1976

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Recommended Citation
Tempo, Vol. 22, no. 1 (1976), p. 40-49

WHAT ARE THE PROBLEMS OF INDUSTRY?

What are the critical issues facing some of the nation's major industries? TEMPO has asked Touche Ross professionals in each of seven fields to discuss his industry's response to its problems and the prospects of reaching a solution. Their common concerns appear to be inflation, capital shortage, and productivity.

Industries selected are banking, construction, energy resources, government, health care, retailing, and savings and loan.

CONSTRUCTION

by DENNIS BERSCH
National Services Director

To a construction man it sometimes seems that even a casual observer could recite a litany of his problems. A weak national economy combined with skyrocketing construction costs has resulted in a lack of work, increased competition, and lower profit margins. New records have been set in the industry for the rate of business failures, defaults on bonded jobs, and chargeoffs by banks on construction loans. Outside influences, particularly in the form of environmental impact studies, have curtailed job progress to an extent never before experienced by the industry.

Delays of course cost money, especially at a time when the price of labor and materials is rising. Shortages have also raised the prices on construction materials more rapidly than has inflation.

But some people within the industry are looking beyond these highly visible problems. A number of respected industry spokesmen feel that the one overriding problem of the industry is its failure to unite its members in an effective communications effort.

The industry is fragmented in many ways, not only between general and trade contractors, but also among those within the same metropolitan area. Ironically, the characteristic of contractors that makes the industry one of the last bastions of entrepreneurship is the underlying cause of such fragmentation. This is their unwillingness to give up their sovereignty. As a result, contractors as a group do not speak with a voice anywhere near as powerful as should be expected from an industry larger than either automobiles or steel.

The industry as a whole has not communicated the reality of its plight to the three main segments of the society with which it deals. Users of its services do not understand the price squeeze that has cut into already marginal profits, contractors believe. Government agencies, particularly OSHA and EPA, in imposing a substantial burden on all industries, have not recognized that implementing the regulations has created a special hardship on contractors. And labor leaders have yet to be persuaded that the identification of the construction industry as a major source of inflation is a problem both parties share.

Are there some signs in the sky that promise a brighter tomorrow? During the past few years, the first unified industry voices have begun to speak. The recently organized Council of Construction Employers represents nearly all segments of the industry in dealing with organized labor, while the Construction Industry Council is a clearinghouse for relationships with the government and other customers. Most contractors are of the "show me" variety and will not support such organizations until they demonstrate the power of the industry working together. But fortuitously, just the right occasion appeared recently. The fight against common situs picketing represented the most significant unified effort in the history of the industry. And it resulted in President Ford's most publicized veto, even over the objection of the Secretary of Labor, who ultimately resigned.

Will contractors learn from that experience and start working together on other problems on their list? These include holding down the inflationary aspects of the next labor bargaining cycle, developing better cost controls, improving financial reporting, and convincing the government of the need for legislation.

The coming year, with its anticipated recovery, should bring better health to the industry. Perhaps it will also provide contractors with a better climate in which to reflect on the lessons to be gained from their recent siege. Maybe they will even learn to listen to each other, and to talk to the world with a single voice.

BANKING

by MICHAEL J. COIE
National Services Director

The public spotlight today is on banking—and the exposure is taking on increasingly negative overtones. The piecemeal and often conflicting disclosures of banks appearing on one or more "watch lists" have been whipped into a near crisis by the press and some politicians. The industry is being accused, for example, of "covering up" insider financial information regarding the difficulties of municipalities. Vocal interest groups are demanding that the industry suspend credit-worthiness evaluations when making certain real estate loans. And trust department activities are under increasing scrutiny. They are charged with impropriety, on one hand, by using information known to the commercial bank and with violating fiduciary responsibilities, on the other hand, by not using this information.

Operating in the public eye creates a fundamental challenge to bank management. Its response will have important implications for the future of each institution and the industry.

