Capitalization in Nonprofit Organizations: A Shared Challenge

Sponsored by the McGregor Fund

May 28-29, 2014

TDC

Why are we here?

- A shared interest in the health and sustainability of nonprofit organizations of all kinds
- A recognition that many of these organizations are facing a number of challenges
- A belief that capitalization is the essential glue

Capitalization – why do we care?

Can you invest in the programs?

Can you invest in reaching your audience or serving target populations?

Can you invest in needed tools & infrastructure?

Can you respond to external forces?

Our agenda today

- Key terms & definitions
- Core capitalization concepts
- The view across the sector
- Creating a capitalization strategy
- What is standing in our way?
- Discussion

Key terms & definitions

- **Capitalization**: Having the cash to execute strategy
- **Business model:** How an organization makes and spends its money in service of its mission
- **Capital markets:** Where organizations seek funding and funders find outlets for their investments
- **Risk**: The chance that a desired result may not materialize

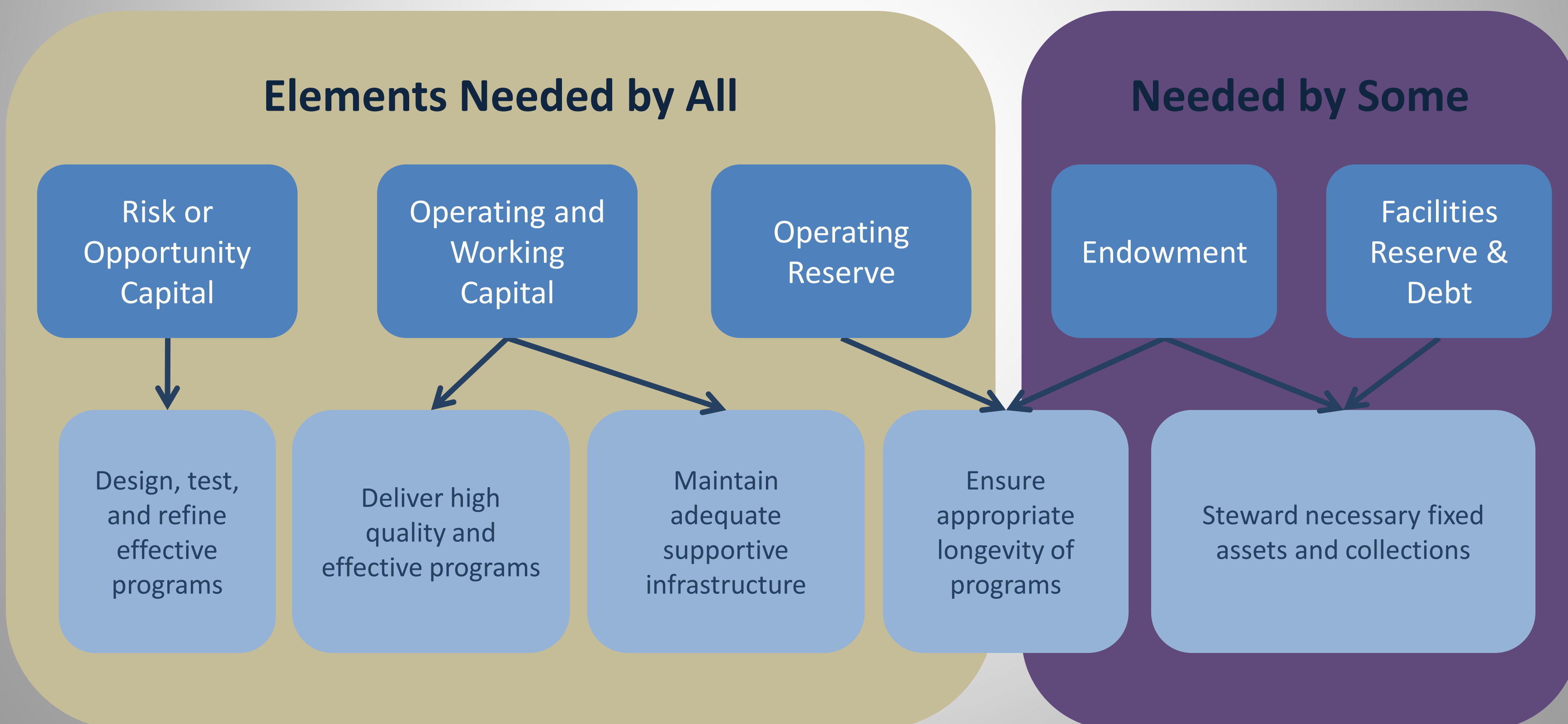
A caveat: revenue vs. capital

- **Revenue** (earned and unearned):
  - Covers annual operating costs
  - Pays debt service
  - When in surplus creates capital
- **Capital** is created by surpluses and external infusions and:
  - Defends against external and internal sudden shocks (risk management)
  - Creates stability of facilities (risk management)
  - Allows for significant programmatic and/or organizational changes (risk taking)
  - Supports programmatic and organization growth (risk taking)
  - Allows for organizational repositioning (risk taking)

