

Nonprofit Finance Fund Linking Mission and Money



AN INTRODUCTION TO NONPROFIT CAPITALIZATION

"Back in 1980, we were seven actors taking turns directing or acting in shows, with a small crew, no house, and multiple day jobs. Now, when we have parties after opening nights, there are still seven actors (different ones for each show), but there are 100 people at the party. We're outnumbered by the folks who run the box office, the financial staff, the support staff, the technical crew, the food service, the board, the education department, the development department, and the building maintenance staff. They're all great—but it's such a clear demonstration of how much more complex we are—how much more stuff we have now. And it's a challenge to be focused on our work, since it's now only a part of the business."

Founding Director, Repertory Theater

For every nonprofit organization, there is a tension between the pursuit of mission on the one hand, and the maintenance of financial viability on the other. This concern exerts pressure on the day-to-day operations and decision-making of every nonprofit, and quite often, it seems as though one must be chosen in favor of the other. We would like to propose, however, that they must be weighed together. In fact, an organization's mission and capital structure, as well as its organizational capacity must all be kept in balance, both as individual areas of concern and, on a larger scale, in relation to one another. The very health of the organization depends on it.

When nonprofits expand, the task of keeping each of these factors in balance becomes more difficult. Expanding programming affects the overall financial structure and organizational capacity, and the smart nonprofit will prepare strategies to compensate for this change. Moreover, when 'spontaneous' growth occurs, there is an unplanned financial impact, which is usually not positive. Growth in programming requires planned growth of overall resources, beyond those required for the programming alone, and an appropriate supporting capital structure.

Any plan to expand a nonprofit organization's activities needs a parallel capitalization strategy – a plan for how the organization's capital structure should be shaped to support a move from point A to B; what it will need to look like when it gets there; and how this differs from -- and represents a risk to -- its current structure (which may or may not be appropriate).

Without creating such a plan, and without taking the actions it prescribes, any expansion of programming will affect the organization in unpredictable, often adverse ways. It may hit cash flow or reserves, or force an organization to eat into endowment, or starve discretionary areas of activity such as development of new work, maintenance of buildings or staff benefits. The net impact of inadequate capitalization is systematic under-investment in the enterprise as a whole, which, over time, will weaken the organization and undermine achievement of the mission.

The significance of capital structure and the need for organizations to have an overt capitalization policy is most dramatically demonstrated in nonprofit organizations' approach to facilities projects. All other things being equal, certain kinds of nonprofits (arts and culture organizations are one) tend to "over-invest" in buildings. This heavily weights their asset structures towards fixed assets (plant and equipment), which not only consumes available cash while being built, but continues to draw on cash via higher fixed costs and the need to expand other parts of the operation. Not only is the absolute amount of cash diminished in a capital project, the percent of cash in comparison to other assets is diminished even farther, since fixed assets have grown. The result is an organization trying to do more with less.

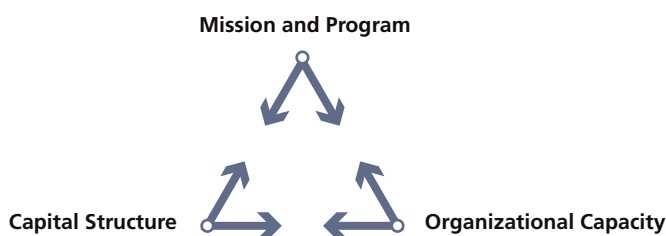
In case after case, when a new building is completed, the occupant has massive fixed assets, and a much-expanded balance sheet, but lacks cash. The building dominates the balance sheet as a percentage of total assets, dwarfing the proportion of assets available in cash. This cash is crucial for use as working capital—funds to provide for programming growth, marketing, increase in support services and the other expenses that can actually make the new venue succeed—and the imbalance is imprinted on the balance sheet. The capital structure of the organization now reflects a radical asset allocation decision: to convert cash, in the form of capital campaign proceeds, debt or a combination of both, into fixed assets in the form of a building.

