March 13, 2007

Honorable County Executive, and
Members of the Montgomery County Council

Ladies and Gentlemen:

I am pleased to present the findings of the Seventh Annual Business Advisory Panel that was convened on February 22, 2007. The attached report was prepared by the County's Department of Finance pursuant to Article XI, Section 20-61 of the Montgomery County Code.

The 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

FINDINGS OF THE EIGHTH ANNUAL
BUSINESS ADVISORY PANEL
FEBRUARY 22, 2007

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 22, 2007. 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 the real estate, biotechnology, academia, and government and trade associations. The meeting was structured to allow participants to brief the panel on the local economy industry 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 requested to provide comments to a paper prepared by the Department that analyzed the County's economy and provided assumptions about the economy over the next six years. The paper analyzed a number of economic indicators including employment, personal income, real estate, inflation, retail sales, construction, and interest rates.

The Center for Regional Analysis (CRA), George Mason University, presented a perspective of the Washington area economy as well as the County's economy. The Center's forecast for the regional economy shows continued strength through 2007 but will experience the slowest growth rate since 2002. Salient points included:

- The regional economy continued to outperform the national economy the past year but it followed the same growth pattern. CRA forecasts a slight deceleration in the regional gross product from 4.5 percent in 2005 to an estimated 4.0 percent in 2006 and 3.5 percent by 2007. CRA also expects that the regional economy will re-accelerate during the latter part of 2007 and expects a stronger economic performance in 2008. However, CRA advises caution for calendar years 2009 through 2011 such that the regional economy may not grow as strong as it did the previous four years.

- Job creation in the region has been excellent and has outperformed other major metropolitan areas. Over the past year, the region's businesses added over 70,000 jobs. Forty-five percent of those jobs were in the professional and business sector. The favorable labor market experienced the past three years means a strong growth in personal income and housing demand. CRA expects the region's businesses to add 60,000 jobs in 2007 attributed to a slowdown in federal spending particularly procurement. Because of the slowdown in the growth of total payroll employment, the disproportionately large share of professional and business jobs will decrease. Also, in the near term, nearly 140,000 jobs will be needed to backfill the current employment base because of current professionals reaching the age of retirement.

- CRA forecasts an increase in residential housing this year. By mid-year, housing starts will surpass starts for the same period in 2006. However, affordability remains the crucial issue in home sales. In previous years, the ratio of average housing prices to average personal incomes was 2.5, currently that ratio is 4.6 times average income. Commercial building construction will experience strong performance in 2007 but decelerate in 2008. Therefore, vacancy rates in office buildings will increase slightly in 2008.

- The risks to the regional economy include:
    - Growth in federal spending declined from 19.0 percent in 2004 to 2.5 percent in 2005, the latest date for which data are available. CRA expects moderate growth in federal spending over the next several years. Hence, the cautionary note about the region's economy in 2009 through 2011. Spending by the Department of Defense constitutes about 50 percent of total spending: 60 percent in Northern Virginia but only 30 percent in Maryland. The moderation in federal spending will have a significant effect on Northern Virginia's economy but less of an impact on suburban Maryland.
    - If energy prices increase to levels experienced during the summer of 2006, consumer spending will moderate and affect retail sales.
    - If the housing does not stabilize during 2007 as expected, the region's economy may experience slower growth than currently estimated for 2007 and possibly 2008.
    - Because of the estimated moderation in federal spending, the growth in "high-end" jobs will not match the growth experienced the past two years and affect the growth in personal income.

Following the Center's presentation, the other participants were requested to provide comments about the state of the County's economy. A number of themes resulted from the discussion:

- The current round of long-term employment and population forecasts by local governments in the region are as follows:
    - Montgomery County is expected to experience little change in its current forecast of employment growth between 2013 and 2030.
    - Fairfax County is expected to experience modest job growth between 2013 and 2030
    - Prince George's County is expected to see a reduction in its job growth between 2013 and 2030.

  - Loudon County projects an increase in job growth while Arlington County expects the opposite between 2013 and 2030.
  - Overall the shares of total employment for the Washington metropolitan area by 2030 are: District of Columbia − 21 percent; Fairfax County −20 percent; Montgomery County − 16 percent; Prince George's County − 11 percent; Loudon County − 7 percent; Frederick County − 4 percent.