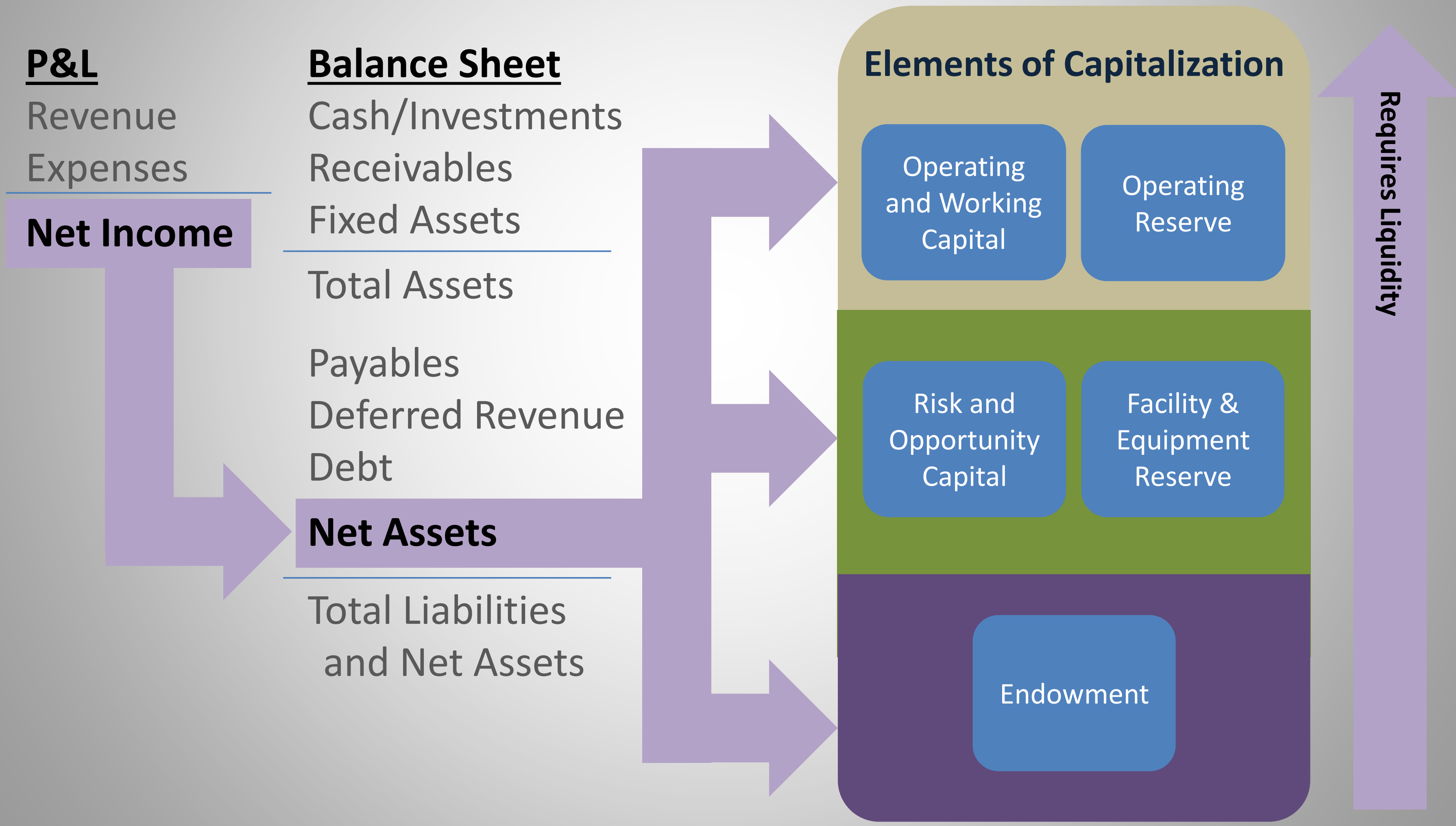
CORE CAPITALIZATION CONCEPTS

What is capitalization?

Capitalization is the accumulation and application of resources to support achievement of an organization's mission over time.



Capitalization comes from surpluses



Sources of surpluses

- The first essential step is to budget for a surplus, preferably substantial
  - Budgeting for breakeven means any shortfall produces a deficit
- Usually, the ability to generate a surplus comes from discretionary income
  - Most often this is contributed revenue
  - Sometimes this is very hard to find, and there are many competing demands for its use

Most human services funding is inflexible

Sources of revenue:	Applied to expenses:
Public payers	
• Contracts	100% to costs
• Fees for service	Small admin margin
Restricted funding	100% to costs
Unrestricted grants	Flexible
Unrestricted donations	Flexible

<u>P&L</u>

Revenue

Restricted >95%

Flexible < 5%

less

Expenses

Unrestricted Net Income

Surpluses critical to generate operating flexibility as well as longer term sustainability

Lack of flexible funding severely limits the ability to build capitalization

THE VIEW ACROSS THE SECTOR

Getting Beyond Breakeven: Capitalization of the Philadelphia arts sector

– 2008 study sponsored by the Pew Charitable Trusts and the William Penn Foundation findings:
  - Sector was undercapitalized
  - Systemic issues stand in the way:
    - Planning without context
