DEPARTMENT OF FINANCE

Isiah Leggett
County Executive

Joseph F. Beach
Director

March 26, 2013

Honorable County Executive, and
Members of the Montgomery County Council

Ladies and Gentlemen:

I am pleased to present the findings of the Fourteenth Annual Business Advisory Panel that was convened on February 15, 2013. The enclosed 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,

Joseph F. Beach
Director of Finance

Enclosures

Office of the Director

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FINDINGS OF THE FOURTEENTH ANNUAL BUSINESS ADVISORY PANEL FEBRUARY 15, 2013

Pursuant to Article IX, Section 10-61, of the Montgomery County Code, the Department of Finance (Department) convened a meeting of the Business Advisory Panel (BAP) on February 15, 2013. 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 County Council. This report provides such advice.

The BAP members representing real estate, finance, health services, academia, and government and trade associations, were joined by County Executive Isiah Leggett and Councilmember Nancy Floreen, Chair of the Planning, Housing, and Economic Development (PHED) Committee. Mr. Leggett began the meeting by outlining the budgetary challenges he undertook since taking office. He stated that since he has been in Office his administration has closed budget gaps of $2.7 billion, and that the County faces two challenges on the short-term horizon. The first challenge is federal sequestration and the potential for furloughs for federal employees. The effect on the County from the furloughs is estimated at $500,000 per day in lost income tax revenue. The second challenge is transportation and the upcoming master plan.

The meeting was structured to allow the participants to brief the County Executive and Councilmember on the local and regional 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 Conditions and Future Economic Assumptions

Finance staff asked the participants to provide comments to a paper prepared by staff 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. The paper follows these findings. The participants did not make any changes to the assumptions. Because of the current national, i.e., federal sequestration, and potential effect of sequestration on the regional economy, a majority of the discussion by the participants focused on the outlook for the region's economy.

Dr. Stephen Fuller, Director, Center for Regional Analysis (CRA), George Mason University, presented a perspective on the regional and Montgomery County economy. Dr. Fuller discussed how the economy has changed in the past five to six years both in terms of salaries and types of jobs. The Greater Washington regional economy has declined and part of the economy will not return. Specifically twenty-five percent of the jobs lost through retirement or the recession have not been replaced, that is, the bottom six sectors have lost 700,000 jobs and are not expected to be filled. The industry sectors that are growing also have the lowest salaries. He identified the Health and Educational Services sector as the best performing sector. According to data provided by Dr. Fuller, that sector in the Washington region did not lose jobs during the "Great Recession" and has added 52,000 jobs from the end of the recession on June 2009 to December 2012. The Professional and Business Services sector lost 25,000 jobs during the "Great Recession" but has added only 28,000 since the recovery for a net gain of 3,000 jobs. Of the nine sectors including Retail, Leisure and Hospitality, Construction, Financial and Information sectors, the total loss of jobs was 169,000 jobs during the "Great Recession" but they added only 53,000 jobs since the recovery for a net loss of 116,000 jobs. Dr. Fuller estimates that three sectors will drive the regional economy: Professional and Business Services, Health and Educational Services, and Construction.

Federal Government employment has been declining in the region and the federal government is not replacing those who have left. Thirty-five percent of the federal workforce has at least 25 years of federal service and thirty-five percent has less than 5 years of federal service. Since 2004, the employment by the federal government increased by 40,000 in the Washington region. However, CRA estimates that because of attrition starting in 2011, federal employment will decline by 22,000 by 2017 – over one-half of the increase between 2004 and 2012. Secondly, federal retirees are not leaving the Washington area and thus there is no housing for their replacements in the short run. Because of the forecast of the decline in the federal workforce, private sector jobs will drive the economy and not the federal government. The number of jobs in suburban Maryland will increase at an annual average rate of 5.7 percent between 2013 and 2015 then nearly double in 2016 attributed to the commercial sector.

The effects of sequestration on the regional economy are reflected in the outlook for federal procurement. Based on estimates provided by CRA, sequestration is expected to extract $5 billion from the local economy. Between 2011 and 2012, federal procurement declined 5.5 percent; and, because of that decrease, the federal contracting workforce has also declined. Because of sequestration, the gross regional product lost one percent. In 2010, federal procurement for the Washington region amounted to $82.5 billion, some of which included the federal stimulus program. By 2012, that amount declined 8.4 percent to $75.6 billion. According to CRA, the share of total federal spending subject to sequestration is 21.0 percent and federal spending as a percent of the region's GRP in 2011 is 39.0 percent.

The real estate market exhibited strong growth in 2012. While the supply of housing was the lowest in six years thereby contributing to a constraint on sales, sales prices were up for all types of housing. All builders surveyed by CRA experienced double-digit growth, but with this dramatic growth, there was not enough supply to meet the pent up demand. The regional housing market in 2012 had recovered 50 percent of the average sales price since the dramatic decline in housing and by 2016 should be back to a level observed prior to the end of the previous housing bubble. Regarding the commercial real estate market, the outlook is for the modernization of lower quality office space with demolition of current property and rebuilding new space. CRA estimates that with the modernization, the square feet of office space will decline from 250 square feet to 190 square feet per employee, yielding a less than higher quality of space.

The representative from the Washington Metropolitan Council of Governments (COG) presented both short-term and long-term perspectives on the region's economy. Referring to the region's economy as complex, COG is guardedly optimistic about the changing economy. Specifically, COG presented five recommendations that are highlighted in its recent report entitled *Economy Forward.* The five recommendations are:

1. Federal-Regional Partnership: As federal procurement and employment in the region declines, a stronger relationship between federal and regional officials is critical.
2. Strong Centers: Metropolitan Washington needs Activity Centers with the right mix of housing, jobs, and access to transit.
3. Workforce Development: There is a mismatch between available jobs and a skilled workforce that is forcing employers to look outside of the region for new employees.
4. A New Image: Further economic growth requires moving beyond the image of being a "government town."
5. Transportation Investment: Greater investment in transportation infrastructure is essential to the region's economic competitiveness.

