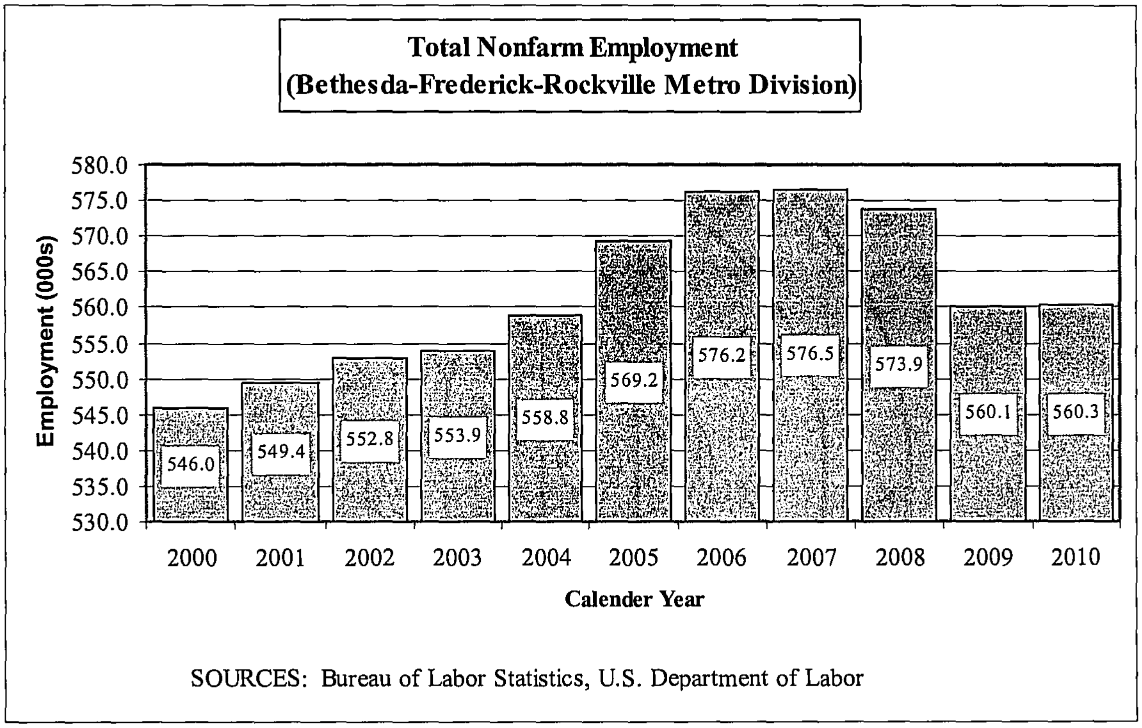
Since the meeting of the Business Advisory Panel in February, the Bureau of Labor Statistics, U.S. Department of Labor (BLS), revised the establishment series, i.e., non-farm employment data, starting with April 2009. While the revisions do not change the points discussed or conclusions reached during the meeting, it is appropriate to present those revisions.

Salient points about the revisions include:

- The Washington metropolitan region added 11,300 jobs in 2010 which followed a loss of 50,300 jobs in 2009. That increase is the second smallest increase since 2002 (↑9,100). Each of the major sectors, except for three, gained jobs during the period: retail (↑3,100 jobs), professional and business services (↑7,600), leisure and hospitality sector (↑1,400), education and health services (↑8,500), and government (↑12,800). The government sector continued to add jobs every month since July when work on the Census was nearly completed. Three sectors lost jobs in 2010: construction (↓8,700), information sector (↓4,300), and financial activities sector (↓1,400).



- The Bethesda-Rockville-Frederick metropolitan division (Montgomery and Frederick counties), a portion of the metropolitan region, added only 200 jobs in 2010 after losing 13,800 in 2009. With such a modest growth in payroll jobs, the total number of employees in the Montgomery and Frederick counties (560,300) was the second lowest since 2004. Similar to the Washington metropolitan region, four of the major sectors added jobs during this period – retail (↑500), professional and business services (↑1,600), education and health services (↑1,700), and government (↑1,600). The leisure and hospitality sector neither gained nor lost jobs. Three sectors continued to shed jobs – construction (↓2,500), information (↓700), and financial activities (↓700).



- Finally, the unemployment rate for Montgomery County remains elevated above the 5 percent level. Employment based on the labor force series, i.e., survey of households, shows a slightly different trend compared to the establishment series. Over the past year, the number of residents employed declined from approximately 486,400 in 2009 to 483,500 – a decline of 2,900. However, since BLS is in the process of revising this series, resident employment for 2009 and 2010 may be adjusted over the next few months.

