

March 17, 2008

Honorable County Executive, and
Members of the Montgomery County Council

Ladies and Gentlemen:

I am pleased to present the findings of the Ninth Annual Business Advisory Panel that was convened on February 21, 2008. 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 NINTH ANNUAL
BUSINESS ADVISORY PANEL
FEBRUARY 21, 2008**

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 21, 2008. 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 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 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 suggested that the slowdown experienced in FY08 to date is more severe and rapid than forecasted before the start of the fiscal year. The first half of FY09 will present a challenge but economic conditions will improve during the second half. The growth in the gross regional product, which peaked at 5.0 percent in calendar year 2004, will only reach 2.9 percent in 2008 – the lowest rate during this decade. CRA expects this slowdown to be short lived. While commercial construction has not yet slowed, residential construction in the region is down by 60 percent. CRA expects a slight increase in the region's economy by the second half of this calendar year. The fourth quarter of last year and the first quarter of this year are expected to be the worst quarters during this decade in terms of economic growth.

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 3.4 percent in calendar 2007 to an estimated 2.9 percent in 2008 and

3.5 percent by 2009. However, CRA advises caution for calendar years 2009 through 2011 based on expectations that the regional economy may not experience as strong a rate of growth as it did between 2002 and 2006.

- Job creation in the region has slowed but has not declined. Of the fifteen largest job markets in the U.S., the Washington region still maintains the lowest unemployment rate of 3.0 percent compared to the national average of 4.8 percent. Over the past year, the region's businesses added 23,000 jobs with an average wage of \$75,000 – the lowest number of new jobs since 2002 (9,000). The favorable labor market experienced during the three years prior to 2007 was attributed to federal spending particularly procurement. Even with the slowdown in employment last year, the region still faces a shortage of workers in the highly skilled professional categories.
- CRA also stated that the inventory of existing homes for sale continues to be the major problem facing the residential housing sector. CRA also stated that foreclosures in the region have increased significantly in the past year. While the average foreclosure rate in February was 158 per 10,000 units, Montgomery County, at 67 per 10,000 units, ranked among the lowest of the fourteen regional jurisdictions. While the economic fundamentals in the region such a low unemployment, steady job growth, and increases in wages and salaries are solid, it has been the psychological factors of the market, i.e., the uncertainty of the economy and a possible recession, that have overtaken those fundamental factors in explaining the current situation of the housing market.
- The risks to the regional economy include:
 - CRA expects moderate growth in federal spending over the next several years. While still growing, federal spending, especially procurement, is expected to reach 54.9 billion in 2007, up from 50.0 billion in 2004. That increase is the lowest rate this decade. 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 continue to increase, consumer spending will moderate and affect retail sales.
 - If the housing sector does not stabilize during 2008 as expected, the region's economy may experience slower growth than currently estimated for 2008 and possibly 2009.
 - 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 will experience changes due to base realignment and closure (BRAC) activities. Data presented by the Washington Metropolitan Council of Governments show that
 - In 2005, there were 4.9 million jobs in the Washington metropolitan area.
 - In 2030, that number should increase to 6.6 million.
 - Fairfax, Prince George's, and Montgomery counties should add the largest numbers of new jobs between 2005 and 2030.
 - Regional employment, which is projected to increase nearly 35 percent, will experience a slightly higher rate of growth than both population and households.
 - Employment growth will mostly occur between 2005 and 2010, with an average of 60,000 new jobs anticipated per year. That rate is up significantly from 49,500 new jobs in 2006 and 20,000 new jobs in 2007.
 - Two-thirds of those new jobs will be in the services industries such as engineering, computer and data processing, business services, and medical research.
 - Job growth in Northern Virginia will outpace the growth anticipated in the Maryland suburbs, and the District of Columbia.

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II. Specific Industry Sectors

Real Estate

The participants discussed the current and future state of the residential and commercial real estate market. The light industrial and flexible office space is tight with low vacancy rates. Some of the negotiations that are closing were started in 2006, and there is still demand for flex office space. The slowdown in residential construction will help non-residential construction but only in the short term. Labor and material costs keep rising and the reason for the increase in the labor costs is that the commercial sector uses a much different labor pool and skills than does the residential sector. However, there are constraints in the commercial sector. There is a high degree of exposure in the financial market such that developers are finding it difficult to secure a loan. Permit fees and impact taxes have gone up and those costs are passed on directly through rents. As such, office rents are in the \$30's per foot and could approach \$40-50 per foot because of building costs and impact taxes. The office space build on "spec", i.e., properties that are started and finished before they are sold (speculatively built), along the I-270 corridor is experiencing a higher vacancy rate than is the flex office space. The practice of spec building is inherently more risky than building under contract.