- In the past, the ratio of jobs to housing was between 1.50 and 1.60, currently that ratio is 1.68. Therefore, the region needs to provide an additional 120,000 housing units to meet the growth in employment.

II. Specific Industry Sectors

Real Estate

The participants discussed the current and future state of the residential and commercial real estate market. Flexible office space, which is running below historical vacancy rates, is now less than one percent for one developer. There is no speculative building in the County compared to Northern Virginia. Therefore, non-residential construction is stable and it is easier to predict rents in such a market. Asking rents have risen 30 percent in the County but construction costs have increased 50 percent. Buildings of older construction are much more profitable than newer buildings because of the costs of construction. In the past, construction contracts had an adjustment clause only for paving and roofing costs. Today, all material costs are negotiable such that a contractor's estimate is applicable for only seven days. While land costs also have increased dramatically, low interest rates have helped offset both land and construction costs. With regard to construction for the federal government in the County, it is limited to the National Institutes of Health and very little from the Departments of Defense and Homeland Security. The County has become more "urban" and land use has gotten denser.

The participants also discussed the current housing market and suggested that residential real estate market appears to returning to a period of normalcy and prices are not expected to decline in Montgomery County as opposed to Northern Virginia. Housing construction and sales are expected to increase this year while mortgage rates are forecasted to decline. Because of strong employment and personal income in the County, foreclosures are not an issue. However, affordability remains a concern in the County. More individuals are locating in the Baltimore area because housing is more affordable than in the Washington region.

Biotechnology Sector

There are approximately 400 biotechnology industries in the County. Of those 400 companies, most of them employ ten or fewer. Very few companies have more than 100 employees. Therefore, the industry consists of very small firms and is not as robust as it is in other parts of the country. Because many firms are small, the access to venture capital, a necessary financial source for research and development, is difficult. Primary venture capital firms are located in Boston, New York, and Silicon Valley. Most of the firms in the County are in the research and development phase of the product life cycle. At that stage of the cycle demand for venture capital is crucial and demand is greater than at any other stage of the cycle.

The participants also discussed the status of the biotechnology industry in the County. The discussion focused on the ranking of biotechnology amongst other regions of the country. Montgomery County is not in the top ten among the other biotechnology regions. The participants suggested that the industry develop a roadmap for the future similar to the process developed by the State of Texas. That roadmap should include a strategy for developing a "pipeline" for the potential workforce and for obtaining much needed venture capital.

Hotel Industry

Prior to 2001, the occupancy rate for hotels in the County was 72 percent. Since that time the occupancy rate had fallen to less than 67 percent by 2006. The industry estimates that an additional 62 to 68 net new hotel rooms were added to the supply in 2006. Convention business in the Washington region was slow in 2006, but market analysis suggests that business will improve in 2007 and experience an excellent year in 2008. The challenge to the industry is that most business travelers to the region prefer to stay in Northern Virginia compared to Montgomery County because of the greater number of high-end luxury hotels and better access to Reagan National and Dulles International airports. However, according to one of the participants, there is a growing demand by companies headquartered in the County for hotel rooms. Because of that demand, there are three major hotel projects that will add to the supply of rooms in the County.

III. Conclusions

The participants generally agreed with the Department's assessment of the County's economy and the short- and long-term trends and projections with a caution about growth rates for calendar years 2009 through 2011. The Department's forecasts of employment personal income are in line with CRA forecasts. The real estate market is expected to rebound in the latter part of 2007, and foreclosure rates on home mortgages are not an issue in the County.

LIST OF PARTICIPANTS
(IN ALPHABETICAL ORDER)
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FEBRUARY 22, 2007

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MONTGOMERY COUNTY

8TH ANNUAL

BUSINESS ADVISORY PANEL

FEBRUARY 22, 2007

MEETING

WHERE:	MONTGOMERY COUNTY DEPARTMENT OF ECONOMIC DEVELOPMENT SUITE 800 111 ROCKVILLE PIKE ROCKVILLE, MARYLAND 20850 (240) 777-2000
WHEN:	THURSDAY, FEBRUARY 22, 2007