The representative from the Washington Metropolitan Council of Governments (COG) discussed recent developments in the region's commercial construction. According to COG's latest *Commercial Construction Indicators 2009* report, commercial construction declined from 2008 by more than 21 million square feet for a total of 15.6 million square feet – the latest date for which data are available. This represents the second lowest year of production since 1980. Of the 15.6 million square feet, 59.0 percent of the construction was in Northern Virginia and 30.1 percent in suburban Maryland. Montgomery County had 28 commercial projects that added more than 1.9 million square feet of new space. That amount represents a decline of 64 percent from 2008. The challenge facing Montgomery County is that there is not enough demand for commercial space.

COG also mentioned that the Round 8 forecast of economic and demographic variables for the Washington region was approved in November 2010. The latest forecast estimates an increase in jobs and population for the region. The Department of Finance incorporated this forecast into its latest revenue estimates for the County Executive's FY12 Recommended Budget.

After CRA's and COG's presentations, the participants discussed the economic outlook for Montgomery County. The major discussion point regarding the County's economy is: where is the sustainable growth engine for the County, i.e., what sectors are the sources for job growth? Law and accounting firms are not optimistic about hiring. In fact, some firms have reduced their workforce and cut their fees. There is a rationalization or consolidation in the industry. Confidence about the economy is very low but the economy is not getting worse. There is a low level of loan demand and business loans are off from the previous year. Because bank regulators currently consider the high risk of commercial real estate loans, very few banks are making such loans.

After the discussion of the County's economic outlook, the discussion focused on specific industry sectors of the County's economy.

II. Specific Industry Sectors

Residential and Commercial Real Estate

The first sector that the participants discussed concerned the current situation in the housing and commercial real estate markets. The participant from the realtor's association stated that prices for existing home have been rising and the mortgage rates are historically low. However, while home prices are rising and buying matrices are improving, i.e., consumer confidence and employment, there are federal actions that may curtail those purchases. For example, while mortgage rates have remained at historic low levels, they may begin to rise in the near term. Second, loan limits from Government Sponsored Enterprises (GSEs, such as Fannie Mae and Freddie Mac) may be an obstacle. Finally, the restructuring of GSEs may also constrain sales growth. Current inventory is a six-month supply.

The participants also discussed the current and future state of the commercial real estate market. As stated previously, there is no growth in commercial construction. Construction costs for a new building are very high. The factors related to costs are: (1) impact taxes are very high, (2) Park and Planning deliberations take forever, (3) water quality regulations outside the beltway are very costly, and (4) material costs were going up while the economy was not. The issue of land was also discussed in that there is a need for land where there are Metro stations. It was suggested that developers and planners provide for interim development.

On the demand side, there is none for office space. The County is losing "long-term" tenants with thirteen to twenty years of occupancy in the County. However, while demand is weak, there haven't been commercial foreclosures but, as stated previously, loan demand is soft.

Hotel Industry

Contrary to the real estate market the hotel industry is currently focused on the short term because of weak consumer confidence. The industry in the County is characterized as "not overbuilt but under-demolished." There has been significant consolidation in the industry this year. The internet has changed the way the hotel industry is doing business, and therefore the industry has supported the County's policy of taxing internet reservations. This industry faces socio-economic issues such as language barriers that require bi-lingual training for employees an a generation gap between employees, i.e., there is a significant age difference between employees.

Other Sectors

The participant from the health services sector provided an assessment of the industry. One of the challenges facing the health services sector is the growth in the aging and the under-insured population. As stated at last year's meeting, there is anticipated a six-fold increase in capacity for senior patients and an increase in both in-patient and emergency cases. Medical costs are dramatically higher for patients sixty-five years and older. Second, demand is increasing. For example, the growth in emergency room visits is growing at a rate of three percent per year. However, while demand is increasing, the supply of hospital staff, particularly medical staff, is not growing at the same rate. The participant also reported that capacity has increased with the new hospital in Germantown. The issue of capacity was addressed at the last meeting of the BAP.

About the business sector, a local economic development representative mentioned the founding of a Women's Center for Business to promote entrepreneurship. It was announced that the first biotechnology initial public offering has been issued. The County and business community needs to have a long-term (five to ten years) perspective on economic growth and not a quarterly or yearly perspective. The representative also stated that new businesses with five-year growth potentials are the establishments that will create jobs. Finally, the representative supports additional funding for incubators and Governor O'Malley's "Invest Maryland" initiative.