And while the financial manifestation of this change on the balance sheet is important, the programmatic impacts are the real story. What are the consequences of this huge reallocation of assets? Here is one example.

In an NFF research interview, a dance company's development director put it this way: "How has this [capital] project changed us? Well, the executive director left and half the board resigned while it was going on...The only way we can possibly hope to meet the deadline set by one of our major donors to open our new building is if the artistic director does nothing but raise money full-time for the next eight months. That knocks out the first part of the season that he's supposed to direct. We realized this last week and we've already announced the season with his works."

THE "IRON TRIANGLE"

The net impact of planned growth and a "holistic" approach to capital structure is a sustainable balance between programs on the one hand and financial and organizational capacity on the other. One useful way of thinking about this is as an "iron triangle" – a fixed relationship between these three elements (programs, capital structure, and organizational capacity), with any change in one inevitably having an impact, planned or unplanned, on the others. This general approach suggests that managed growth requires that a balance be struck between the pace of program growth on the one hand, and the pace at which organizational and financial capacity can grow on the other. The risks inherent to growth need to be taken into full account.



One way to gauge the impact of changes in capital structure and asset reallocation on the "iron triangle" is to think about relative liquidity of assets and timing of liabilities, because the volume and timing of cash availability is a major determining factor in organizational efficiency, results and risk. It is axiomatic that overly high current liabilities create cash flow crises, poor operating results, program interruptions, and similar symptoms. It is less well understood that such symptoms can be a direct result of poor capital **structure**, encompassing factors such as poorly conceived endowments, overly large or expensive buildings and inappropriate debt.

For example, let's say a donor makes a \$1 million contribution to restricted endowment with the stipulation that the recipient raise a similar amount to match it, restricting the proceeds to new program development. The organization is pretty well capitalized, with revenue of \$1 million—60 percent of which is earned, mainly between October and March—and a cash reserve of \$200,000 which is used to fund pre-production costs of shows. It employs 12 people, 8 of whom work roughly full-time on program and production, and the other four raise money and run the support operation.

What has the increase of \$1 million in net assets done to the organization's capital structure? And if it's negative, who would turn away \$1 million, anyway? No one, but it is important to bear in mind that while an endowment is a powerful tool, like a capital project, it can create imbalance within the capital structure that puts pressure on the other two points of the "iron triangle:" mission and capacity.

Let's continue with the example. Matching the \$1 million endowment will create an immediate demand for fundraising efforts to raise the match—and the match will also be restricted. This requires a draw on unrestricted cash (to pay for increased fundraising capacity) while diminishing its availability, since fundraising will focus on restricted cash for endowment. The program restrictions will create other pressures. Artistic staff will be expected to develop new works and present them, which will require draws on the existing cash reserve (now used to front approximately \$600,000 in revenues from shows). If the calendar of shows is expanded, the cash reserve will need to be permanently expanded as well, requiring more fundraising and management capacity. Moreover, the new shows are more likely to be risky with respect to revenue, so the cash reserve will eventually need replenishment.

But won't the endowment create net revenue to defray some of these costs? The immediate revenue of about \$50,000 in interest income (an estimated five percent realized return) will allow the organization to expand by approximately one-half a person. This is arguably inadequate for the development of new programs, certainly inadequate to also take on the increased program and administrative toil that will accompany the creation and rollout of new works and definitely inadequate to fund the ongoing cost of increasing and maintaining reserves, beefing up fundraising, administration and similar. Even the eventual \$100,000 in "new money" from interest will be restricted to new works, requiring **more** unrestricted cash rather than filling the need for it.

The point here is not that endowments are a bad idea, or that the challenge grant described here is an opportunity to be avoided. The point is that an endowment is a change in capital structure. And any change in a point of the iron triangle—even the addition of thrillingly large amounts of capital in the form of endowment—requires adjustments in capacity, capital structure and program as well. The adverse effects can be avoided by careful planning and structuring of the award. This notion that money and investment create expenses is counterintuitive for most people.