    - Ineffective financial technical assistance
      - Leaders know, but feel powerless to change
    - Incentives not aligned – leadership, boards, funders
      - Breakeven as the goal
      - Surpluses are punished
      - Funder and organizational goals not always in sync

What we found: Philadelphia

- Over 75% had weak balance sheets and highly constrained capital structures.
  - Those in capital campaign were particularly weak.
- On average, in 2007 we found:

Elements Needed by All

Risk or Opportunity Capital	Operating and Working Capital	Operating Reserve
Not present	**Inadequate**	**Not present**

Needed by Some

Endowment	Facility & Equipment Reserve
Inadequate or inappropriate	**Not present**

Encore: Massachusetts study

- In 2011, TDC conducted an initial financial health scan of 240 organizations in Massachusetts using CDP data from 2008.
- We found:
  - Philadelphia is not unique; overall sector profile was similar in Massachusetts
    - Facility ownership and significant debt were associated with higher incidence of weak financial health
  - About 70% of organizations in Massachusetts exhibited weak financial health

Recent experiences across the country

- Over the past two years, TDC has visited 15 cities nationwide, sponsored by Grantmakers in the Arts, to share our research.
  - Local snapshots confirm the same picture
  - Only one city's profile broke the mold
- Last year, a foundation sponsored project in Arizona reinforced the pattern of pervasive weakness.