The participants also discussed the current housing market and suggested that the residential real estate market will continue to experience challenges through the remainder of 2008. As stated earlier, the issue with the housing market is not because of economic fundamentals, rather, buyer psychology has superseded those fundamentals. It is unclear whether the market has bottomed out from its recent lows between November and February. Inventory of existing homes for sale is at an all time high such that the average days on the market reached 120 in February. While overall, the market has been stagnant, there are some neighborhoods where homes have sold quickly. However, overall the County is not in a pro-

growth situation, and a return to a robust market is very unlikely in the near term. While the recent upward adjustment to the ceiling for a jumbo loan may help the high-end market, the participants suggest that that adjustment will not have an effect until mid summer.

Health Services Sector

One of the significant developments in non-residential construction has been the substantial increase in building in the medical services sector both locally and statewide. Holy Cross hospital is undertaking an expansion program and is establishing two more outpatient clinics. They also have a joint venture with Montgomery College in sharing technology.

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. As discussed during last year's meeting, many local firms are small and 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. However, firms are adding jobs but anticipate consolidation in the business sector, especially among the pharmaceutical companies.

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 65 percent in 2007. The Department of Finance in conjunction with the Conference and Visitors Bureau expect the occupancy rate to edge up slightly in FY08 and peak in FY09 at 70 percent. Average room rates are expected to steadily increase reaching nearly \$136 per room. One member of the industry is concerned that the credit crunch may have a significant effect on business travel and the business customer. Last year was the best year for some of the hotel companies. An issue confronting the hotel-motel industry was the recent increase in the sales tax enacted by the Maryland General Assembly. That may have an impact on out-of-state travelers to the County compared to Northern Virginia. A 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.

III. Conclusions

Overall the participants were mixed in their outlook for the County's economy. One participant was generally bullish about the local economy especially with the Rockville area. There is new construction in the city for the first time in a few years and one-third of the

condominiums in the Rockville Town Center have been sold. Most of the participants suggested that firms in the County will continue to hire and some sectors, such as the health and accounting industries, have difficulty finding candidates for a number of vacancies. Some participants expressed concern over relocation of some of the industries because the corporate officers live outside of the region. This issue was discussed among the participants in light of the move from Northern Virginia to New York of a number of employees of an internet firm. Finally, the issue was addressed whether the slowdown in employment growth was acceptable. The discussion did not focus on Finance's forecast instead it focused on whether the County officials should be more active in promoting business development and growth.

**LIST OF PARTICIPANTS
BUSINESS ADVISORY PANEL
FEBRUARY 2008**

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MONTGOMERY COUNTY
9TH ANNUAL
BUSINESS ADVISORY PANEL



FEBRUARY 21, 2008

MEETING

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

WHEN: THURSDAY, FEBRUARY 21, 2008

AGENDA

9:00 A.M. WELCOME AND OPENING REMARKS
9:15 A.M. ROUNDTABLE DISCUSSION BY PANEL PARTICIPANTS
11:15 A.M. CONCLUDING REMARKS
11:30 A.M. ADJOURNMENT

ECONOMIC CONDITIONS AND OUTLOOK

Montgomery County’s economy continued to experience a slowdown in 2007. Economic activity during this period was mixed. The primary reason for the economic slowdown was the continuing decline in housing sales, a moderation in the growth of average home prices, a reduction in added construction, and weak retail sales. These factors were offset with modest increases in payroll and resident employment.