Another participant representing the business community stated that the County needs more "headquarters" companies in order to create the demand for support industries. Also, the County should pursue more manufacturing companies to complement the high-tech sectors. Currently, there is consolidation in the service sector and because of such consolidation, small companies should work with larger companies in order to maintain the current employment base and help create more jobs.

III. Other Comments and Conclusions

Overall, the participants were mixed in their outlook for the County's economy. While the small banks are cautious about their lending to small businesses, the participants commented that there is weak demand for loans, especially commercial loans. While the economic cycle has improved starting the latter part of last year, the fiscal-revenue cycle may not improve until next fiscal year.

MONTGOMERY COUNTY

12TH ANNUAL

BUSINESS ADVISORY PANEL

FEBRUARY 17, 2011

MEETING

WHERE:	MONTGOMERY COUNTY DEPARTMENT OF FINANCE EXECUTIVE OFFICE BUILDING 15TH FLOOR 101 MONROE STREET ROCKVILLE, MARYLAND 20850 (240) 777-8877
WHEN:	THURSDAY, FEBRUARY 17, 2011

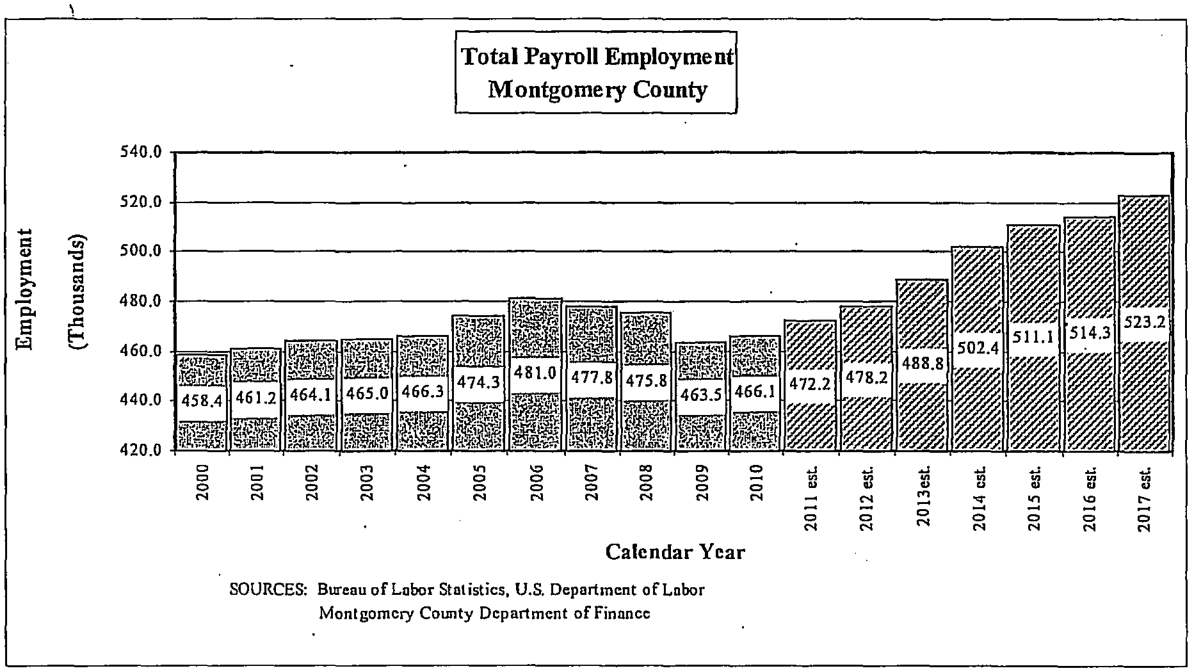
AGENDA

9:00 A.M.	WELCOME AND OPENING REMARKS
9:15 A.M.	ROUNDTABLE DISCUSSION BY PANEL PARTICIPANTS
10:45 A.M.	CONCLUDING REMARKS
11:00 A.M.	ADJOURNMENT