AGENDA

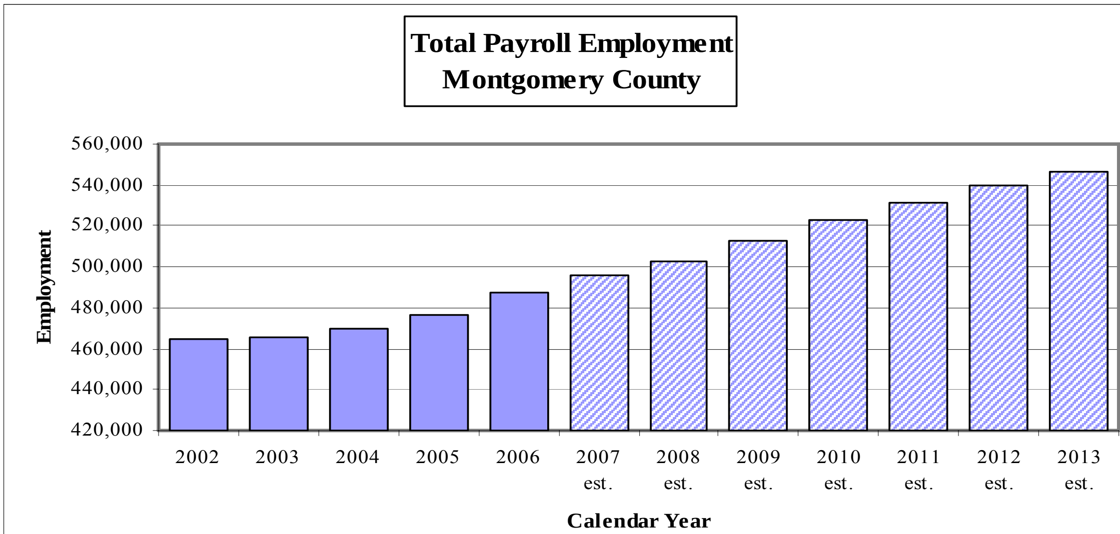
8:30 A.M.	WELCOME AND OPENING REMARKS
8:45 A.M.	ROUNDTABLE DISCUSSION BY PANEL PARTICIPANTS
10:15 A.M.	CONCLUDING REMARKS
10:30 A.M.	ADJOURNMENT

ECONOMIC CONDITIONS AND OUTLOOK

Montgomery County experienced a slowdown in 2006 compared to 2005. Economic activity during this period was mixed. The primary reason for the economic slowdown was the significant decline in housing sales, a continued reduction in residential construction, and weak retail sales. These factors were offset with increases in payroll employment, total personal income, and non-residential construction.

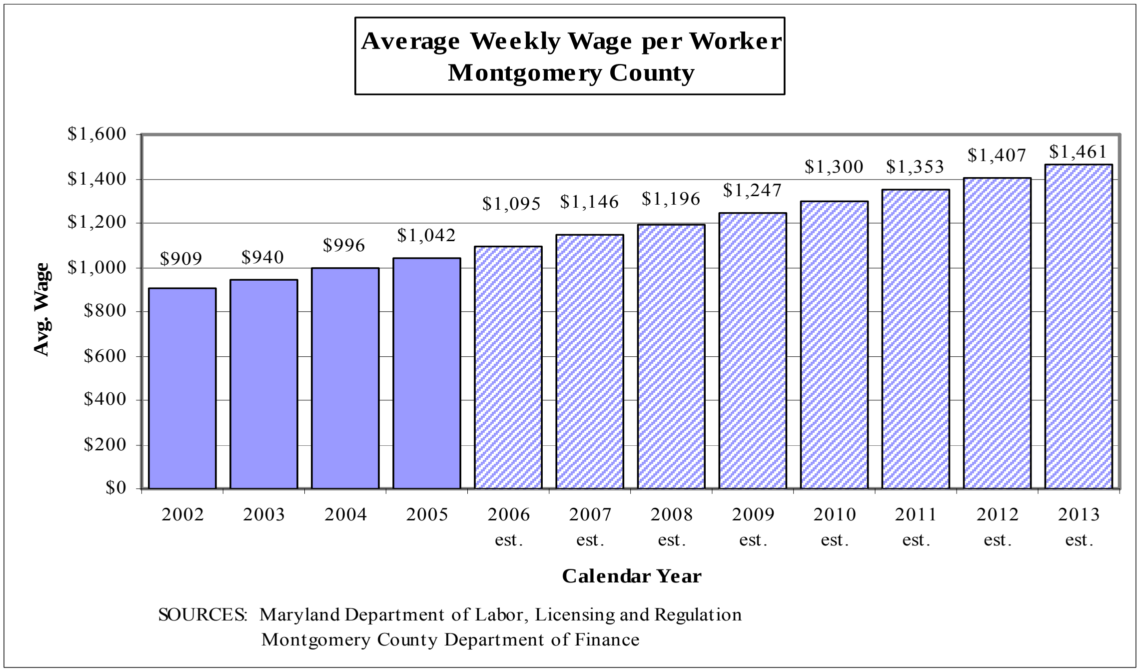
- ***Employment.*** During the past ten years, total payroll employment in Montgomery County has experienced three distinct cycles: significant growth from 1996 to 2000 of 3.5 percent per year, a period a weak growth between 2000 and 2004 with the average annual rate of 0.6 percent, and moderate employment growth between 2004 and 2006 of 1.9 percent per year. In terms of the number of jobs added to the County's total payroll employment, an average of over 15,000 per year were added between 1996 and 2000, an average of 2,700 jobs per year between 2000 and 2004, and an average of approximately 9,000 in 2005 and 2006. Based on estimates derived by the Department of Finance (Finance), the County added nearly 11,000 jobs in 2006. The best performance since 2000 when approximately 16,700 jobs were created.