The theme discussed amongst the panel members was the need to look outside the federal government for growth in employment. The Washington region and Montgomery County in particular must rely less on the federal government and more on the private sector for employment and economic growth. Federal sequestration may be the impetus for the local economies to focus on the private sector as the engine of economic growth.

II. Specific Industry Sectors

The residential housing market was the first sector discussed by the participants, reviewing its current and future outlook. The representative from the Realtor's Association confirmed Dr. Fuller's comment that the current housing inventory or supply is low and there is significant pent up demand. However, while there is strong demand for housing, prices have increased a modest 4 percent and haven't recovered to their post-market crash. Another aspect of housing demand is that because of the demographic shifts occurring among the County's population, incoming residents will move into smaller residences. Specifically, the younger population is locating in urban or more densely populated areas such that the market is based on how and where individuals want to live. For those areas that have become very popular, there are multiple contracts on "well priced" housing stock. The potential risk to improvement in the residential housing market is federal sequestration that could "freeze' the market and halt any potential transactions.

The representative from the Health Care Industry noted two economic factors that are currently affecting the economy: the aging population and pressure on costs. Medicare patients currently consist of 10 percent of total patients but represent 64 percent of medical spending. As the aging of the population increases, there will be increased pressure on costs, specifically per patient costs, over the near term.

The representatives from the Commercial Development sector discussed the current economic state of commercial construction. Construction costs continue to increase and are offset in part by the decline in financing costs. The office and industrial markets have experienced declines because of rents. The "flex" market is in good shape but it is difficult to estimate the number of potential developments. Jobs in construction have begun to increase after years of decline, and because of the demand for "urban" style living by new residents, the area is "urbanizing" in terms of specific types of property. Vacancies remain stable in the commercial sector.

The first representative from the Financial Services sector expects income as reported on tax returns will be lower in 2013 compared to 2012 which was the best year since 2007. However, the high income earners continue to show strong results. The challenge in the future from income tax revenues is the recent ruling by the Maryland Court of Appeals on the "Wynne case." According to the ruling, a taxpayer who pays a tax in another state must get credit against the county income tax. Current State tax policy does not allow a taxpayer to receive credit against the county income tax for taxes paid in another state. As of this writing, the State of Maryland has requested the court to reconsider its ruling.

The second representative from the Financial Services sector stated that 21 to 24 percent of the loan growth by his institution is with small companies. He estimates that small businesses will continue to grow. His concern is that the savings from refinancing (refi's) are not recycled back into the local economy and the market has shifted its investment focus from credit risk to interest rate risk. When interest rates go up, rents do not go up at the same rate, and therefore, interest costs are not compensated with rents. Regarding the business real estate environment, companies are "backfilling" from B^- space to C^+ space. Finally, the Certificate of Deposit Account Registry Service (CDARS) is providing benefits to the local financial community.

The representative from the Engineering Services sector provided an upbeat discussion on the current and future outlook for development. Demand for infill residential and condominium construction is strong. While the retail sector has struggled because of the "Great Recession", it is beginning to recover with the demand for "life-style" shopping. Development of power companies and transportation facilities has also increased. The health care industry needs more facilities in order to meet the growing demand for care. The demand for investment in development projects has increased and non-residents are providing investment in such projects.

The representative from the County's Department of Economic Development provided an overview of the commercial sector in the County. There are only two office projects under construction: MCI and Parklawn. The vacancy rate for office space has increased from 4 to 4.5 million square feet. As mentioned by a previous representative, there is popular demand for small office space. There are rent "givebacks" to encourage businesses into commercial property because of the intense pressure on rents. Focusing on specific sectors, the representative stated that the Life Sciences sector is maturing, but the opportunities in that sector are changing from therapeutics to diagnostics. There are growth potentials in the "knowledge" economy such as Cyber Security, Health Care Information Technology, Life Sciences, and General Information Technology. The challenge has been that federal sequestration has created a situation whereby businesses have stopped growing and are awaiting resolution from the federal government.

The representative from the Hotel Industry stated that while tourism has improved that has not yielded increased revenues to the hospitality industry. The average daily room rate has just begun to increase but the benefits of that increase have been reduced because of the additional hotel space that has come on line. The goal of the County is to increase weekend visits and increase the demand to offset the increase in the supply of rooms.

The last representative from the Business Association provided an overview of the business environment in the County and provided a wrap up to the discussion. The representative noted that the County has been successful in creating incubator companies. However, as those companies grow in size (100+ employees) and mature, they experience the challenge of retaining employees because of the high cost of living and began to look elsewhere where those costs are much less. The County can maintain the small and medium-size companies but has difficulty in retaining larger companies. The County's economic goal is to allow and encourage existing companies to grow and retain those companies as they mature. Some sectors such as financial services companies are applying their business expertise to the health care records business and federal contractors are focusing on international contracting.

III. Conclusion

The representatives expressed cautious optimism regarding the region's and County's economy. While there has been improvement in specific sectors such as residential real estate and growth in small and medium-size businesses, there are challenges as well. Foremost among those challenges is the effect of the federal sequestration. While the County's economy has been dependent on the federal government, the theme by some of the representatives is to move from the strong dependence on the federal government to greater reliance on the private sector for growth. Another theme from the discussion is that the composition of the labor force should emphasize growth in the workforce with strong technical skills that can support and maintain complex equipment.