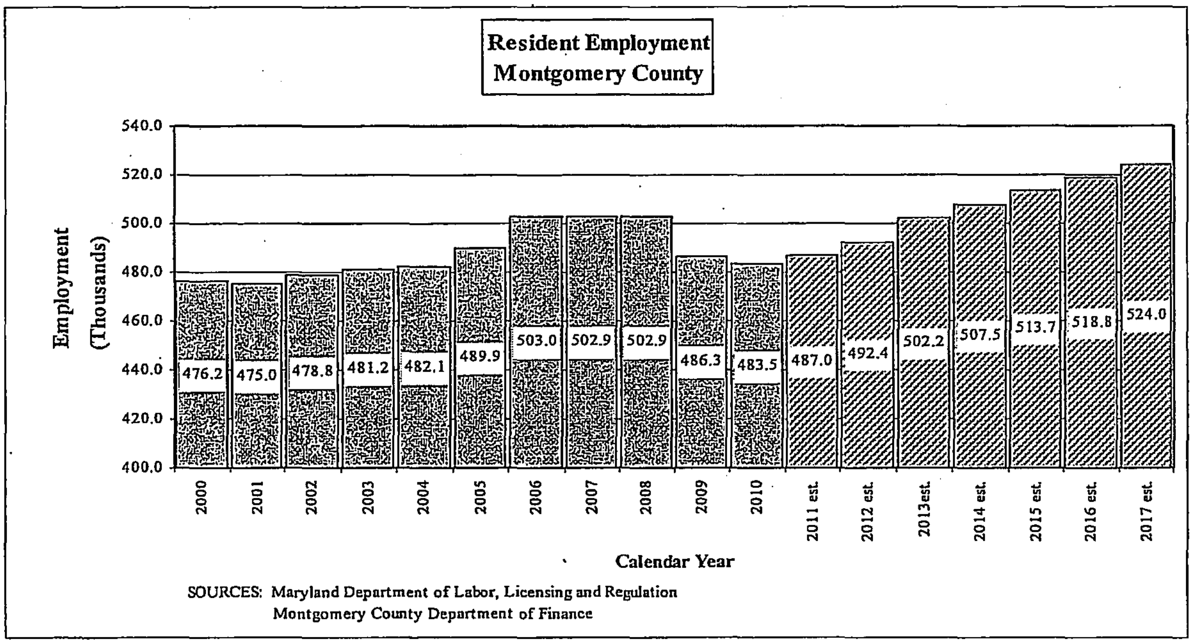
ECONOMIC CONDITIONS AND OUTLOOK

Impacted by the national recession and modest recovery, Montgomery County's economy continued to experience a slowdown in calendar year (CY) 2010. The primary indicators of the economic slowdown were a decline in housing sales during the second half of CY2010, a continuation of modest construction in single-family homes, and elevated unemployment rates that remained at historic high levels.

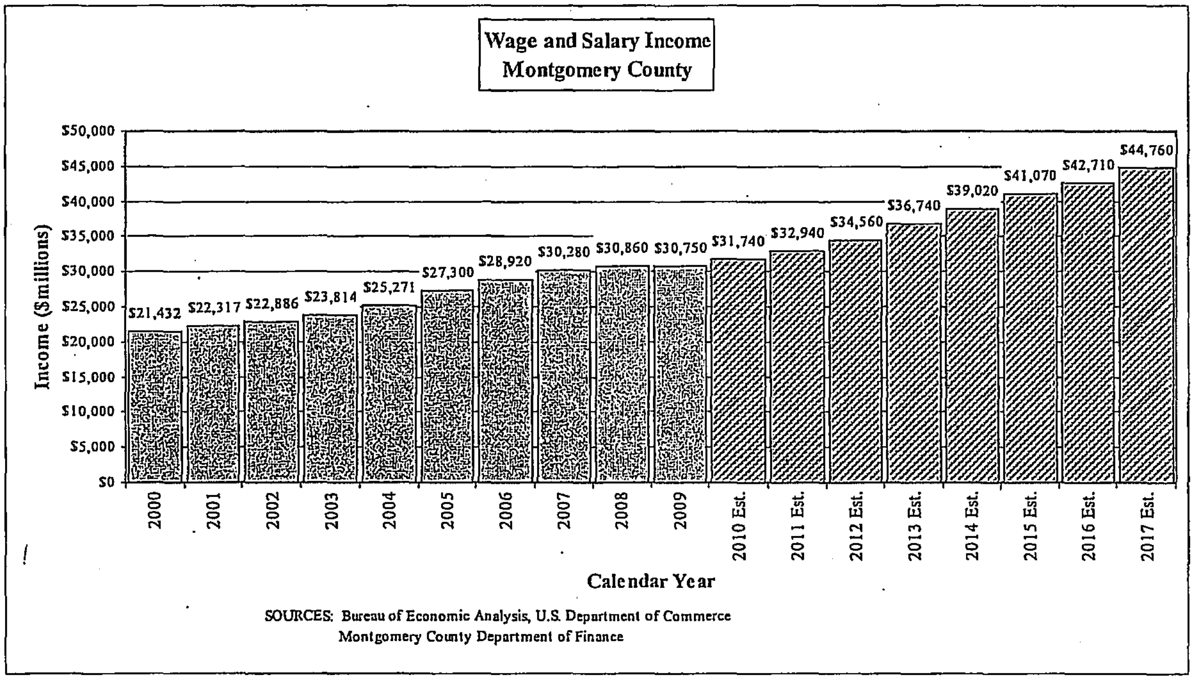
Employment. During the past eleven years (CY2000 – CY2010), total payroll employment in Montgomery County, which is based on the survey of establishments, experienced two distinct cycles: modest growth from 2000 to 2006 at an average annual rate of 0.8 percent, and a decline between 2006 and 2010 at an average annual rate of -0.8 percent. The Department of Finance (Finance) assumes payroll employment will rebound in 2011 and grow at an average annual rate of 1.7 percent between 2011 and 2017. In terms of the number of jobs added to the County's total payroll employment, an average of 8,000 new jobs per year is estimated between 2011 and 2017 with most of that growth occurring between 2013 and 2014.