But what are the causes behind these issues now in the spotlight? A look at certain aspects of the industry during the last five years reveals some of the contributing factors:

1. *The operating spread:* The difference between operating income

and the cost of funds has shrunk by approximately 20 basis points from 1970 to 1974. While operating income yield has increased by over 156 basis points, the cost of funds has increased more than 176 basis points in relation to average assets.

2. *Reliance on purchased funds:* Purchased funds as a percentage of total liabilities and capital have increased from approximately 50 percent to almost 60 percent, which compounds the problem of shrinking spreads.

3. *Contribution to capital:* As a percentage of assets, this declined, despite a reduction in dividends, from .37 percent of assets in 1970 to .32 percent of assets in 1974.

4. *Industry structure:* During the last five years, "interesting discussions" about changing the structure of the industry have moved to specific debate on legislative proposals. The changes could blur longstanding differences in the roles played by the commercial banks, thrift institutions, credit unions, and other financial institutions. These changes are prompted in part by the institutions outgrowing their traditional markets.

5. *Technology:* The improvement of delivery systems has accelerated faster than almost anyone had predicted. But increasing one's capability involves larger commitments to nonearning assets for much longer periods of time. And longer lead times are needed for the decisions.

Because of the nature of these issues, the decision-making that is required may not produce measurable results for long periods of time. This, of course, substantially increases the risk associated with them.

In the meantime, many banks must develop a strategy for the future based on answers to questions that in the past did not appear critical:

1. What is the role of banking in terms of services, markets served, and customers?

2. To what extent has prior success been caused by management action, and to what extent by external conditions and statutory powers?

3. What is the trend in employee productivity and operating efficiency?

4. Do we have management professionals or highly trained, functional specialists serving as managers?

5. How secure are both the earnings base and historical sources of earnings?

These and many other questions must be resolved if the industry is to deal effectively with the fundamental issues facing it. For only then will bank management be able to respond to the more visible issues that today are placing the industry in the public eye.

GOVERNMENT

by JAMES H. FALK
Director, Government Services

In his 1976 State of the Union message, President Ford called for a *"new realism,"* with limits on federal spending and tax reductions, and a new balance in the relationship of individuals and government. He also called for a new balance in our system of federalism—a balance that favors greater responsibility and freedom of action for the elected leaders of state and local government.

The governors, both Republicans and Democrats, are saying many of the same kinds of things to their legislatures. Negative reaction to "big government," which seems to be widespread this year, formed the foundation of most of their 1976 "state of the state" addresses.

"For too long," Governor Carey

(D-NY) said, "government has been dealing with difficult problems by creating more government." "Our most important single goal in 1976," Governor Dukakis (D-Mass.) said, "must be to continue and broaden the tough fiscal and management policies which we began in 1975. It means an end to the kind of shell game . . . in which we raise public expectations by promising new programs without the slightest idea of how we are going to pay for them." And Governor Lucey (D-Wisc.): "These days, government must be judged as much by what it does not attempt to do as by what it does do."

All of these leaders are trying to restore confidence in government by barring general tax increases and by selectively lowering and raising other taxes to make them more equitable. They are trying to hold down wage increases and government employment figures, proposing organizational changes to make local government more responsive.

Clearly the times have changed for states and municipalities. The themes today are more sunshine, more austerity, and more accountability.

The recent "sunshine" laws enacted from Maine to California reflect efforts to open up government to public scrutiny. These include disclosure in campaign financing and reducing the potential government invasion of individual privacy, while at the same time disclosing what public officials are doing in an official capacity.

With few exceptions, state and local surpluses of the past are gone. The result is austerity. Many state and local governments, unprepared for the last recession, have adjusted to new economic and financial realities by exercising greater restraint in fiscal operations. Thus, they hope, operating deficits will not become widespread.

The willingness of government officials to acknowledge publicly the need for more austerity goes hand in hand with "sunshine"—more openness in government about what government does. In view of the complexity of government and the growing financial problems, the need for current, reliable, comparable information about what governments are doing and how they are doing it is highly important.