Final List of Participants BAP 2013
February 15, 2013

Mr. Lawrence N. Rosenblum, CPA
Grossberg Company, LLP

Ms. Annice Cody
Chief Strategy Officer
Holy Cross Hospital

Mr. Michael Moran
Chief Executive Officer
Greater Capital Area Association of Realtors

Ms. Kelly Groff
Executive Director
Conference and Visitors Bureau
of Montgomery County, MD, Inc.

Dr. Stephen S. Fuller
Director, The Center for Regional Analysis
School of Public Policy
George Mason University

Mr. Paul Chod
Corporate President, General Partner of Real Estate Affiliates
Minkoff Development Corporation

Mr. Bradley Chod
Vice President
Minkoff Development Corporation

Ms. Sally Sternbach
Deputy Director
Department of Economic Development

Ms. Georgette Godwin
President and Chief Executive Officer
Montgomery County Chamber of Commerce

Mr. Paul DesJardin
Director, Community Planning and Services
Department of Housing and Planning
Metropolitan Council of Governments

Mr. Ronald D. Paul
Chairman and CEO
Eagle Bank

Mr. Richard DeBose
Division Chief, Research and Technology Center
Montgomery County Department of Planning

Mr. James A. Soltesz
President and Chief Executive Officer
Loiederman Soltesz Associates, Inc.

Internal Attendees:

Mr. Isiah Leggett, County Executive

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

Joseph Beach, Director
Department of Finance

Rob Hagedoorn, Treasury Division Chief
Department of Finance

David Platt, Chief Economist
Department of Finance

Michael Coveyou, Chief
Debt & Cash Management and Fiscal Projects
Department of Finance

Jacob Sesker
County Council Staff

Lilly Qi
County Executive Office

MONTGOMERY COUNTY

14TH ANNUAL

BUSINESS ADVISORY PANEL

FEBRUARY 15, 2013

MEETING

WHERE:	COUNTY EXECUTIVE'S CONFERENCE ROOM EXECUTIVE OFFICE BUILDING 2nd FLOOR 101 MONROE STREET ROCKVILLE, MARYLAND 20850 (240) 777-8877
WHEN:	FRIDAY, FEBRUARY 15, 2013

AGENDA

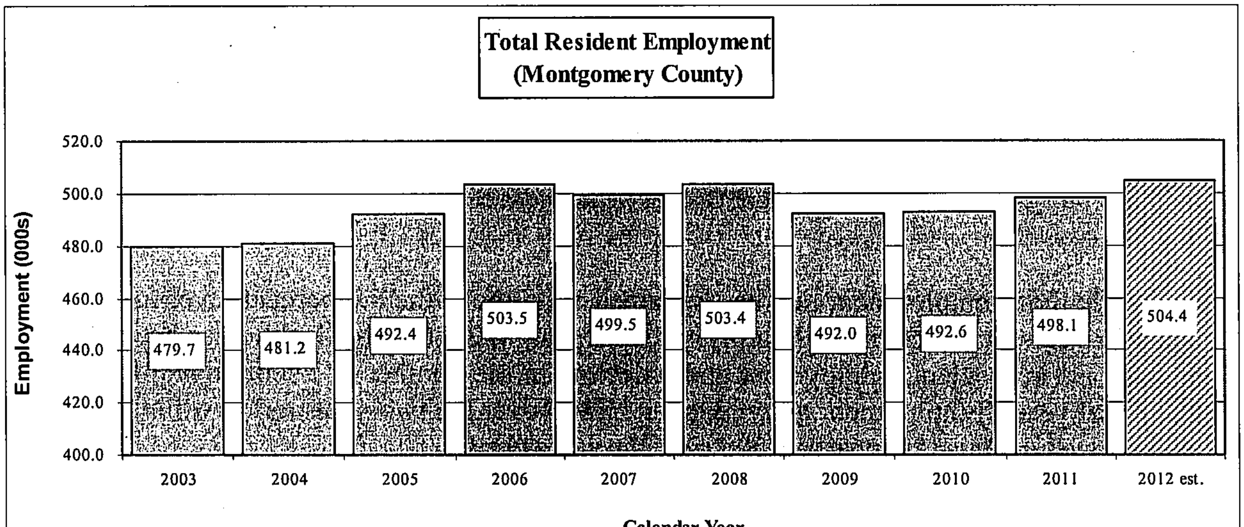
9:00 A.M.	WELCOME AND OPENING REMARKS
9:15 A.M.	ROUNDTABLE DISCUSSION BY PANEL PARTICIPANTS
10:45 A.M.	CONCLUDING REMARKS
11:00 A.M.	ADJOURNMENT

ECONOMIC CONDITIONS AND OUTLOOK

Montgomery County's economic performance improved during calendar year 2012. The major reasons for the improvement were a decrease in the unemployment rate, an increase in employment – both resident (labor force series) and payroll employment (establishment series), an increase in the median sales price for existing homes, and strong residential construction growth.