Resident employment in the County, which is based on a survey of County households, provides a slightly different picture of employment growth. For example, resident employment grew at an average annual rate of 0.9 percent between 2000 and 2006 (compared to the 0.8 percent for payroll employment). Between 2006 and 2008, resident employment in the County experienced no growth and remained at the 503,000 level each year during that period. Following declines in employment in 2009 and 2010, Finance assumes that resident employment is expected to increase at an average annual rate of 1.2 percent from 2011 to 2017.

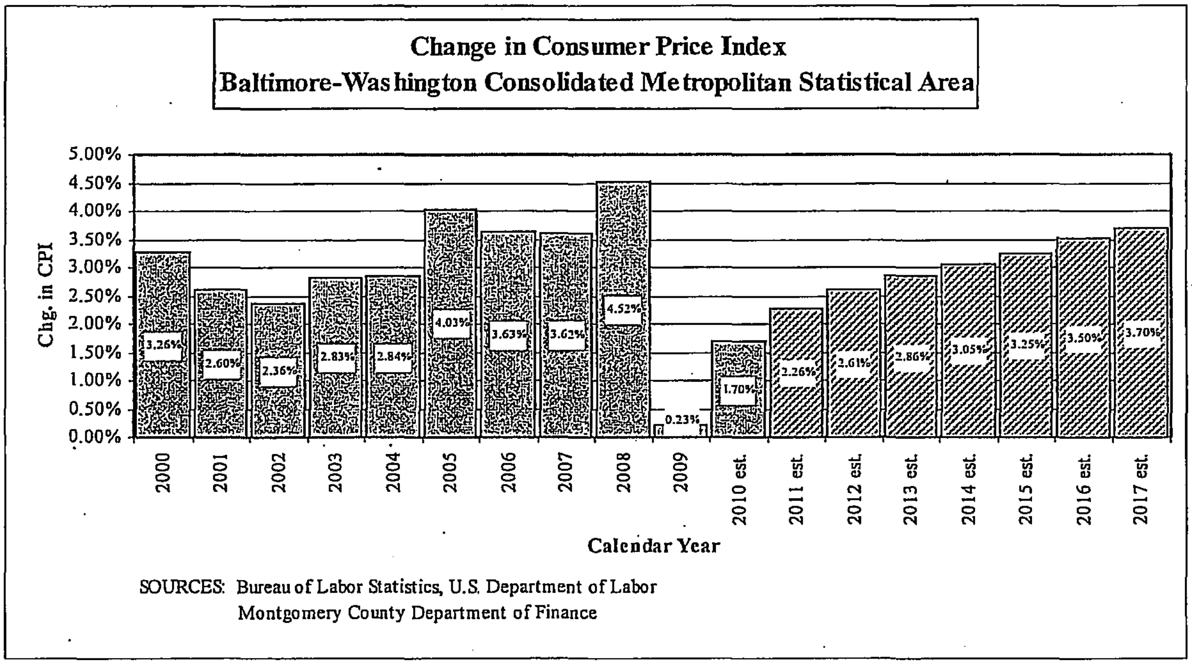


Wage and Salary Income. Finance expects wage and salary income to grow at an average annual rate of 4.7 percent between 2009, the latest date for which data are available from the Bureau of Economic Analysis, U.S. Department of Commerce, and 2017, compared to a rate of 5.0 between 2000 and 2006, and a modest rate of 2.0 percent between 2006 and 2009. Total wage and salary income is estimated to reach $44.8 billion by 2017.