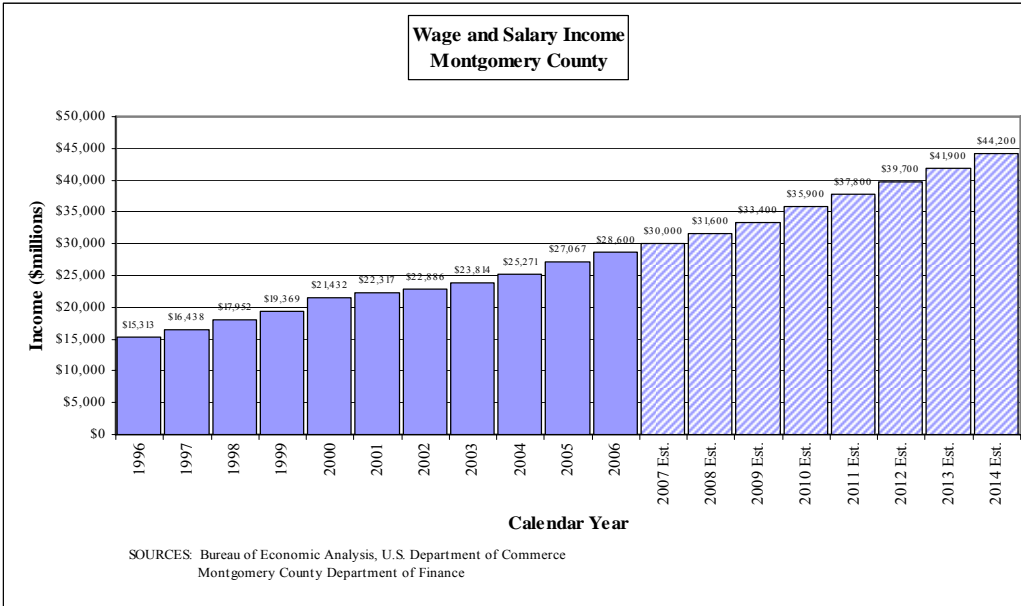
Employment. During the past ten years, total payroll employment in Montgomery County, which is based on the survey of establishments, has experienced three distinct cycles: significant growth from 1996 to 2000 of 3.5 percent per year, a period a weak growth between 2000 and 2004 with the average annual rate of 0.4 percent, and moderate employment growth between 2004 and 2007 of 1.5 percent per year. The Department of Finance (Finance) assumes payroll employment to grow, an average, 1.1 percent per year between 2007 and 2014. In terms of the number of jobs added to the County’s total payroll employment, an average of 5,500 per year new jobs are added between 2007 and 2014, well below the average of 8,200 per year between 1996 and 2007.



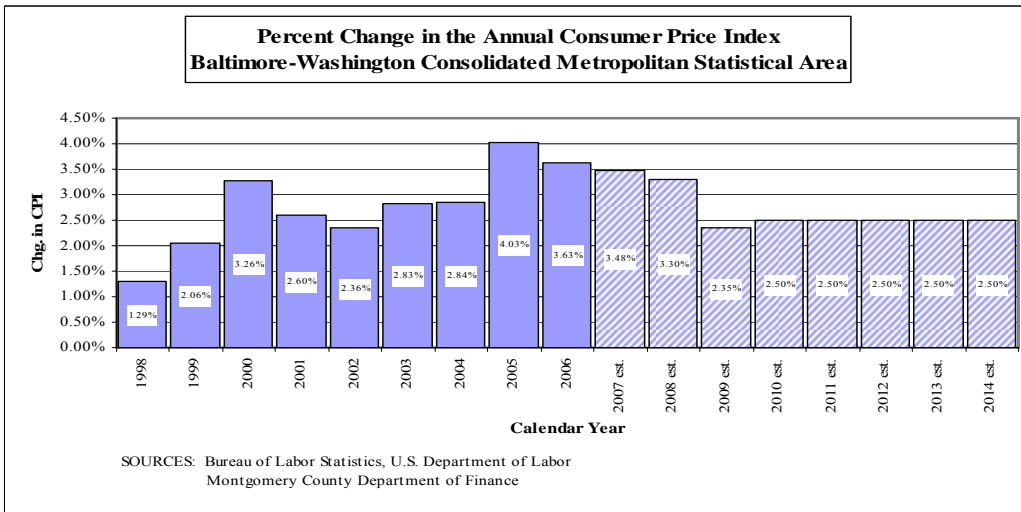
Resident employment in the County, which is based on a survey of County households, provides a slightly different picture of employment growth. For example, resident employment grew only 1.1 percent between 1996 and 2000 (compared to the 3.5 percent for payroll employment), 0.3 percent between 2000 and 2004 (compared to the 0.4 percent for payroll employment), and 1.7 percent between 2004 and 2007 (compared to 1.6 percent for payroll employment). Finance assumes that resident employment is expected to grow a modest 1.0 percent per year between 2007 and 2014. As such, employment among County

residents will average an additional 5,200 new jobs between 2007 and 2014, slightly lower than the annual growth in payroll employment.