Employment Situation

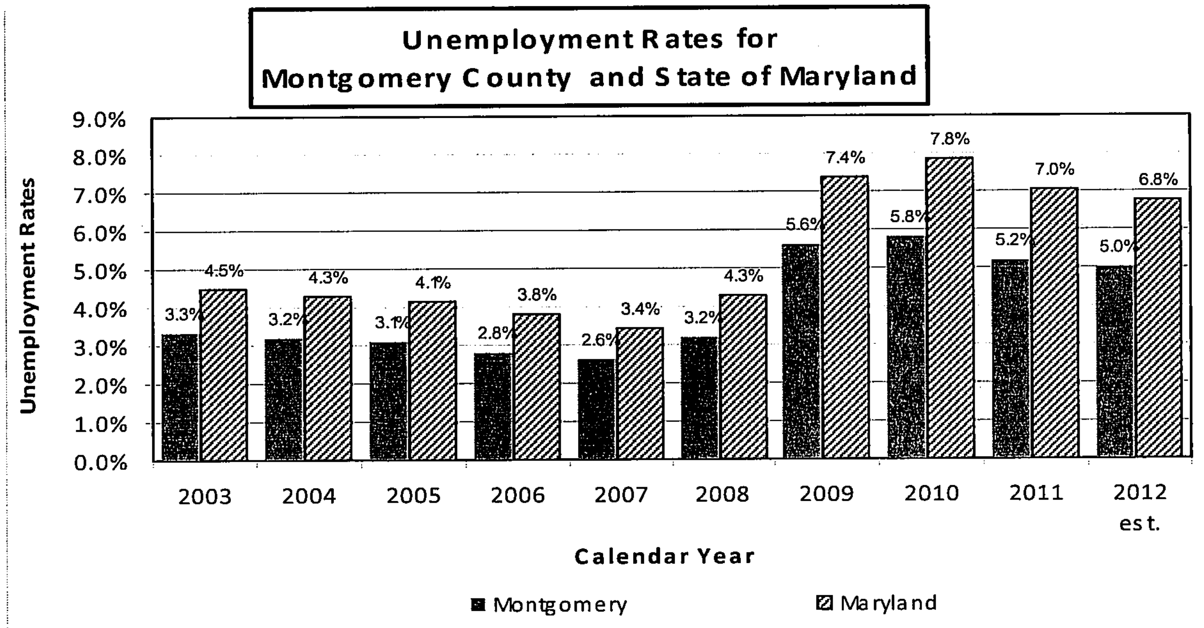
Based on data from the Maryland Department of Labor, Licensing and Regulation (DLLR), average monthly resident employment (labor force series and not seasonally adjusted) in Montgomery County increased by an estimated 6,300 (↑1.3%) during 2012. Average monthly resident employment stood at an estimated 504,400 in 2012 compared to 498,100 during the previous year.



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

However, the County's total payroll employment, as derived by the Department of Finance incorporating the establishment series from the Bureau of Labor Statistics (BLS), U.S. Department of Labor, for the Bethesda-Rockville-Frederick metropolitan division increased by approximately 5,100 jobs (↑1.1%) during 2012. Total payroll employment stood at an estimated monthly average of 473,600 jobs during calendar year 2012 compared to a monthly average of 468,500 in 2011. The modest discrepancy between the series (6,300 versus 5,100) is attributed to the sources of payroll data. The DLLR series is derived from the survey of households while the BLS series is derived from a survey of establishments.

The County's unemployment rate declined from 5.2 percent in 2011 to 5.0 percent in 2012. Throughout the calendar year, the County's unemployment rate remained one of the lowest in the State and averaged 1.8 percentage points below the State's average in 2012.

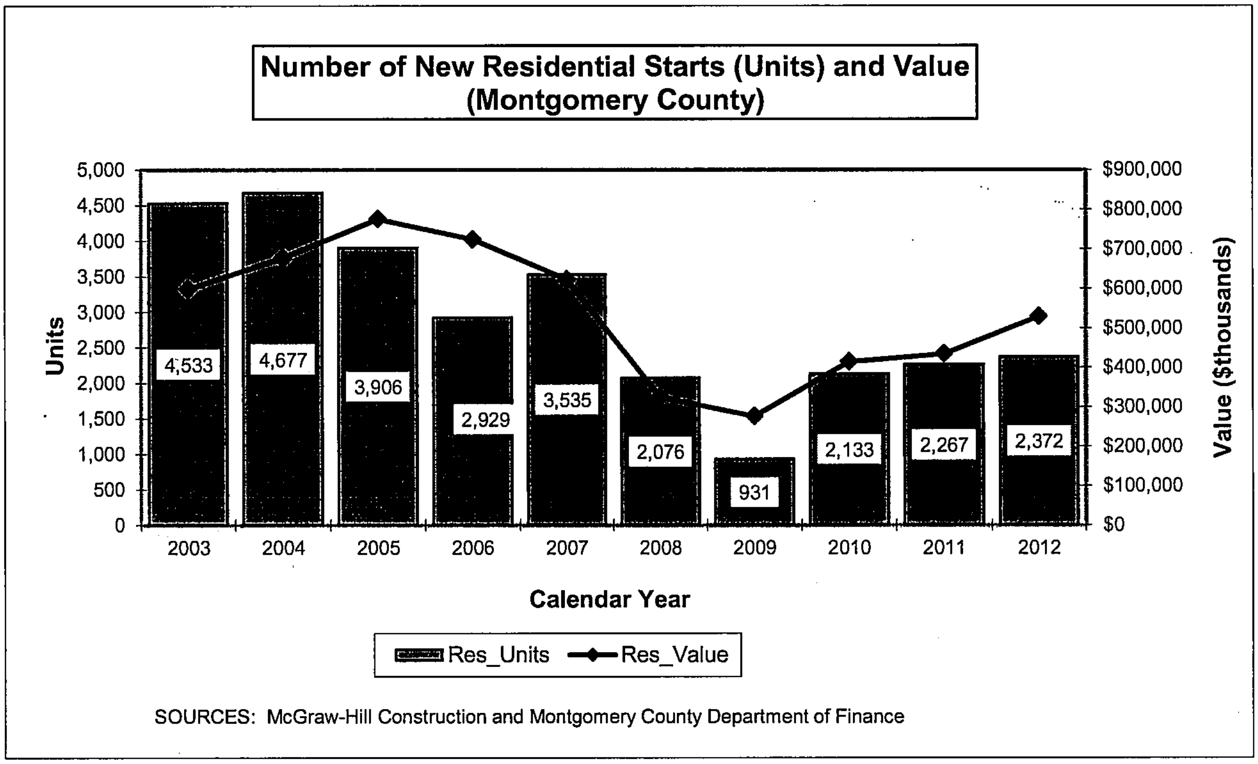


Sources: Bureau of Labor Statistics, U.S. Department of Labor
Montgomery County Department of Finance

While the unemployment rate has remained at or above the 5.0 percent level for the past four calendar years, it has declined steadily since its peak in 2010. The decline has been attributed to an increase in resident employment and a decline in the number of unemployed during the past two fiscal years. Employment grew by over 11,800 over the two-year period while the number of unemployed declined by nearly 3,500 over the same period.