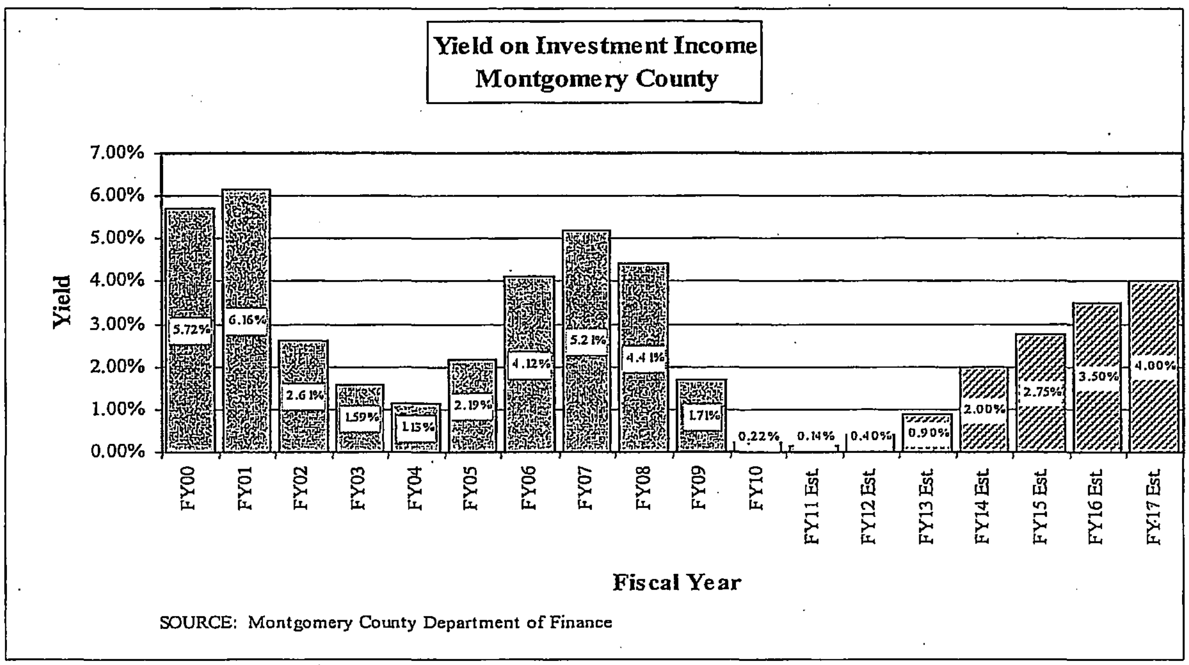


Personal Income. Finance estimates that total personal income in Montgomery County will grow at an average annual rate of 4.8 percent from 2009 to 2017, which is slightly lower than the previous ten-year average of 5.0 percent from 1999 to 2009. By 2017, Finance assumes that total personal income will reach $94.7 billion.