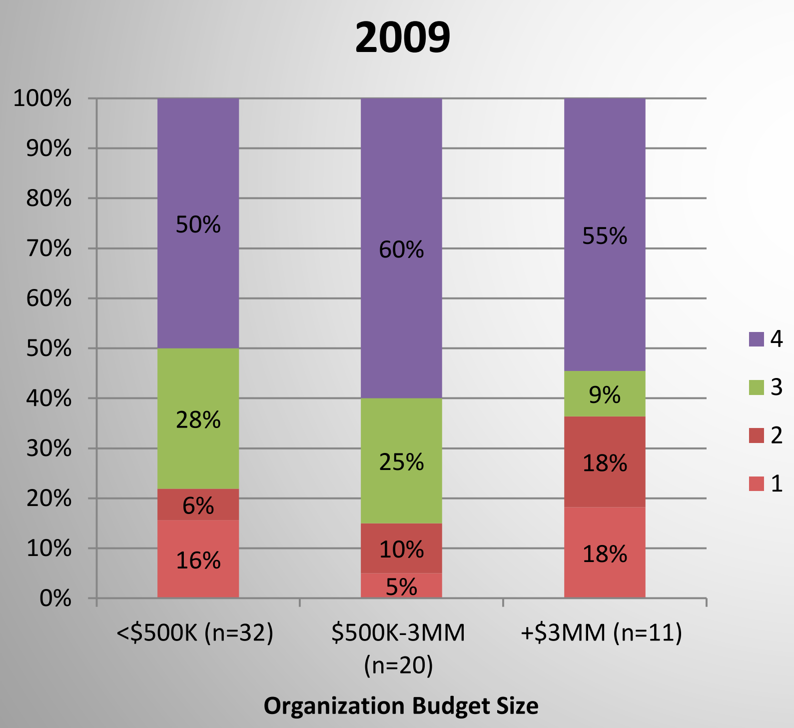
How does Detroit compare?

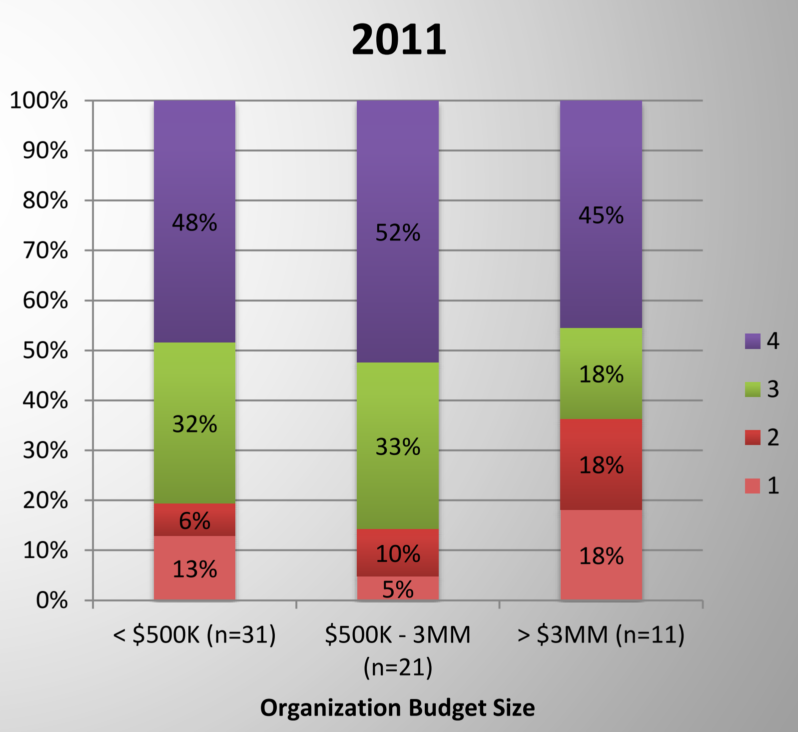
- In 2009 & 2011, over 75% had weak balance sheets and highly constrained capital structures
  - Those in capital campaign were particularly weak
- On average, we found:

Elements Needed by All			Needed by Some	
Risk or Opportunity Capital	Operating and Working Capital	Operating Reserve	Endowment	Facility & Equipment Reserve
Not present	**Inadequate**	**Not present**	**Inadequate or inappropriate**	**Not present**

Detroit snapshot by organization size

- There was some observable difference in financial health by size, with mid-range groups most challenged in both 2009 & 2011
  - Fewer in the weakest category 4 in 2011 – a hopeful indication