  Based on this assessment, Finance estimates that total payroll employment will grow at an average annual rate of 1.6 percent from 2006 to 2013. As such, the County will add an average of 8,400 jobs per year, which is slightly below the latest ten-year average of 8,900 new jobs.

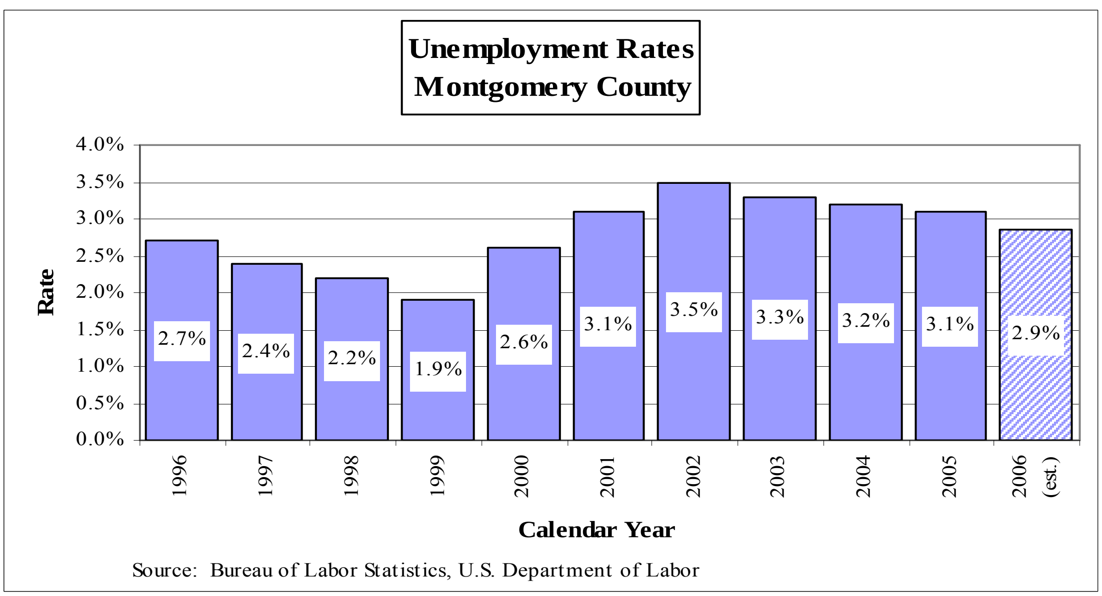


SOURCES: Bureau of Labor Statistics, U.S. Department of Labor
Montgomery County Department of Finance

From 2002 through 2005, average weekly wages increased from $909 to $1,042 − an average annual increase of 4.6 percent. Finance estimates that average weekly wages will increase from $1,042 to $1,461 by 2013 − an average annual increase of 4.2 percent. A rate less than the 2002-2005 annual average and attributed to a maturation of the labor market in Montgomery County.