Capital structure is a prime determinant of the capacity of an organization to take on program risk. This is because an inadequate or inappropriate one stanches an organization's primary hedge against risk: cash when it's needed. An asset and liability composition that creates a high level of fixed expenses (and therefore, demands on cash): mortgage payments, fixed operating expenses for buildings, or pledges of future activity--especially against a backdrop of a high proportion of restricted

cash—cuts down maneuvering room at best and at worst may give rise to a built-in or "structural" deficit. Thus, the relationship between the program, capacity and capital structure is critical to long-term sustainability and growth, since organizational capacity is, in essence, the program's connection to market and the income it implies.

The time for an organization – and the field itself – to think about organizational and financial capacity is, therefore, not after the fact -- when it is being weakened by the unforeseen consequences of ill-planned growth -- but as part of the process of strategic planning itself. This process includes analyzing the dynamics of the business (or businesses) of the organization as a whole to better understand what capitalization is optimal; and acknowledging and planning for the real costs of supporting operations during growth. The end result is having the right amount and mix of assets to support that growth and maximize the organization's full potential. This approach is what we have termed *comprehensive capitalization*.

MISSION AND PROGRAM

We speak of programs as those activities an organization undertakes directly in support of its mission. There is never a one-to-one relationship between mission and program. An organization's mission is usually compatible with a significantly larger range of programs than it has the resources to pursue, and choices have to be made about which subsets of programs are both synergetic with one another and represent together the best way to pursue the organization's mission. Determining this wisely and ensuring an informed consensus amongst board, staff and stakeholders that the programming mix is the right one is a central part of nonprofit leadership.

It is important to distinguish "program" from "business", for in pursuing compatible programs in support of mission, organizations choose diverse businesses to get there. For example, an organization may have as a mission "disseminating the work of female choreographers of the 20th century," but may pursue that mission through a variety of business strategies. The organization might operate a touring dance company, for example, that performs in venues all over the world; or create a repertory dance center where a variety of companies perform; or create a dance school dedicated to the choreographers' work, or even commission a series of films that are shown in a variety of venues. While each is an activity of a dance organization, the underlying "core" businesses of each are quite different from the others. Each requires a different capital structure.

More complex organizations often simultaneously operate more than one core business under the same roof—a school and a touring company, for example. And to complicate things, they may also have ancillary earned income ventures not directly connected to mission but helpful for other reasons. This complexity can make the job of seeing the big picture, and understanding capitalization needs, even more challenging.

For example, let us look at the large theater company with the mission of "presenting theatre as an art form and engaging artists and audiences in the reflection of the complexities of contemporary life." The company owns its own space and offers educational outreach programming and public amenities such as food service and retail on site, runs a venue management business, a theater production business, an off-site services business (its educational programs), a retail business, and possibly a bar and restaurant business (if these are not outsourced). Despite the fact that this is a very complex operation with diverse funding streams and lines of business, it is important to note above all that the organization has a core business that is the most directly related to the fulfillment of its mission -- the task of filling seats in its theater. If its core business fails, so too does it fail in achieving its mission.

The other businesses support the core mission in other less direct ways (for example, the retail operation and restaurant might be amenities for audiences or an important and significant source of earned income to support program). However, what is significant in considering capitalization needs is that the businesses differ substantially in terms of their costs, revenue sources, profit margins (or deficits), and annual investment required (be it in terms of capital or of cash). Most important, each varies substantially with respect to its relevance to mission and draw on organizational capacity. And naturally, each requires a different kind of capitalization.

ORGANIZATIONAL CAPACITY

Organizational capacity is the short-hand term used for the sum of the resources an organization has at its disposal and the way in which they are organized – development skills, marketing skills, financial management skills, program delivery mechanisms, staffing, etc. It also encompasses the capacity of the organization to plan, to implement and to evaluate, as well as the quality of governance (the extent to which a board executes its duties effectively, working to a clearly defined strategic plan and through an appropriate structure of sub-committees), the quality of budgetary and financial control, and the sophistication of human resources management. In essence, organizational capacity is the ability of an organization to operate its business.