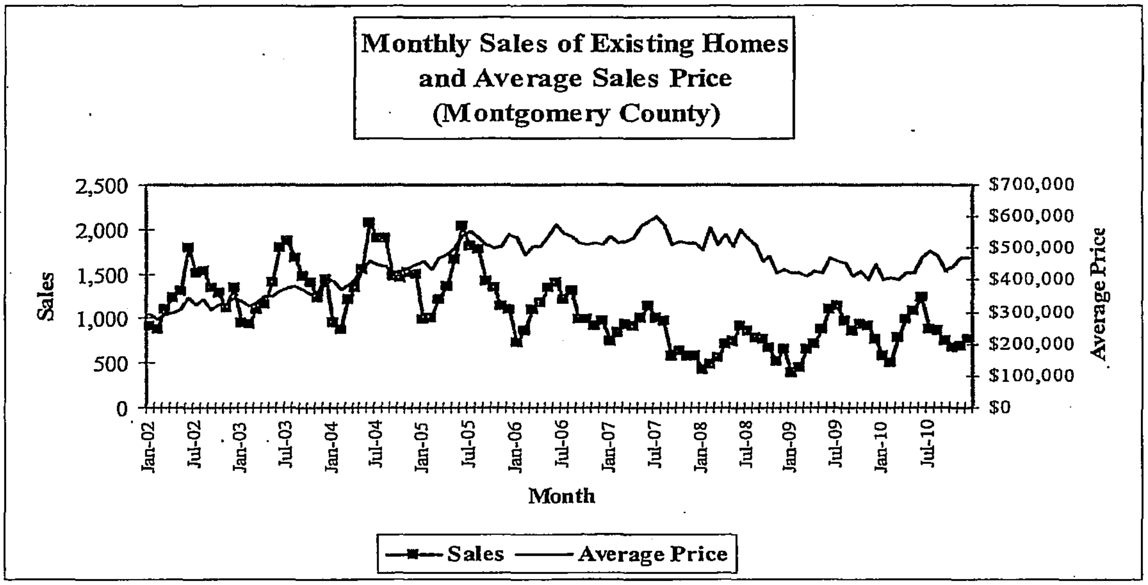
Inflation (annual average). As measured by the Consumer Price Index for All Urban Consumers (CPI-U), inflation in the Washington-Baltimore Consolidated Statistical Metropolitan Area was slightly above the national average in 2010 (1.7% compared to 1.6% through November, respectively). The "core" inflation rate, which is the CPI excluding the volatile food and energy prices, increased 1.4 percent for the region through November compared to the nation's 1.0 percent. Finance assumes that overall inflation, which is the percent change in the annual regional index, will gradually increase from 1.7 percent in 2010 to 3.7 percent by 2017.



Interest Rates. From September 2007 to December 2008, the Federal Reserve Board, through its Federal Open Market Committee, aggressively cut the target rate on federal funds from 5.25 percent to a range of 0.00-0.25 percent. The ten rate cuts were in response to the credit crisis that had significantly affected the financial markets (both bonds and stock markets) and the national economy since the summer of 2007. Based on data from the Federal Funds futures market (Chicago Board of Trade), Finance assumes that the FOMC will maintain its current position of an effective target rate of 0.00-0.25 percent through the first half of this calendar year at which time interest rates may increase modestly during the second half. Since the yield on the County's short-term investments are highly correlated with the federal funds rate, Finance estimates that the County will earn an average of less than 0.20 percent in investment income on its short-term portfolio for fiscal year (FY) 2011 and 0.40 percent for FY2011.