Construction Activity

Construction experienced generally strong performance during calendar year 2012. The total number of building permits (residential units and commercial permits) increased 37.5 percent and the number of total new construction starts (residential units and commercial projects) increased 6.5 percent compared to calendar year 2011. Strong residential construction starts attributed to multifamily and single-family units added a total value $529.3 million – an increase of 21.9 percent over 2011.



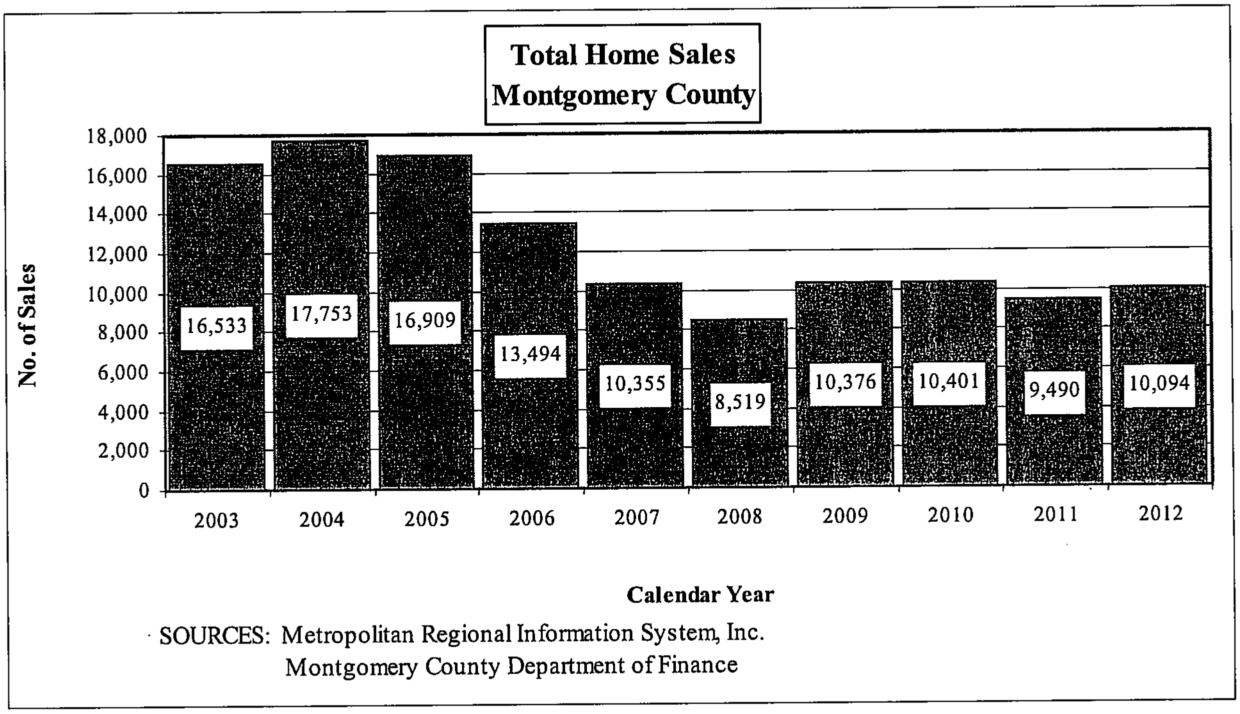
However, while non-residential starts increased 45.7 percent in 2012, the total value decreased from $904.2 million to $761.6 million (↓15.8%). Overall, construction starts added a total value of $1.291 billion to the property tax base. Because of the decline in the value of non-residential starts, the total value of new construction was 3.6 percent below 2011.

At the same time that the total number of construction starts increased during 2012, construction costs were up 3.5 percent. The construction cost index developed by the *Engineering News Record* (ENR) for the Baltimore area increased 5.2 percent in 2010 and 2.9 percent in 2011. Therefore, while construction activity increased in 2012, that increase was in part due to inflation in construction costs.

Residential Real Estate

Total construction of new residential units increased 4.6 percent from 2011 to 2012. The number of new single-family units increased 39.2 percent from 650 single-family units in 2011 to 905 units in 2012. Construction of single-family units in 2012 was the second highest number since 2007. At the same time that the number of total new residential construction starts increased during 2012, the number of permitted units increased 55.9 percent in 2012 compared to 2011 suggesting continued improvement in residential construction.

During 2012, home sales increased 6.4 percent following a decline of 8.8 percent in 2011 and an increase of 0.2 percent in 2010. Median sales prices for existing homes increased 4.9 percent and followed an increase of 2.9 percent in 2010 and no increase in 2011.