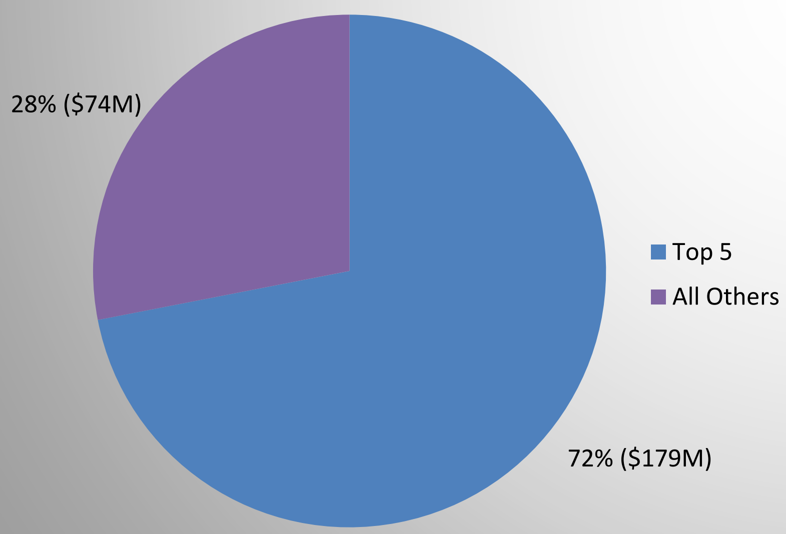




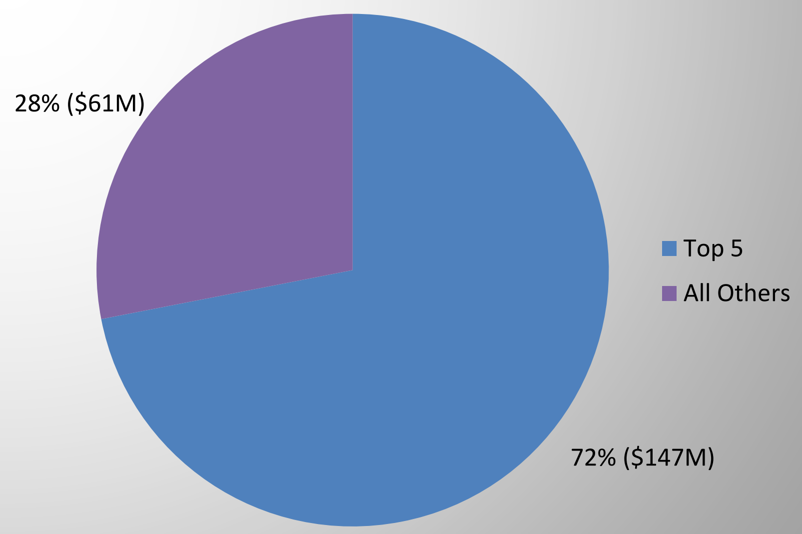
Dominance of largest organizations

- The five biggest organizations in this cohort account for 72% of the aggregated budget dollars, unchanged from 2009
  - Total dollars in the system shrank but proportions were static

2009 Share of Total Budgets of $253M In Detroit's 5 Biggest Organizations



2011 Share of Total Budgets of $208M In Detroit's 5 Biggest Organizations



McGregor Fund research project on Detroit human services ecosystem

- Six sample organizations, representing different sizes and services
  - Snapshot in 2012
- Details differ, but patterns are similar to arts and cultural organizations

Adequate capitalization for all is unrealistic

Just our sample of six would require over $30 million

Budget size	$839K	$2.7M	$3.8M	$8.4M	$13.8M	$24.7M
Average monthly expenses	$70K	$228K	$315K	$700K	$1.2M	$2M
Working capital *	$210K	$684K	$945K	$2.1M	$3.5M	$6.2M
Operating reserves *	$210K	$684K	$945K	$2.1M	$3.5M	$6.2M
Replacement reserves	Needed in addition					
Risk & innovation capital	Needed in addition					
Minimum basic capitalization	$420K	$1.4M	$1.9M	$4.2M	$6.9M	$12.3M

* Estimated at 3 months each

CREATING A CAPITALIZATION STRATEGY

A capitalization strategy considers:

- Mission and vision
- Business model drivers
- Time horizon and lifecycle
- Market and resources
- Your position today is the starting point
- These factors take different forms in different types of organizations, but the principles are the same

Mission and vision

Arts & culture

- Mission & vision centered on:
  - Artistic expression
  - Cultural transmission
  - Conservation of heritage, artifacts & art
- Audiences vary by focus on:
  - Discipline
  - Cultural context
  - Performance, education, preservation or all three