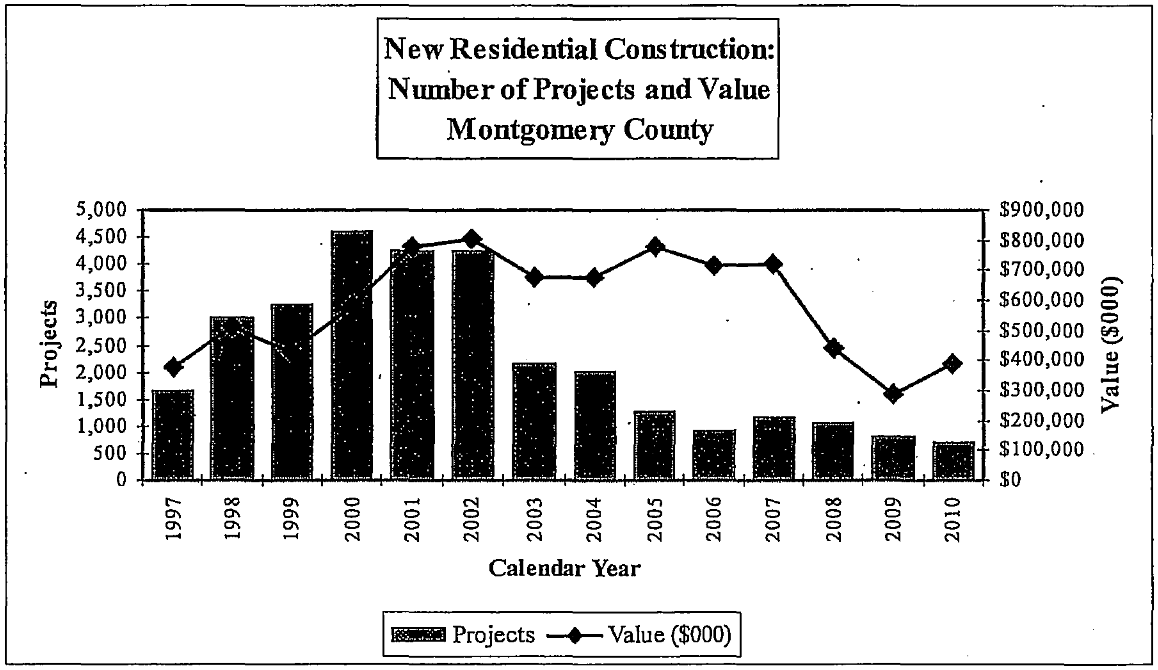

Yield on Investment Income
Montgomery County
7.00%
6.00%
5.00%
4.00%
3.00%
2.00%
1.00%
0.00%
Yield
5.72%
6.16%
2.61%
1.59%
1.15%
2.19%
4.12%
5.21%
4.41%
1.71%
0.22%
0.14%
0.40%
0.90%
2.00%
2.75%
3.50%
4.00%
FY00
FY01
FY02
FY03
FY04
FY05
FY06
FY07
FY08
FY09
FY10
FY11 Est
FY12 Est
FY13 Est
FY14 Est
FY15 Est
FY16 Est
FY17 Est
Fiscal Year
SOURCE: Montgomery County Department of Finance

Real Estate Market. The housing market in Montgomery County experienced two different trends within CY2010: 1) a dramatic increase in home sales between January and June when the Federal Government's first-time home buyers credit was available and a dramatic decline since the expiration of the credit during the second half of CY2010, and 2) a continued decline in the average sales price between January and June and an increase during the second half of CY2010. Overall, existing home sales decreased 5.6 percent in 2010 which followed an increase of 21.8 percent in 2009. After two consecutive years of price declines in 2008 (↓8.4%) and in 2009 (↓3.8%), housing prices increased by less than 2.0 percent in 2010.



Construction. Construction is a cyclical activity that can have a significant effect on a local economy and employment owing to secondary and tertiary effects on construction supply and service industries. Permits and starts are key indicators of the near-term economic condition of the housing industry and are considered crucial indicators for the local economy. Of lesser note, new single-family home sales and construction outlays are important indicators for monitoring the level of current investment activity. Construction starts measure initial activity as opposed to permits, which measure planned activity. However, permits and starts closely track each other and therefore, a four-month moving average provides a more reliable indicator of the housing trend compared to month-to-month changes. The primary source of construction data is McGraw-Hill Construction, formerly known as Dodge Analytics.

While the value of additional residential property increased 38.1 percent in 2010 ($392.4 million), following decreases of 39.0 percent in 2008 and 35.3 percent in 2009, it remained significantly below the $734.7 million average between 2001 and 2007. The number of new single-family units was 564 compared to 775 in 2009 – a decrease of 27.2 percent.



New Residential Construction:
Number of Projects and Value
Montgomery County
Projects
5,000
4,500
4,000
3,500
3,000
2,500
2,000
1,500
1,000
500
0
$900,000
$800,000
$700,000
$600,000
$500,000
$400,000
$300,000
$200,000
$100,000
$0
Value ($000)
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
Calendar Year
Projects
Value ($000)

DISCUSSION FRAMEWORK

The economic assumptions provide a framework for the Department of Finance's revenue projections for 2012 through 2017. The following issues create the framework for the discussion that is the focus of the Business Advisory Panel. In order to gain a better sense of the direction of the major industrial sectors, it would be helpful if the participants of the Business Advisory Panel could comment on our assumptions and discuss the major economic trends that affect your industry sector in the next six years. The following list of items, if applicable to your sector, may be used to focus your discussion:

Real Estate

- Residential
- Commercial
- Foreclosures
- Prices
- Loan conditions – commercial sector
- Short sales

Income

- Capital gains
- Estimated payments

Industry Sectors

- Business activity
- Employment outlook
- Construction industry outlook
- Banking–Small business lending
- Federal Government Spending & Employment
- Retail

Risk to the Forecasts (Assumptions)

- Employment
- Interest rates
- Inflation
- Stock market
- Residential/Commercial development

Attendees
Business Advisory Panel
February 17, 2011

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<u>Internal Attendees</u>:

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Department of Economic Development

Ms. Nancy Floreen, Councilmember
Planning, Housing, and Economic Development (PHED)

Joseph Beach, Director
Office of Management and Budget

Jennifer E. Barrett, Director
Department of Finance

Rob Hagedoorn, Treasury Division Chief
Department of Finance

David Platt, Chief Economist
Department of Finance

Michael Coveyou, Policy and Fiscal Projects Manager
Department of Finance