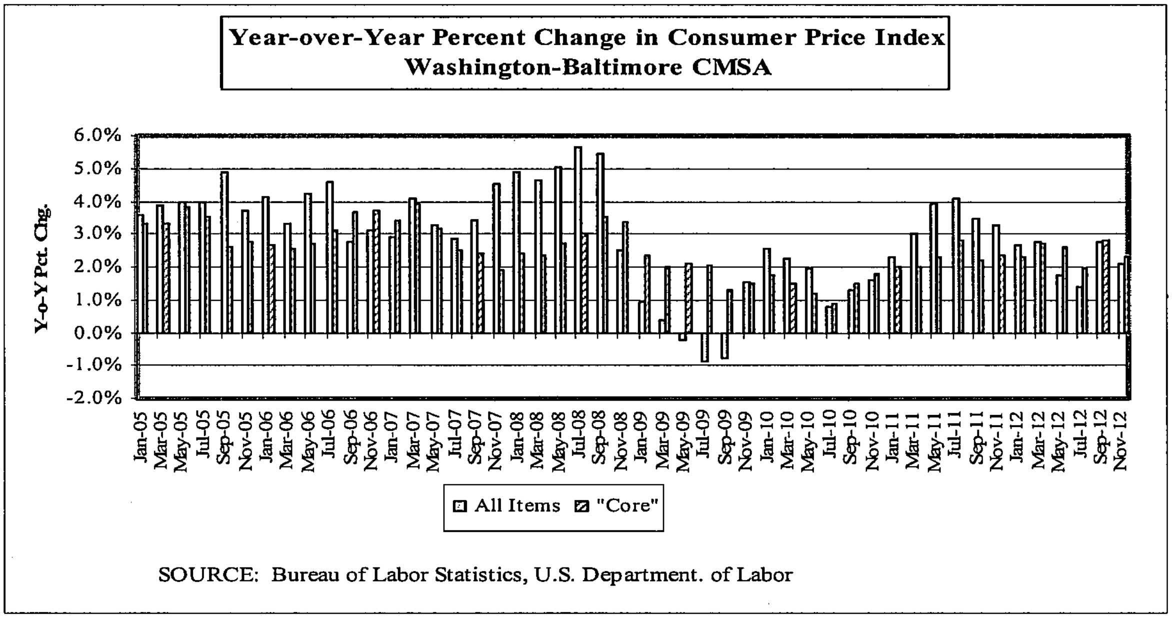


Retail Sales

Using sales tax receipts as a measure of retail sales activity in the County, the growth in sales of durable and nondurable goods, excluding miscellaneous and assessment collections, increased 2.9 percent through October 2012 compared to the same ten-month period in 2011. Purchases of nondurable goods, which include food and beverage, apparel, general merchandise, and utilities and transportation, increased 6.5 percent during this period while sales of durable goods were up 1.7 percent. The increase in nondurable good purchases was attributed to food and beverage sales (↑6.3%). The increase in purchases of durable goods was attributed to growth in sales of hardware, machinery, and equipment (↑7.8%) and building and industrial supplies (↑2.5%).

Consumer Prices and Inflation

As measured by the Consumer Price Index for All Urban Consumers (CPI-U), inflation in the Washington-Baltimore region increased 2.1 percent on a year-over-year basis in November, i.e., November 2012 over November 2011. That modest growth continued a deceleration trend in the rate of inflation since July 2011 (↑4.1%). Consumer prices excluding food and energy purchases were up 2.3 percent in the region (on a year-over-year basis), which was higher compared to the national rate (↑1.9%) over the same November 2011-to-November 2012 period.



Year-over-Year Percent Change in Consumer Price Index
Washington-Baltimore CMSA
6.0%
5.0%
4.0%
3.0%
2.0%
1.0%
0.0%
-1.0%
-2.0%
Y-o-Y Pct. Chg.
Jan-05
Mar-05
May-05
Jul-05
Sep-05
Nov-05
Jan-06
Mar-06
May-06
Jul-06
Sep-06
Nov-06
Jan-07
Mar-07
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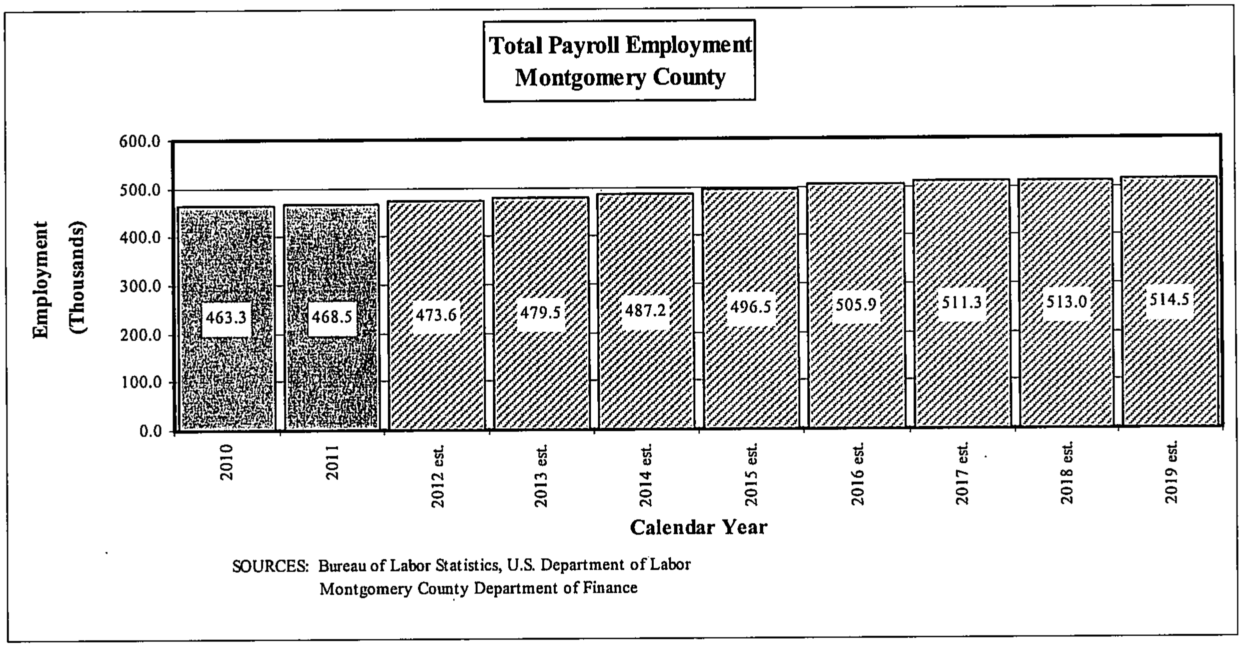
Jan-11
Mar-11
May-11
Jul-11
Sep-11
Nov-11
Jan-12
Mar-12
May-12
Jul-12
Sep-12
Nov-12
All Items
"Core"
SOURCE: Bureau of Labor Statistics, U.S. Department. of Labor