The bigger and more complex the task, the greater the required organizational capacity and capital. Just as a person needs greater resources, planning and equipment to climb Mt. Everest than to walk

around the block, a nonprofit needs greater organizational capacity the more ambitious its programs. If an organization chooses to undertake a major capital campaign, mount a season of plays and run an educational program simultaneously, all in pursuit of its mission, it will be nearly impossible to attempt it with three actors and a budget of \$300,000, because each implies additional organizational capacity. By taking it on, the three actors—who should arguably devote themselves as much as possible to program—will probably damage their program and damage themselves in the process.

Similarly, changes in capital structure drive changes in organizations. Small and young organizations may become larger overnight, with increased levels of organizational complexity, fixed assets and implied longevity (often called "institutionalization"). This in turn has a profound impact on the long-term effectiveness and flexibility of the program itself. For example, once a major facility project is completed, an organization's "business" activities become irrevocably accelerated: permanent staff need to be added, maintenance of the space needs to be stepped up, ongoing costs are assumed, and organizational capacity increased to accommodate this larger need. On the other hand, if an organization chooses to grow with cash, as opposed to fixed assets, it takes on a different business in pursuit of mission, and a different set of capitalization challenges.

CAPITAL STRUCTURE

Capital structure is the pattern of distribution of an organization's financial assets and liabilities. We have suggested that an organization's effectiveness in pursuing its program is critically dependent on both its organizational capacity and its capital structure. While a great deal of attention has been given to the relationship between organizational capacity, program and mission, rather less systematic thought is generally given to the impact of financial capacity – the overall capital structure, or the third point in our triangle. This negligence of capital structure is widespread and can exert a greater drag on organizational effectiveness than any of the other points in the triangle.

The reasons for this neglect of capital structure and of building the financial capacity requisite for an organization's plans run deep. There is a belief in the nonprofit sector that energy, will power, stamina and enthusiasm can overcome all obstacles, and that where it does not, this is rooted in some sort of personal failing. The idea that an inappropriate capital structure can somehow subvert an organization's ability to meet its objectives can seem overly deterministic, fatalistic even. The temptation in the face of adversity is to say to oneself, "*We must work harder,*" rather than to look at the balance sheet – where money is or is not allocated – for systemic reasons for failure.

However, what works for small organizations rarely works for larger, more complicated institutions, and vice versa. In other words, "sweat equity" and an organizational culture (and capacity) driven mainly by stamina or enthusiasm does not scale well. A major international opera company doesn't

use amateur singers or a volunteer orchestra; and a small group of recent graduates who want to sing and perform experimental works does best with the least possible "infrastructure" (i.e., baggage) in the form of building, sets, costumes, orchestra, etc. Neither is better, but each implies differing capital structures and capacity requirements, and each has a differing array of artistic choices.

Along the way, organizations make implicit decisions about capital structure – because any program growth or asset acquisition decision necessarily does so – without understanding explicitly the effects of this decision. There is, alas, no healthy "natural equilibrium" in nonprofit organizations' capital structures. Left to its own devices, the balance sheet of an organization will not necessarily settle down in a form that best supports mission and enhances organizational capacity. All other things being equal, it will tend to do the opposite. Growth, in and of itself, tends to exacerbate rather than alleviate these problems. Organizations, therefore, need to analyze their current capital structure, assess the appropriateness of the structure and then develop an explicit strategy for moving from one point to another.

The elements of an organization's capital structure are divided into assets and liabilities. Our discussion of capital structure will focus primarily on assets and the way they are allocated.

Major assets are:

- cash
- investments
- buildings and equipment
- receivables, inventory, and prepaid expenses

Cash and investments may carry a range of use restrictions imposed by the source (donors, government, or in some cases, internally by the board or management of the organization itself). Most organizations have some cash that is unrestricted and used for ongoing operations. Sometimes this is referred to as working capital. Other cash is categorized as reserves (cash set aside for specific purposes such as building repairs) and restricted funds (cash which is meant for a specific purpose as stipulated by the donor). Investments can similarly be unrestricted or restricted. The most restrictive is endowment – funds whose corpus cannot be used, and where the use of interest earned is generally limited to a program purpose.