Human services

- Mission & vision centered on:
  - Whose needs will be targeted and how?
- Agendas vary by focus on:
  - Public needs: e.g. mental health
  - Public goods: e.g., youth services
  - Social supports: e.g., job training
  - Social change: e.g., community action

Business model drivers

Arts & culture

- Audience
- Facilities
- High fixed costs

Human services

- Government contracts
- Scale/impact
- Evaluation
- Facilities
- High fixed costs

High flexibility
Low capital intensity

Low flexibility
High capital intensity

Time horizon

	Arts & culture	Human services
Immediate	• Individual view • Personal artistic expression	• Intervention • Emergency response
Medium	• Organizational view • Established brand identity	• Systemic need • Solution is possible
Long Term	• Institutional view • Civic anchor or stewardship	• Perpetual need • Chronic circumstances

Where are you in the lifecycle?

Start-up | **Growth** | **Decline** | **Renewal**

- Organizations need more opportunity capital and reserves at moments of change.
- Organizations should use periods of stability to grow reserves.
  - This is not always possible given constraints of the marketplace.

The role of the marketplace

- A thorough understanding of the marketplace tests the mission and vision and predicts the resources available :
  - Definition of Audience or Service Population
  - Demand/Pricing
  - Support
  - Competition
- These questions can only be answered in the context of the **local** community and are particularly important during projected program or facility expansions

Resources

- Analyzing the marketplace also helps determine the cost of doing business:
  - Talent
  - Fixed costs
  - Marketing and development investments
- Organizations with facilities must also define long-term systems replacement needs and funding requirements

Integrated, holistic planning

Time Horizon, Business Model Drivers, Life Cycle

Mission and Vision
- Artistic/cultural production
- Theory of change for impact on audiences and other beneficiaries

Market
- Customers/Consumers
- Donors/Funders
- Competition

Resources
- Ongoing resources to sustain operations and fixed costs
- Human resources
- Key investments

Planning process is informed by the above data and analysis, and engages board, staff, partners, and supporters to have a shared and holistic understanding of the organization.

Integrated Strategy

- **Programmatic strategy** maximizes program quality and impact, scaled to demand and available resources
- **Organizational strategy** includes adequate human and other resources to manage program and support activities (e.g. marketing, development, finances, facilities)
- **Capitalization strategy** articulates size and shape of capital needs to support programmatic and organizational strategies

SIZING THE NEED

Assessing your risk profile

Operational Risk

- Program Risk
- External Risk
  - Audience
  - Funders
  - Shifts in the economy
- Human Capital
  - Loss of Leadership

RISK MANAGEMENT

Strategic Risk

- Programmatic Innovation
  - Pilots
  - New Opportunity
  - Change in Core Offerings
- Organizational Capacity
  - Marketing/Development
  - Facilities
  - Change in Scale or Size

RISK TAKING

How much do you need?

	Working Capital & Operating Reserve	Risk & Opportunity Capital	Facilities & Equipment Reserve	Endowment
Sizing	• Fixed costs • Predictability, timing of annual revenue receipts	• Anticipation of negative events (e.g. funding loss) • Innovation • Strategic investment needs	• Facility intensity • Useful life of assets	Dependence of mission on longevity and/or stewardship of collection or other perpetual asset
Funding	Adequate operating surplus, seed reserve grant, or debt	Surplus or episodic infusions of non-operating fundraising	Operating surplus, non-operating fundraising	Scale generally requires non-operating fundraising

You may need transition funds, too

	Recovery Capital	Change Capital
Sizing	• Size of accumulated deficit (negative liquidity)	• Viable plan to improve biz model • Amount required to achieve plan
Funding	• One-time support to restore balance sheet • Recipient needs viable plan to improve biz model	• Sizable infusions of non-operating fundraising • Debt (e.g. PRI) is also an option

