Capitalization in Nonprofit Organizations: A Shared Challenge

Sponsored by the McGregor Fund
May 28-29, 2014
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)
What is capitalization?

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

### Elements Needed by All
- Risk or Opportunity Capital
- Operating and Working Capital
- Operating Reserve
- Design, test, and refine effective programs
- Deliver high quality and effective programs
- Maintain adequate supportive infrastructure
- Ensure appropriate longevity of programs

### Needed by Some
- Endowment
- Facilities Reserve & Debt
- Steward necessary fixed assets and collections

Prepared by TDC for the McGregor Fund
Capitalization comes from surpluses

P&L
Revenue
Expenses

Net Income

Balance Sheet
Cash/Investments
Receivables
Fixed Assets
Total Assets
Payables
Deferred Revenue
Debt

Net Assets
Total Liabilities
and Net Assets

Elements of Capitalization
Operating and Working Capital
Operating Reserve
Risk and Opportunity Capital
Facility & Equipment Reserve
Endowment

Prepared by TDC for the McGregor Fund
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:
- Public payers
  - Contracts
- Restricted funding
- Unrestricted grants
- Unrestricted donations

### Applied to expenses:
- 100% to costs
- Small admin margin
- 100% to costs
- Flexible
- Flexible

### P&L
- Revenue
  - Restricted >95%
  - Flexible < 5%
- Expenses

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

Lack of flexible funding severely limits the ability to build capitalization

Prepared by TDC for the McGregor Fund
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:

![Diagram showing elements needed by all and some]

- **Elements Needed by All**
  - Risk or Opportunity Capital: Not present
  - Operating and Working Capital: Inadequate
  - Operating Reserve: Not present

- **Needed by Some**
  - Endowment: Inadequate or Inappropriate
  - Facility & Equipment Reserve: 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:

<table>
<thead>
<tr>
<th>Elements Needed by All</th>
<th>Needed by Some</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk or Opportunity Capital</td>
<td>Endowment</td>
</tr>
<tr>
<td>Not present</td>
<td>Inadequate or inadequate</td>
</tr>
<tr>
<td>Operating and Working Capital</td>
<td>Facility &amp; Equipment Reserve</td>
</tr>
<tr>
<td>Inadequate</td>
<td>Not present</td>
</tr>
<tr>
<td>Operating Reserve</td>
<td></td>
</tr>
</tbody>
</table>
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

Prepared by TDC for the McGregor Fund
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

- **Top 5**: 72% ($179M)
- **All Others**: 28% ($74M)

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

- **Top 5**: 72% ($147M)
- **All Others**: 28% ($61M)
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

<table>
<thead>
<tr>
<th>Budget size</th>
<th>$839K</th>
<th>$2.7M</th>
<th>$3.8M</th>
<th>$8.4M</th>
<th>$13.8M</th>
<th>$24.7M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average monthly expenses</td>
<td>$70K</td>
<td>$228K</td>
<td>$315K</td>
<td>$700K</td>
<td>$1.2M</td>
<td>$2M</td>
</tr>
<tr>
<td>Working capital *</td>
<td>$210K</td>
<td>$684K</td>
<td>$945K</td>
<td>$2.1M</td>
<td>$3.5M</td>
<td>$6.2M</td>
</tr>
<tr>
<td>Operating reserves *</td>
<td>$210K</td>
<td>$684K</td>
<td>$945K</td>
<td>$2.1M</td>
<td>$3.5M</td>
<td>$6.2M</td>
</tr>
<tr>
<td>Replacement reserves</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk &amp; innovation capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum basic capitalization</td>
<td>$420K</td>
<td>$1.4M</td>
<td>$1.9M</td>
<td>$4.2M</td>
<td>$6.9M</td>
<td>$12.3M</td>
</tr>
</tbody>
</table>

* 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

Prepared by TDC for the McGregor Fund
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
- Immediate: Individual view, Personal artistic expression
- Medium: Organizational view, Established brand identity
- Long Term: Institutional view, Civic anchor or stewardship

Human services
- Immediate: Intervention, Emergency response
- Medium: Systemic need, Solution is possible
- Long Term: Perpetual need, Chronic circumstances
Where are you in the lifecycle?

- 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

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

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

**RISK MANAGEMENT**

**RISK TAKING**

Prepared by TDC for the McGregor Fund
How much do you need?

**Working Capital & Operating Reserve**
- Fixed costs
- Predictability, timing of annual revenue receipts
- Adequate operating surplus, seed reserve grant, or debt

**Risk & Opportunity Capital**
- Anticipation of negative events (e.g. funding loss)
- Innovation
- Strategic investment needs
- Surplus or episodic infusions of non-operating fundraising

**Facilities & Equipment Reserve**
- Facility intensity
- Useful life of assets
- Operating surplus, non-operating fundraising

**Endowment**
- Dependence of mission on longevity and/or stewardship of collection or other perpetual asset
- Scale generally requires non-operating fundraising

Prepared by TDC for the McGregor Fund
You may need transition funds, too

**Funding**

**Sizing**

**Recovery Capital**
- Size of accumulated deficit (negative liquidity)
- One-time support to restore balance sheet
- Recipient needs viable plan to improve biz model

**Change Capital**
- Viable plan to improve biz model
- Amount required to achieve plan
- Sizable infusions of non-operating fundraising
- Debt (e.g. PRI) is also an option

Prepared by TDC for the McGregor Fund
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.
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

Prepared by TDC for the McGregor Fund
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

Prepared by TDC for the McGregor Fund
Lack of integrated planning

**Bad Planning**
- Strategy and financial planning occur independently
- Lacks strong understanding of market realities
- Not supported by data

**Good Planning**
- 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

<table>
<thead>
<tr>
<th>Funders</th>
<th>Organizations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Losses:</strong> breaking even = victory</td>
<td><strong>Losses:</strong> breaking even = victory</td>
</tr>
<tr>
<td><strong>Surpluses:</strong> organization doesn’t need my money</td>
<td><strong>Surpluses:</strong> provide breathing room</td>
</tr>
<tr>
<td><strong>Reserves:</strong> nonprofits can do without; they’ll get by</td>
<td><strong>Reserves:</strong> funders won’t provide them; I’ll ask for money I can get</td>
</tr>
<tr>
<td><strong>Risk:</strong> I am looking for positive impact, need to know it will work</td>
<td><strong>Risk:</strong> I’ll tell a positive story; funders don’t want to hear about risks</td>
</tr>
</tbody>
</table>
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?