Receivables reflect the business cycle and are financed by cash. The most typical receivables in arts and culture organizations are capital campaign or other fundraising pledges. Other possibilities include credit card receivables for merchandise or subscriptions, and billings for services such as educational programs or classes. Inventory is similar, in that cash must be laid out with the expectation that revenue will come in as a result of sales. For both inventory and receivables, there is collection or sales risk.

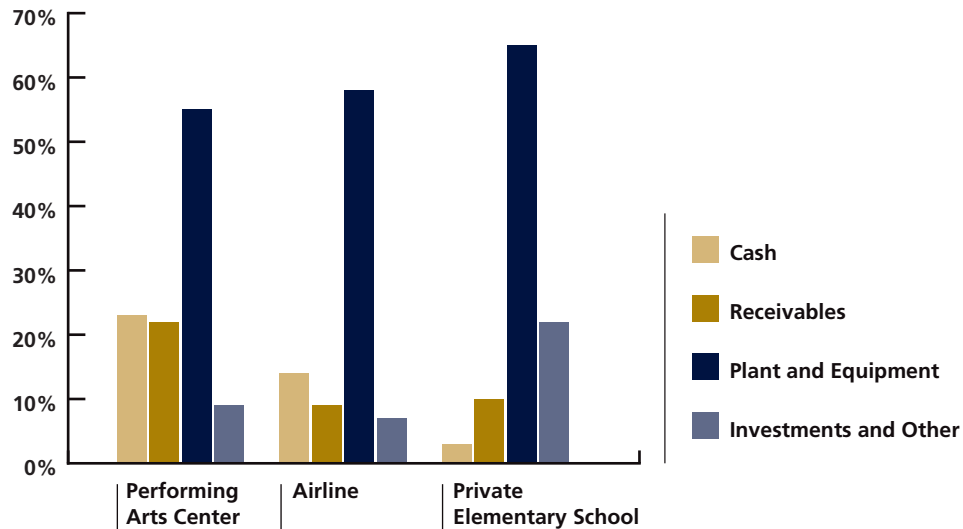
Liabilities are the other side of the balance sheet equation. Liabilities include various accounts payable, short-term debt, long-term debt, etc. They also include advance ticket sales or subscriptions prior to productions. In many cases, liabilities represent the source of cash for financing assets: the mortgage on the building; a line of credit to finance inventory; or a cash flow loan against a school district contract. They are broken down into current liabilities (those requiring payment within one year) and non-current liabilities (those requiring payment beyond one year). Liabilities are organized on the balance sheet by increasing maturity, much as assets are listed in order of decreasing liquidity. Matching the relative liquidity and longevity of assets and liabilities is important to keeping the capital structure in balance.

The difference between assets and liabilities is the organization's net worth or net assets. The nature of the assets and liabilities dictates the varying degrees of flexibility in net assets, and donor restrictions are only part of the story. The lion's share of the "unrestricted net assets" of most performing arts organizations, for example, consists of plant and equipment (hardly a source of ready cash!) Where cash net assets are restricted by the donor for, for example, endowment, liquidity is also restricted. It bears noting, however, that it is the liquidity of an organization's net assets that has the greatest relevance to its cash flow, not simply whether or not there is a positive balance in net assets.

DEVELOPING A STRATEGY FOR COMPREHENSIVE CAPITALIZATION

How, then, does one go about developing a more comprehensive and systematic approach to the asset structure of an organization?