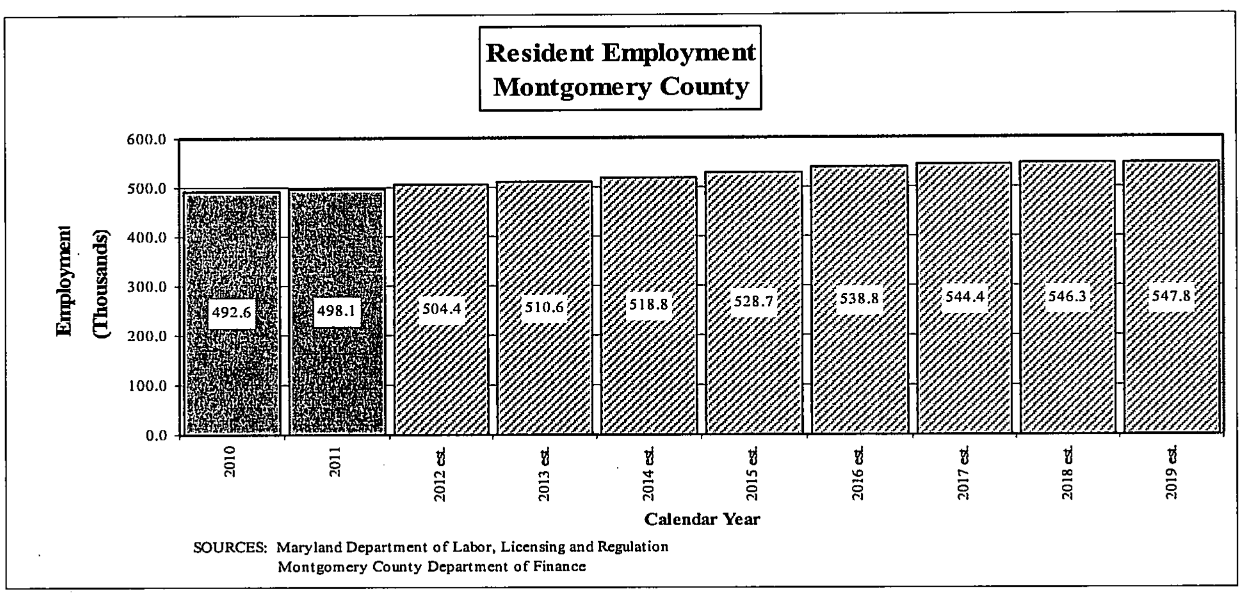
ECONOMIC OUTLOOK

The Department of Finance assumes that Montgomery County's economy is expected to continue to improve through the next six years.

Employment. The Department of Finance (Finance) assumes payroll employment will continue to increase from CY2012 to CY2019 and grow at an average annual rate of 1.2 percent over that period.



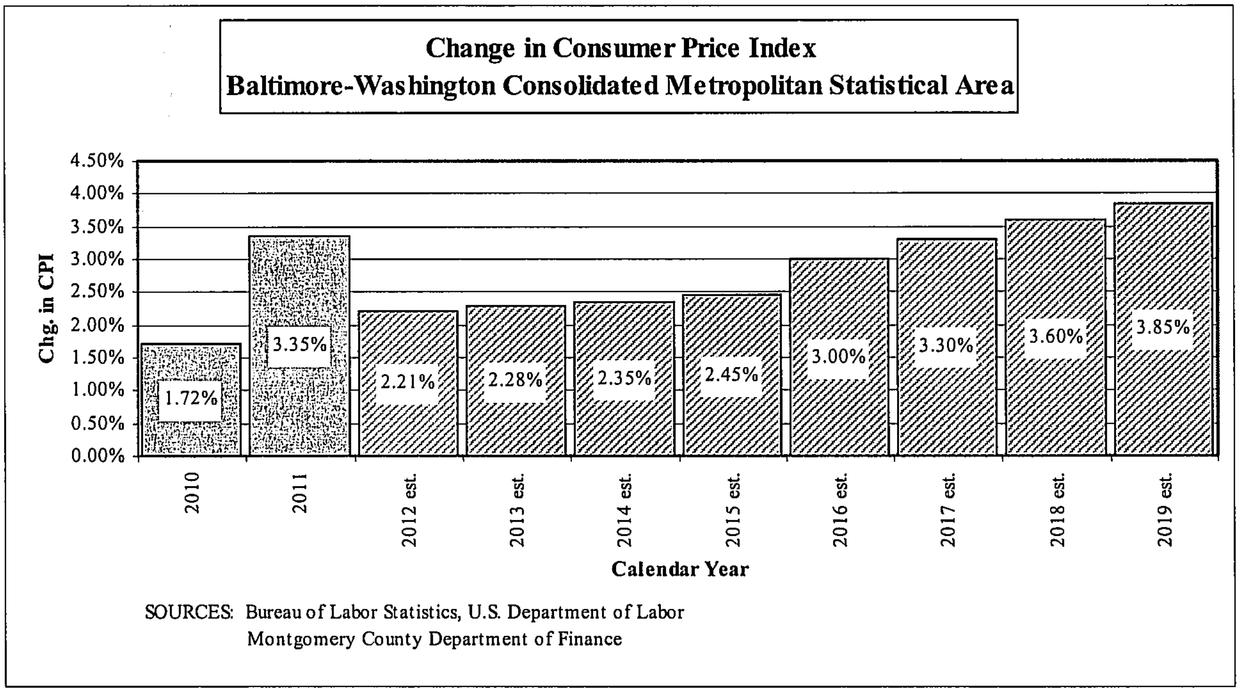
Finance assumes that resident employment is expected to increase at an average annual rate of 1.2 percent from CY2012 to CY2019.