Thus, the interest in accountability. The financial information provided by governments is rarely displayed in simple, comparative terms. This causes difficulty in verification, interpretation, and public understanding. Where is the accountability if no one can read, understand, and relate the data to other data?

Many questions remain unanswered and much has to occur before there will be a sound basis for projecting new trends. But it is clear that tighter budgets are producing greater demands for more information in a more understandable form. Elected officials are clearly responding to today's demand that governments both open up and straighten out their affairs.

RETAILING

by DAVID L. FLEISHER
National Services Director

Retailers today are seeking a successful formula for growth and increasing profitability, but they face a radically changed environment characterized by:

—Too many retail outlets.

—High capital costs.

—More selective consumers.

—Increasing government and consumer influence on operations.

In recent years, a large number of major retailers have demonstrated they could not compete effectively in this environment. One of the largest, W.T. Grant, represents the second largest bankruptcy in the nation's history. A number of major discount chains are in bankruptcy and several others are in deep financial trouble. Several major food chains have also been forced to go into bankruptcy.

On the other hand, many retail firms have continued historical patterns of growth and profitability during the recent recession. Many general merchandise companies experienced dramatic sales increases ranging from 30 to 40 percent in the fourth quarter of 1975 and are now forecasting new records in 1976.

What are the characteristics of such firms? Certain patterns can be detected:

—*First,* they are careful to fit merchandise, store locations, and price to the customers they want.

—*Second,* they develop, reward professional management talent.

—*Third,* they plan their growth in relation to management talent and available capital. Growth is achieved through improving productivity of stores, rather than through opening new stores.

—*Fourth,* they emphasize controls over investments in accounts receivable and inventory, and over payroll and other expenses. Return on capital is a primary measure of performance.

Automation will pose a major challenge to retailers during the next few years. To date, electronic point of sale systems are being used primarily to replace functions performed by mechanical cash registers. But the development of the Universal Product Code (UPC) in the food industry and the Universal Vendor Marking (UVM) for general merchandise offers a major opportunity for stores to improve their systems. This will bring improved productivity through reduced marking and check-out labor, fewer marking errors, reduced ringing errors at the point of sale, reduced stock-outs, lower markdowns and higher inventory turnover. Automation, however, will require major capital investments which must be carefully evaluated.

Another area of challenge is electronic funds transfer service (EFTS). Depending on how EFTS is implemented, it could offer retailers the opportunity to reduce their investment in accounts receivable, reduce cash required at store level, and practically eliminate bad check losses. Many department stores have been reluctant to give up their own credit cards. EFTS will present a new challenge to this policy.

In summary, the current retailing environment presents challenges that are dramatically different from those of the past. No longer can cheap and readily available capital be assumed. No longer can a formula of "finding good locations and opening new stores" by itself assure profitable growth. No longer can a growing number of increasingly affluent customers be the basic assumption for strategic planning. No longer can performance be measured simply by growth in earnings per share; liquidity and soundness of the balance sheet will be increasingly important to outside lenders and financial analysts. New technological developments offer significant potential benefits—but require major investments to achieve them. In short, it is a whole new ball game.

HEALTH CARE

by ROBERT CERRONE
Program Support Administrator

There are many problems facing the health care industry, but they are all part of a single major crisis—rising costs. The dilemma is simply stated:

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how can a provider supply quality care at the lowest possible cost to the patient, meet the high costs for capital assets, salaries, and other expenses, and yet be a going concern?

What are the specific problems? They are legion: an increasing regulatory environment, implementing planning legislation, changes in the health care delivery system, malpractice insurance, Medicare/Medicaid issues, cost containment, equal access to quality health care, increased consumerism, national health insurance, health education and preventive medicine, and the substitution of less expensive care for in-hospital care.

Each of these problems must be solved in an era of cost and budgetary controls, and in an environment marked by a decreasing supply of available funds. It is estimated that 8.5 percent of the gross national product is spent on health care. Many believe this figure to be at its maximum. Can the industry meet this challenge? To do so it must provide a higher quality of health care in the future with approximately the same percentage of the GNP available to finance such services.