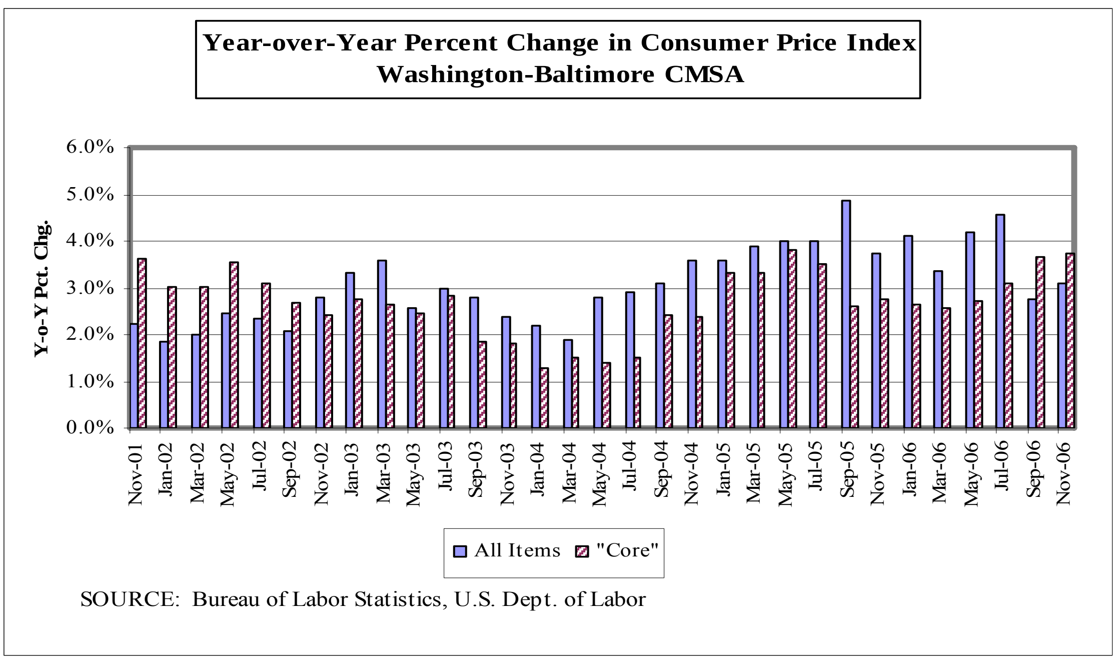


With payroll employment making a modest recovery in 2005 and 2006, the County's employment rate of 2.9 percent remained below the State's average of 3.8 percent. The low unemployment rate for the County suggests that both the public and private sectors are providing a relatively stable foundation against significant volatility in the County's labor market.



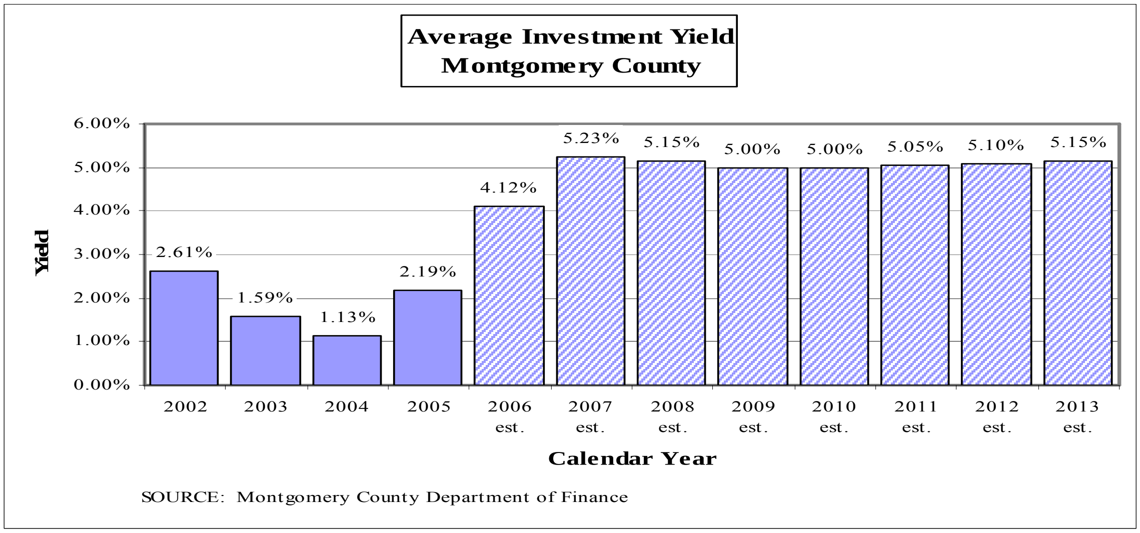
- ***Personal Income.*** With the significant increase in employment and average weekly wages in 2005 and 2006, Finance estimates that wage and salary income grew 6.4 percent and 7.1 percent, respectively. As such, total personal income is expected to have grown 6.7 percent and 6.5 percent in 2005 and 2006, respectively. With Finance estimating a slowdown in the growth of the County's employment between 2006 and 2013, total wage and salary income is assumed to grow at an average annual rate of 5.7 percent, slightly lower than the ten-year average of 6.3 percent between 1996 and 2006. Total personal income is assumed to grow at an average annual rate of 5.4 percent, which is also slightly lower than the ten-year average of 6.0 percent between 1996 and 2006.