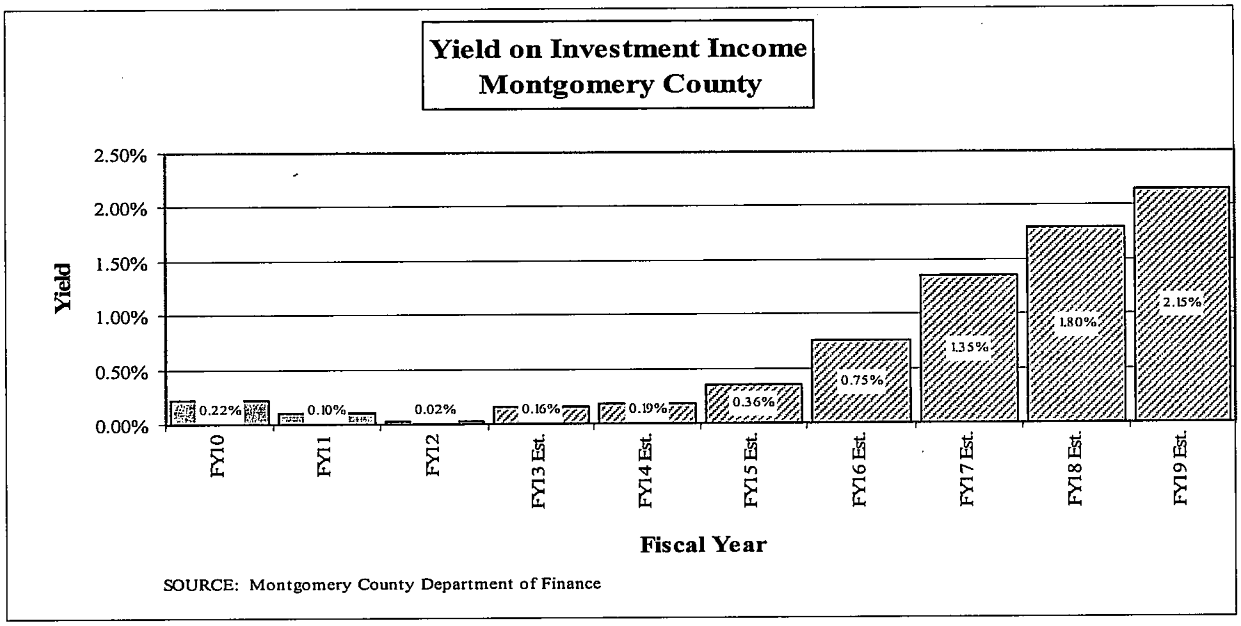
Finance assumes wage and salary income to grow at an average annual rate of 4.4 percent between CY2011, the latest date for which actual data are available from the Bureau of Economic Analysis, U.S. Department of Commerce, and CY2019. Total wage and salary income is estimated to reach $46.820 billion by CY2019.

- ***Personal Income.*** Finance assumes that total personal income in Montgomery County will grow at an average annual rate of 4.7 percent from CY2011 to CY2019. By CY2019, Finance assumes that total personal income will reach $99.550 billion.

- ***Inflation (annual average).*** Finance assumes that the overall regional inflation index will gradually increase from 2.21 percent in CY2012 to 2.45 percent in CY2015, and then gradually to 3.85 percent by CY2019.



- ***Interest Rates.*** From September 2007 to December 2008, the Federal Reserve Board, through its Federal Open Market Committee (FOMC), 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 bond and stock markets) and the national economy since the summer of CY2007. Based on its decision at the January 2013 meeting, the FOMC "decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent." Since the yield on the County's short-term investments are highly correlated with the federal funds rate, Finance assumes that the County will earn an average of less than 0.16 percent in investment income on its short-term portfolio for fiscal year (FY) 2013 with modest increases to 0.19 percent in FY2014 and 0.36 percent in FY2015.



Yield on Investment Income
Montgomery County
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
Yield
0.22%
0.10%
0.02%
0.16%
0.19%
0.36%
0.75%
1.35%
1.80%
2.15%
FY10
FY11
FY12
FY13 Est.
FY14 Est.
FY15 Est.
FY16 Est.
FY17 Est.
FY18 Est.
FY19 Est.
Fiscal Year
SOURCE: Montgomery County Department of Finance

DISCUSSION FRAMEWORK

The economic assumptions provide a framework for the Department of Finance's revenue projections for FY2014 through FY2019. 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 construction
- Commercial construction
- Foreclosures/short sales
- Prices/rents
- Vacancy rates
- Loan conditions – residential and commercial sectors

Income

- Capital gains
- Estimated payments

Industry Sectors

- Business activity
- Employment outlook
- Federal government spending and employment

Risk to the Forecasts (Assumptions)

- State government: income tax increase and pension shift
- Federal government
- Employment
- Interest rates
- Inflation
- Stock market
- Residential/Commercial development

Reference Documentation:
http://www.mwcog.org/uploads/pub-documents/oV5dXFc20120912132659.pdf
http://www6.montgomerycountymd.gov/content/finance/data/economic/BAP_Presentation_FY2013.pdf