The *first* step in developing this strategy is to look at the underlying financial character and logic of the business(es) that you are in – your core business. What is relevant here is not that an organization is a hospital or an art gallery, *per se*, but that the out-patient services business differs from that of a mobile medical unit; building a collection is a different business from hosting only traveling temporary exhibitions. Structurally, a performing arts center has more in common with, say, a school, in terms of its capital structure and balance sheet than it does with performing arts companies that don't own a performance space, and its bar business more in common with the local pub, its outreach initiatives perhaps more in common with the mobile medical unit. The underlying nature of an organization's business can best be grasped by looking at its balance sheet, and the balance sheets of a performing arts center, a school and an airline have much in common. Even though they have widely divergent missions, they have in common the business of filling seats.



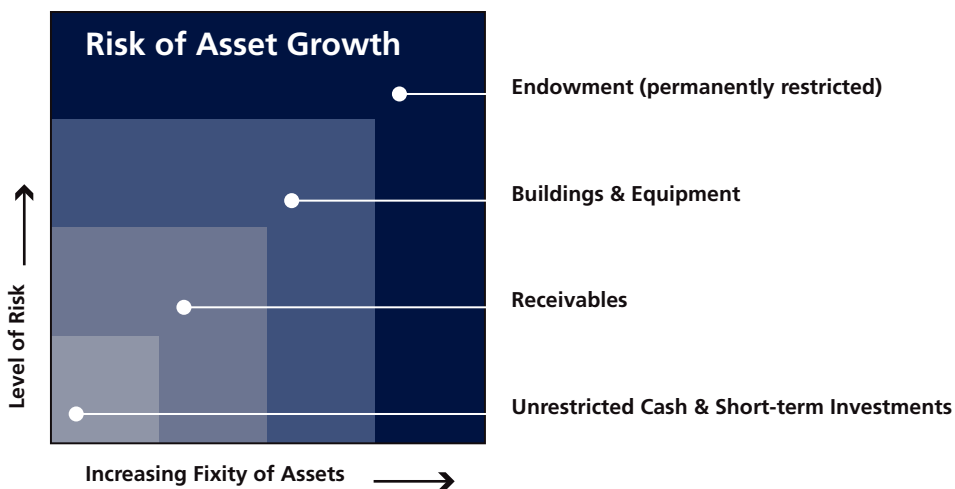
Accordingly, organizations in the same subsector often have highly diverse capital needs. An organization's core business is not the same as the particular sub-sector (arts, education, human services, etc.) to which it may belong. Simply identifying this important dimension of your work in a new way, and observing how other organizations or businesses that would seem to be wholly removed from your world— a school, walk-in clinic, church, or hotel – but are similar in their capital structures is instructive.

The *second* step is to make capital structure an explicit object of board and management attention, rather than it being merely the aggregate *de facto* result of other, unrelated decisions. There are explicit questions to be answered: What is your organization's capital structure? What priorities are implied by your existing capital structure? Is this an appropriate structure for your purpose and plans? What is your organization's policy for the development of an appropriate structure? How do you develop a shared understanding of the meaning of the organization's assets and liabilities? How will a growth plan affect capital structure? How will it go out of balance, or improve as a result of growth?

Third, the fact needs to be embraced that asset growth (or reallocation) of whatever kind equals risk—risk of imbalancing the capital structure and the organization itself in the process. A large, "no-strings attached" infusion of cash into an organization would seem risk free – and it is, indeed, the least risky of assets because it is the most liquid and flexible. But once new cash is converted into other goods – into funds for additional programs, or additional staff positions, or vehicles, buildings, or whatever – an explicit asset allocation decision has been made, opportunity costs have been

assumed, and there are implications for the ongoing costs of servicing this growth that need to be considered.