- ***Inflation.*** 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 2006. Overall, consumer prices increased 3.7 percent for the region compared to 3.2 percent for the nation. While overall price increases were largely attributed to high energy prices during 2006, the "core" inflation rate, which is the CPI excluding the volatile food and energy prices, increased 3.1 percent for the region compared to the nation's 2.5 percent. Finance assumes that overall inflation will moderate gradually from 3.7 percent in 2006 to 2.5 percent by 2013.



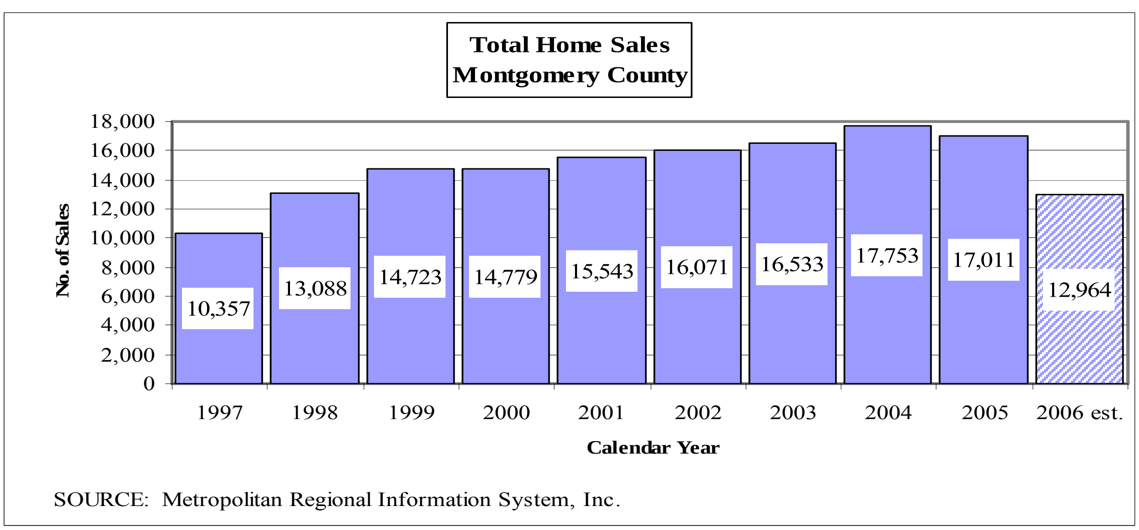
- ***Interest Rates.*** Since June of last year, The Federal Reserve Board, through its Federal Open Market Committee, has kept the target rate on federal funds at 5.25 percent. After seventeen consecutive increases in the target rate from 1.00 percent to 5.25 percent, the FOMC has not changed the target rate since late June of last year. Based on data from the Federal Funds futures market from the Chicago Board of Trade, Finance assumes that the FOMC will not change the target rate through most of this year. 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 5.23 percent on its short-term money market investments for fiscal year (FY) 2007 and 5.15 percent for FY2008.