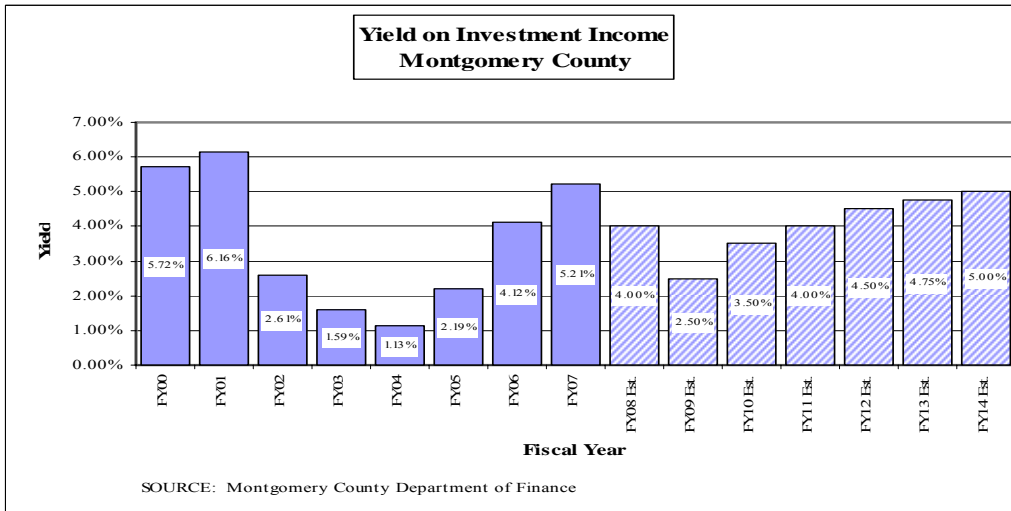
From 2000 through 2007, average weekly wages are expected to increase from \$840 to \$1,167 – an average annual increase of 4.8 percent. Finance estimates that average weekly wages will increase from \$1,167 to \$1,562 by 2014 – an average annual increase of 4.2 percent. Finance assumes that wage and salary income is expected to grow 5.5 percent per year between 2007 and 2014, therefore, total wage and salary income is expected to reach \$44.2 billion dollars by 2014.



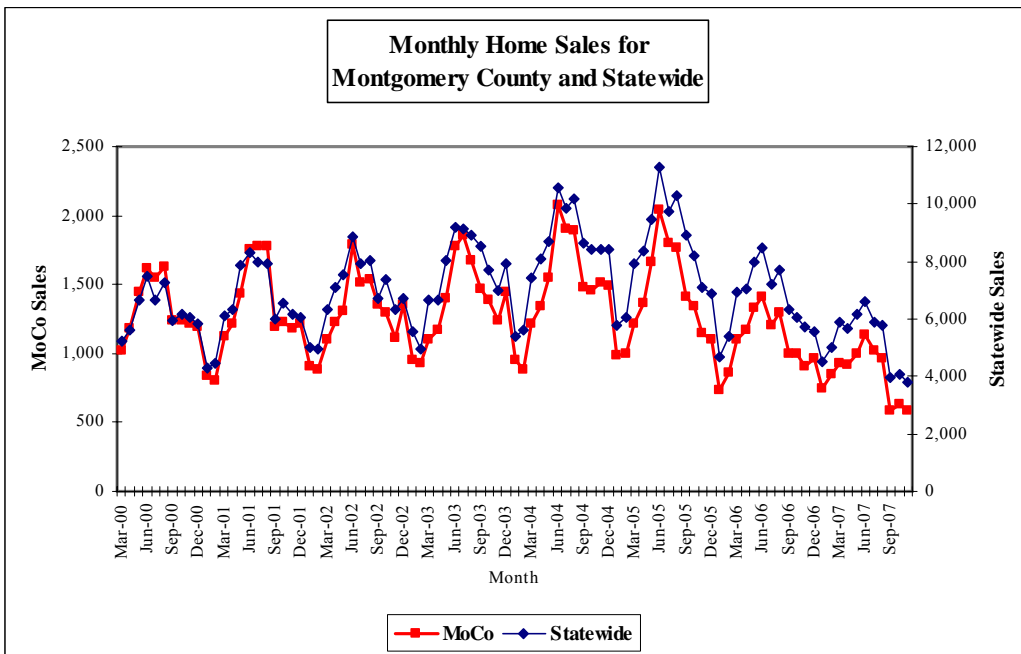
- Personal Income.** With a modest increase in employment and average weekly wages between 2007 and 2014, Finance estimates that total personal income will grow at an average annual rate of 5.2 percent, which is also slightly lower than the ten-year average between 1997 and 2007 (6.3%). By 2014, Finance assumes that total personal income will reach \$89.9 billion or an average of \$233,000 per County household.
- 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 2007 (3.5% compared to 2.9% through November, respectively). While overall price increases were largely attributed to high energy prices during 2007, the “core” inflation rate, which is the CPI excluding the volatile food and energy prices, increased 2.9 percent for the region through November compared to the nation’s 2.4 percent. Finance assumes that overall inflation rate, which is the percent change in the annual index, will moderate gradually from 3.5 percent in 2007 to 2.5 percent by 2014.