Strategy aligns with your capitalization stage

Recovery

Broken Business Model	Negative URNA	Structural Deficits	Negative Cash

Transition

Weak Operating Model	Thin Balance Sheet	Breakeven or Deficit	<1 Month Cash

Strengthen

Working Operating Model	Thin Balance Sheet	Breakeven or Better	Undercapitalized

Deploy & Maintain

Stable Operating Model	Healthy Balance Sheet	Regular Surpluses	Well capitalized

Your capitalization stage dictates the types of capital funds you require today

Recovery	Transition	Strengthen	Deploy & Maintain
Recovery Capital	Change Capital	Working Capital	Working Capital
Change Capital	Working Capital	Operating Reserve	Operating Reserve
Working Capital	Endowment (if applicable)	Facilities Reserve (if applicable)	Facilities Reserve (if applicable)
		Endowment (if applicable)	Endowment (if applicable)
		Risk or Opportunity Capital	Risk or Opportunity Capital

BREAK TIME

WHAT IS STANDING IN OUR WAY?

Barriers to capitalization

Technical barriers

- Focus on symptoms
- Lack of integrated planning

Communication barriers

- Counterproductive norms
- Inability to have transparent conversations about needs and risk

Structural barriers

- Chaotic capital markets

Symptoms versus root causes

Inadequate Working Capital
- Borrowing from advance ticket sales
- Permanently drained lines of credit

Damage to quality programs

Inadequate Operating Reserve
- Inability to absorb a deficit

Inability to withstand shocks

Inadequate Risk & Opportunity Capital
- Passing up new program ideas
- Inadequate cash to handle expansion

No innovation

Inadequate Facilities & Equipment Reserve
- Roof has been leaking for past 18 months
- Collections are crumbling

Failure to steward assets

Inadequate Endowment
- Deficits covered by draws from endowment and reserves

Inability to deliver quality over time

Lack of integrated planning

Bad Planning	Good Planning
• Strategy and financial planning occur independently • Lacks strong understanding of market realities • Not supported by data	• Integrates program, organizational and capitalization strategies • Defines need for capital until sufficient revenue can be generated • Connects mission activities with the resources to support them • Considers the organization’s market and resources • Informed by data and analysis

Counterproductive norms

Funders

- **Losses:** breaking even = victory
- **Surpluses:** organization doesn't need my money
- **Reserves:** nonprofits can do without; they'll get by
- **Risk:** I am looking for positive impact, need to know it will work

Organizations

- **Losses:** breaking even = victory
- **Surpluses:** provide breathing room
- **Reserves:** funders won't provide them; I'll ask for money I can get
- **Risk:** I'll tell a positive story; funders don't want to hear about risks

Opaque conversations

Funders

- **Restricted project money:** protects impact
- **Organizations' new ideas:** I want to help, but I'm cautious
- **Foundations' new ideas:** grantees must fit my strategy
- **Partnership:** I should participate in strategy and management to steward my investment
- **Pricing:** I'll fund part of this work; someone else can do the rest

Organizations

- **Restricted project money:** is better than no money, but where will the overhead come from?
- **Organizations' new ideas:** funding is usually slow
- **Foundations' new ideas:** I can contort the work to fit the initiative
- **Partnership:** only significant commitments can buy real influence
- **Pricing:** I'll have to do it for less; I have no other funding options

Chaotic capital markets

Participants

- Capital markets include institutions, major donors, individuals, consumers, and government
- Foundations often shape markets
  - Others absorb counterproductive norms and ineffective practices
  - Organizations respond by chasing ideas, not impact

Dynamics

- In business, success is defined and measured by financial return
- In nonprofit world, success can be difficult to measure, leads to:
  - Inefficiency
  - Inadequate resources for promising opportunities

The status quo

- Organizations are typically “sustainably broke”
- Pressure to reinvest any available funds in the art, or
- The current services trap favors immediate provision of services over organizational sustainability
- There is a price to pay:
  - Vulnerable organizations cannot reliably address the needs of vulnerable populations or sustain a community’s interest for cultural expression
  - Innovation and long-term thinking are out of reach

The conversation can change

Arts funders and organizations have begun to address capitalization with a deepened understanding of each discipline and a clear focus on organizational profile

McGregor Fund has taken the lead in extending the discussion to human services. How can this effort be extended and deepened?

Discussion questions

- How these principles are applied depends on a community's funding environment, economy, and nonprofit ecosystem.
  - What are the distinctive characteristics that shape this community?
- What other questions about capitalization, generally, emerge for you?
- What are other implications?