The health care industry is struggling to find the answers. It is seeking new approaches to the delivery of services and to financial reporting. However, it is not alone. Government, concerned for the public welfare, has also tried to help. Congress has passed the National Health Planning and Resources Development Act of 1974 as the framework for implementing required changes.

Specifically, the act requires that existing planning agencies be replaced by new agencies responsible for controlling areawide planning and the funding of programs. New services must be prompted by a proven need as well as by financial feasibility. Existing services will be subject to the same scrutiny. Inappropriate services, duplication of facilities and services, and excess beds will be controlled and/or eliminated when not justified. Cost justification will be demonstrated in part by uniform systems for cost accounting, rate setting, and reporting. Similar health care providers will be grouped and their related costs compared.

But other obstacles must first be overcome. The bright promises for prepaid group practices, particularly health maintenance organizations (HMOs) have been tarnished by marketing, staffing, and rate setting problems. Expenditures for patient care in hospitals and by physicians must be reduced. Resources must be reallocated so that more will be invested in health education and preventive medicine, reducing the amount expended on treatment.

There is probably no single answer to these problems. Providers, hospitals, physicians, and others must be given incentives both to reduce costs and to improve the quality of health care. A variety of methods to determine the effects of alternate financing schemes on cost, utilization, and health status is required.

Physicians, who play a major role in the cost of health services because they prescribe the type, method, and intensity of care, must be educated on the cost implications of their decisions. Financing for consumers and providers must include an incentive for choosing less costly care.

The industry, as we know it today, will be altered by the current crisis and the steps taken to solve it. No one, however, can forecast the direction of the change. Will it meet the challenge, thereby sustaining the private health care system as modified by legislation, or will it be absorbed by the government and function as one of its bureaucratic arms?

SAVINGS AND LOAN

by ERIC L. STATTIN
National Services Director

What is the most critical issue the savings and loan industry faces today? The answer to the question probably depends on where in this country it is asked. Some think the loss of Regulation Q protection on interest rate limits is the most critical issue. Others cite inflation, urban decline, excessive governmental regulation, and the creeping nationalization of the housing industry. Also high on the list is the inability to compete for capital with government, commercial banks, and industry.

Whatever is labeled the most critical issue, one thing is clear. The industry has been put to severe tests in the past 10 years and has survived. Not only has it survived, in some respects it has come through such tests with surprising strength.

In this economic and political battle for survival, the savings and loans have benefited from an increasingly activist Federal Home Loan Bank Board. The FHLBB has met the challenge of failing institutions by aggressive and timely use of FSLIC. In 1970, the year of Penn Central and Lockheed, it used its default prevention authority to preserve the going concern value of the largest financial institution that up to that point had faced imminent failure. Later the board went to the capital market for literally billions of dollars in order to keep housing finance from almost totally drying up.

The Federal Home Loan Mortgage Corporation, Freddie Mac, has become another adjunct of the FHLBB. Freddie Mac's role is to facilitate and finance a secondary market for mortgage loans. In doing so, it has already helped savings and loans to achieve greater portfolio liquidity.

Some observers consider governmental assistance to be a long-term disadvantage. One may well ask if savings and loans are more vulnerable to changing economic and social conditions, and if so will they become more dependent on government, tax, and competitive subsidies? (Examples are: limited access, federal bad debt deduction, and subsidies running through the Federal Home Loan Bank Systems.) Since this is an industry with no visible equity interest, the dividing lines between regulation, control, and outright ownership would seem to be easily crossed.

The industry's response has not been monolithic. Large segments seem to be oriented toward the status quo while other groups favor change. Retaining Regulation Q, the tax subsidy, and the specialized housing role offer the main thrust for many in the business. Others look for success in broader services, investment authorities, and checking accounts.

Whatever the optimum solution is—and perhaps there really needs to be a series of alternatives—the biggest single obstacle appears to be the natural, human, and organizational tendency to resist change of any kind. This is a sociopsychological version of Newton's law dealing with inertia. It suggests that the critical factor for success will be the leadership and management talent the industry has or will be able to attract in the next few years.