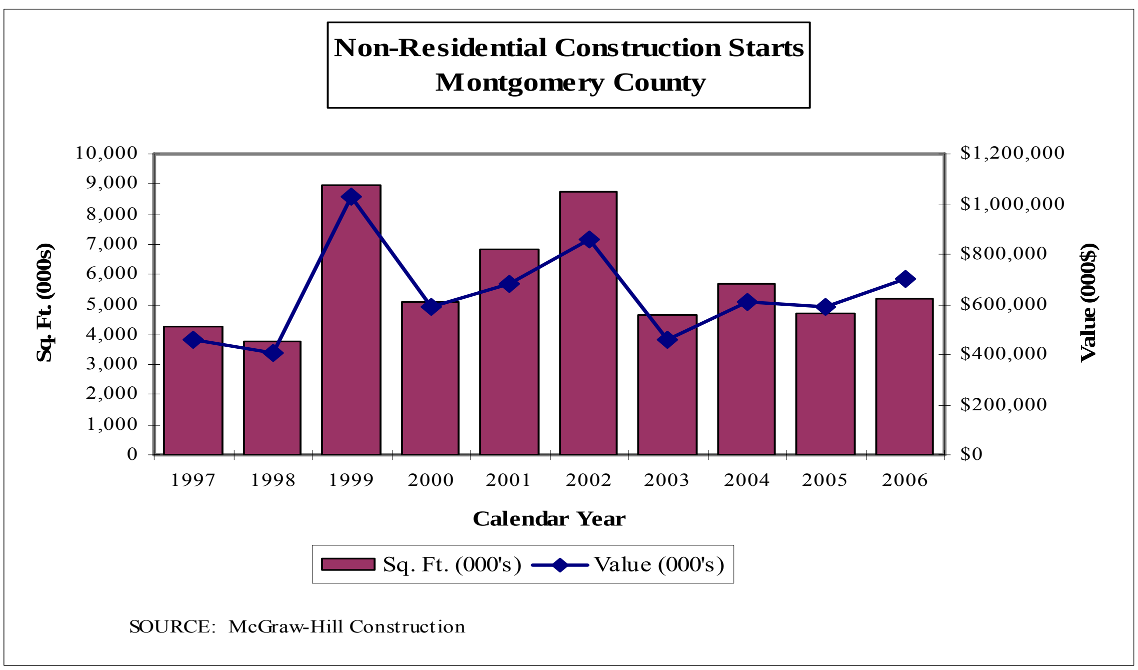
- ***Retail Sales.*** Using sales tax receipts as a measure of the level of retail sales for the County, sales for nondurable and durable goods increased 0.6 percent in 2006, the lowest rate in over eight years. Sales of nondurable goods were up 4.0 percent, the lowest level since 2002, while sales of durable goods, led by purchases of home furnishings, were down nearly 5.0 percent from the previous year. Both meager increases can be attributed to high energy prices in 2006 and the dramatic decline in housing sales.

- ***Real Estate Market.*** The housing market in Montgomery County experienced a dramatic decline in sales and modest house price appreciation in 2006. Existing home sales declined nearly 24 percent. Sales were at their lowest level since 1997. After four consecutive years of double-digit price increases, the average selling price increased a 4.5 percent in 2006, the lowest increase since 1998.