- Interest Rates.** Between June of 2006 and July of last year, The Federal Reserve Board, through its Federal Open Market Committee, has kept the effective target rate on federal funds at 5.25 percent. Since that time, the FOMC has cut the target rate four times by a total of 225 basis points to 3.00 percent by the end of January 2008. Based on data from the Federal Funds futures market (Chicago Board of Trade), Finance assumes that the FOMC will cut the target rate another 50 basis points in March and another 25 basis points before the end of this fiscal year. Since the yield on the County’s short-term investments are highly associated with the federal funds rate, Finance estimates that the County will earn an average of 4.00 percent on its short-term portfolio for fiscal year (FY) 2008 and 2.5 percent for FY2009 – the lowest yield since FY05.



- Retail Sales.** Using sales tax receipts as a measure of the level of retail sales for the County, sales for nondurable and durable goods decreased 0.1 percent in 2007 (through November). Sales of nondurable goods were up 4.2 percent, while sales of durable goods, led by purchases of home furnishings, were down nearly 8.3 percent from the previous year. The decrease in the purchases of durable goods can be attributed to the dramatic decline in housing sales.
- Real Estate Market.** The housing market in Montgomery County experienced a continued decline in sales but a modest house price appreciation in 2007. Existing home sales declined nearly 23 percent in 2007 which followed a 21 percent decline in 2006. Total sales of approximately 9,900 units were at their lowest level since 1996. After four consecutive years of double-digit price increases between 2002 and 2005, the average selling price increased 3.6 percent in 2007, which followed a 4.4 percent increase in 2006 – the lowest increase in seven years.



- 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, 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.

The value of new non-residential construction in the County added to the property tax base decreased 6.8 percent in calendar year 2007 from \$1,431.5 million to \$1,343.4 million. The decline in the value was led by the drop in commercial construction, which represented 61 percent of total non-residential construction. In 2006, the value of new commercial activity was \$451.2 million but by 2007, that value declined to \$407.8 million (↓9.6%). The value of other non-residential construction, which includes manufacturing, education and science, hospital and health treatment facilities, added to the property tax base decreased 2.1 percent in 2007 from \$266.2 million to \$260.5 million – the lowest added value since 2003.

Residential construction also decreased for the second consecutive year. The value of additional residential property declined 5.5 percent, which followed a decline of 7.9 percent in 2006. The value of new residential construction stood at \$675.0 million in 2007, which was significantly below the previous five-year average of \$729.3 million. Because of the high inventory-to-sales ratio for existing homes, Finance assumes that the value of new residential construction will decline in calendar year 2008 to the level experienced prior to the housing construction boom that began in 2001.

DISCUSSION FRAMEWORK

The economic assumptions provide a framework for the Department of Finance's revenue projections for 2009 through 2014. 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
- Non-traditional mortgages and foreclosures
- Prices
- Credit conditions – commercial sector

Federal Government

- Procurement
- Construction
- Fiscal stimulus package

Income

- **Personal income**
- Capital gains

Industry Sectors

- Business activity
- Employment outlook

Risk to the Forecasts

- Economic growth
- Demographics
- Interest Rates
- Labor Markets
- Inflation
- Stock market