The savings and loan industry by itself cannot solve such problems as inflation, urban decline, or on-again, off-again housing construction. These are problems the nation as a whole must solve. However, there is no question that the role of this $320 billion industry in dealing with those problems will be a key one.

Continued

ENERGY RESOURCES

by HERBERT J. BREWER
National Services Director

During the next 10 years, this nation's economy will depend on its ability to deal with foreign energy sources—assuming a peaceful world. In the long term, its future will depend on the ability to discover additional petroleum reserves and alternative sources of energy.

The facts are:

—The petroleum industry provides approximately 75 percent of all energy consumed in the United States; coal, water, nuclear, and other sources provide 25 percent.

—US oil production peaked in 1970 and has decreased steadily since then.

—The nation's use of refined products increased 18 percent from 1970 to 1973, and dropped only five percent in the recent economic decline.

—Between 1970 and 1975, US dependency on foreign petroleum sources increased from 25 percent to 37 percent of total needs.

This last factor is critical. Foreign countries have become increasingly difficult to deal with as they rescinded or altered various operating agreements, such as ownership participation (sometimes resulting in complete nationalization), royalties, and taxes. OPEC (Organization of Petroleum Exporting Countries) has become a medium from which these nationals deal in strength.

To put this nation's problem in perspective, one need only compare its oil reserves, annual production, and consumption with those of the other major oil producers. The table below is for 1974.

Comparable natural gas statistics for the United States are 11 percent of the world's reserves, 44 percent of production, 44 percent of consumption, and 10.4 years remaining supply. The need to find additional domestic reserves is readily apparent.

Spiraling cost, however, is limiting the current search for additional reserves. Not only have the costs of drilling more than doubled during the past five years, but the shallower and more accessible locations have been used up. Because of these and other factors, the cost of finding and producing a barrel of oil tomorrow will approach 10 times what it was in 1965—in 1965 dollars.

Where will the tremendous amount of capital come from to finance such needs? The Bankers Trust Company of New York has estimated, *assuming no imitations on imports and no inflation,* that capital outlays for the domestic energy industries will amount to $790 billion through 1990. This compares with the total market value of $771 billion for

Oil: Percent of Worldwide Total

	Available Reserves	Production	Consumption	Remaining Supply at '74 Production
United States	6.2%	15.6%	29.6%	10.9 years
Russia	8.7	16.4	12.3	14.2 years
Arab States	65.0	43.7	3.3	40.0 years
All Other	20.1	24.3	54.8	
Total	100.0%	100.0%	100.0%	

all stocks listed on the New York Stock Exchange on January 31, 1976.

Some of these capital requirements can be funded from future profits, but the petroleum companies point out that they have traditionally been average performers when profits are compared to net investment. Only in 1974 was their yield in the upper one-third of the major industries. By 1975, earnings were down 23.6 percent.

Nevertheless, the major integrated oil companies are under heavy criticism from both consumers and the government. All industries placed under wage and price controls in 1971 were released from control by 1973, except the oil and gas industry. The 1975 Energy Policy Conservation Act provides for continuing oil price controls with escalating prices under specified conditions until 1979. Additional bills have been introduced in Congress that will require the breakup of the five largest U.S. oil companies and up to 17 others. Antitrust proceedings have been implemented against the major oil companies. if successful, each company might be limited to but one of its four major activities: production, transportation, refining, or marketing. Thus, industry leaders are disturbed.

What is clear is that oil and gas, as a natural resource, is *finite*. Additional oil and gas reserves must be discovered, and alternative sources of energy must be developed. Inevitably, consumer, industry, and political leaders must one day cooperate in developing a national energy program that will: (1) continue to stimulate our economy, (2) conserve our natural resources, (3) encourage discovery and development of domestic petroleum reserves and other sources of energy, and (4) provide incentives to attract enough capital to get the job done