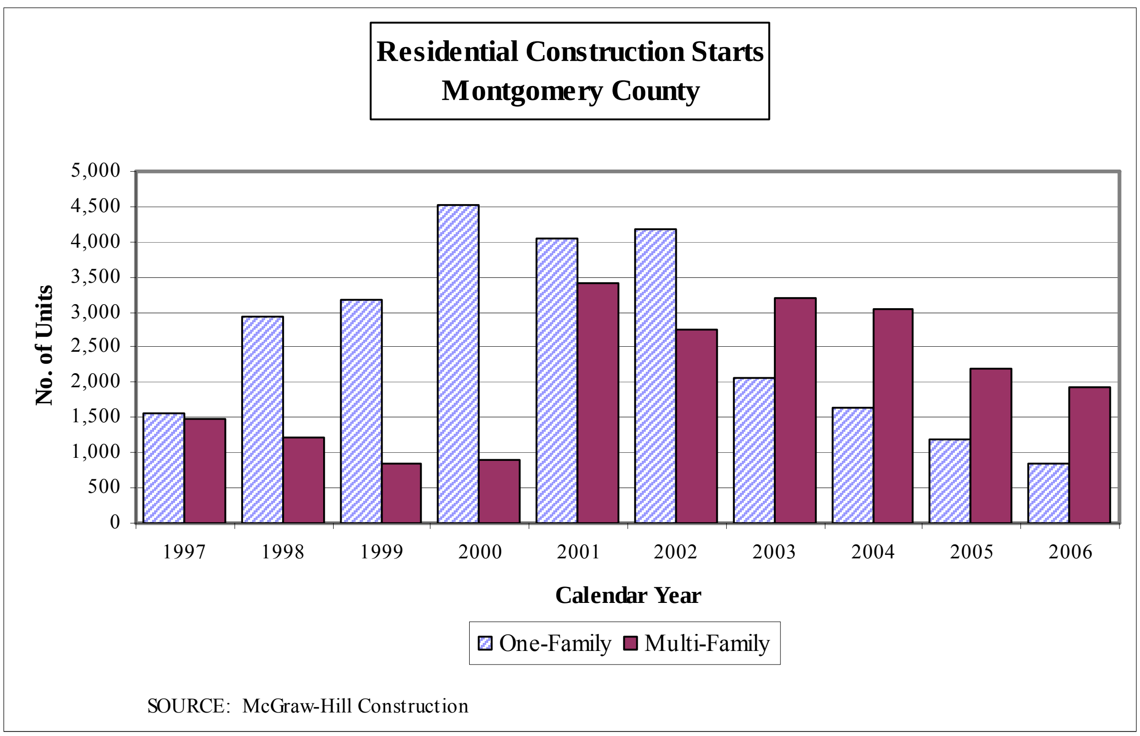
- ***Construction.*** Construction is a cyclical activity that can have a significant effect on a local economy and employment owing to secondary and tertiary effects on construction supply and service industries. Permits and starts are key indicators of the near-term economic condition of the housing industry and are considered leading 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, starts and permits closely track each other and as such, 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.

  The amount of square footage added to non-residential property increased 10.7 percent in 2006 from 4.698 million square feet to 5.203 million square feet, while the value of new construction in the County increased 19.0 percent. The sector that experienced the largest growth was the commercial sector. The amount of square footage added to the County's property base increase from 2.599 million square feet to 4.259 million square feet (↑ 63.9%). Essentially, commercial construction accounted for nearly 82 percent of the additional square footage in 2006. Of the commercial construction activity during 2006, the major contributor to growth was construction of new office and bank buildings. That sector added 2.503 million square feet of additional capacity and nearly $333.0 million in added value to the property base. Even with the addition of commercial property, the vacancy rate among Class A properties in the County was slightly above 6.0 percent − down from the 9.7 percent in 2004 and 8.2 percent in 2005.



While non-residential construction activity improved in 2006, residential construction continued to decline. The number of starts declined nearly 27 percent, the value of additional property declined 15 percent, and the amount of additional square footage declined nearly 24 percent. For the past four years, the value of additional residential property added to the County's property based averaged less than $700 million per year while the number of projects and additional square footage steadily declined. That trend suggests that for each of the last four years, home builders are constructing fewer but more expensive homes.

Finally, the type of dwelling units constructed in the County experienced a dramatic decline over the past four years. The number of single-family units started in the County declined at an average annual rate of 40 percent. However, between 2003 and 2004, home builders added over 3,100 multi-family units per year to the County's real estate market. Over the past two years, the number of units steadily declined such that only 1,900 units were started in 2006.



DISCUSSION FRAMEWORK

The economic assumptions provide a framework for the Department of Finance's revenue projections for 2008 through 2013. 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:

Employment
- Job growth
- Wage growth

Federal Government
- Procurement
- Construction

Income
- Personal income
- Capital gains

Real Estate
- Residential
- Commercial
- Vacancy Rates
- Non-traditional mortgages and foreclosures

Construction
- Residential
- Commercial
- Other Non-residential (e.g., hospitals, hotels, government)

Risk to the Forecasts
- Economic growth
- Demographics
- Interest Rates
- Labor Markets
- Inflation
- Stock market