Growth in restricted grants presents greater risk than that in unrestricted grants because they are liquid and more likely to make demands on capacity. As noted above, additional expenses are created through restricted grants and the restricted funds themselves rarely cover them (a classic example being restricted grants for new programs, which rarely include provision for the additional staffing and operational costs that would help ensure effective delivery). These assets therefore bring greater organizational risk because of the necessary structural changes they bring to the balance sheet. *The less liquid the additional assets, the greater the inherent risk involved because of their impact on the balance sheet and the ongoing expenses required to service them.* This relationship – a fundamental one that is frequently not understood or ignored – can be represented by the following graph:



Fourth, with these principles in mind, one should work systematically through the balance sheet and address the organization’s requirements under each asset category and in relation to the relevant businesses (as opposed to programs). *An understanding of the dynamics of each business and the specific market or markets that will pay for or subsidize the real costs of the business are required in order to analyze and construct a model balance sheet for an organization.* We have discussed cash/working capital. Cash reserves set aside for specific purposes are often important in smoothing out the gaps in operating cash flow, for investment in new productions or equipment, or for meeting the unpredictable outcomes of risk taking in certain specific areas. Short and long-term debt – and access to lines of credit— should also be seen in this context.

Capital invested in equipment and buildings presents another set of issues. Buildings often represent the most significant capital investment undertaken by nonprofit organizations. They represent an asset allocation decision with profound long-term implications for operations and capacity, and they are, in addition, a highly illiquid investment. All other things being equal, a balance sheet heavy in fixed assets is necessarily a higher risk balance sheet.

An endowment – cash that is restricted and only the interest of which is available for use (and use that is often restricted) – is not a "silver bullet" or *deus ex machina*. It is simply another component of the capital structure and, therefore, best understood in the context of other components. An organization's endowment requirements – and the fundraising case for them – can only be understood by analyzing the other elements of the actual and desired capital structure and then by establishing how best to close the gap between the two. Contributed income and earned income have more significant parts to play in the ongoing business dynamics of an organization than endowment—they generally make up a considerably greater percentage of the resources used for annual operations, and they are more dynamic in their responsiveness to strategic decisions the organization makes.

Endowment ties up large blocks of funding that, all other things being equal, the organization might put to use in other ways as it grows and develops. While endowment can support sustainability where mission driven programming yields no "natural equilibrium", the opportunity costs are high. While the security of an endowment may be appealing and provide a financial cushion, it can also enable organizations to become disconnected from market realities. One example is a symphony orchestra that uses its substantial endowment to cover up cash shortfalls year after year, and – to the detriment of its long-term health – ignore a steady downward trend in membership and earned revenue.

CAPITALIZATION AND THE FUNDING SYSTEM

As we have stated, capital structure is critical to the health and effectiveness of nonprofit organizations. Unfortunately, the sector's primary source of funding for growth – contributions from funders – traditionally ignores the big picture, most explicitly the importance of capitalization.

In confining their criteria for eligible funding to the marginal costs of programs that are relevant to the pursuit of their own missions, funders may unintentionally contribute to the systemic undercapitalization of the sector – controlling rather than developing the sector and incentivizing the growth of programs without providing for the commensurate growth in capacity. Growth, as we have suggested, is inherently destabilizing, particularly when only its marginal costs are supported. Financial and organizational capacity is stretched thinner and there is systemic under-investment in physical and organizational infrastructure.

There is, however, a growing realization amongst more enlightened funders that funding program costs without meeting the associated (and necessary) additional organizational costs is as short-sighted for *their* mission as is the operating nonprofit's pursuing mission-related programming without regard to long-term resource implications. It is for this reason that some have increasingly shown willingness to fund reserves and working capital funds as well as endowments and buildings. Further progress in this area, however, is critically dependent both upon the broader foundation community's recognizing the necessity of investing in the real costs of growth and, in turn, upon nonprofit organizations themselves being able to articulate the case for a more comprehensive approach to capitalization and its importance in their own context. Our work on comprehensive capitalization is designed to help organizations in that process, to educate funders about the real impact of their grantmaking practices, and to inform the nonprofit community. In this way, we hope ultimately to bolster the effectiveness and long-term health of nonprofit organizations as they make key contributions to the cultural, economic and civic health of their communities.

The next work in *The Business of the Arts* series will propose some specific models of optimal capitalization for different nonprofit businesses. It will also provide some tools to view your organization's capital structure, how to keep it in equilibrium, and maintain this equilibrium as you grow.