



Capitalization & Strategy

AGM Southeastern Massachusetts
Local Engagement Group
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Overview

- Introduction to TDC's capitalization research
- Concepts of capitalization strategy & planning
 - Why it matters
 - How to develop a capitalization strategy
- How to respond?
- Questions and discussion

CAPITALIZATION RESEARCH

Seminal study: Philadelphia

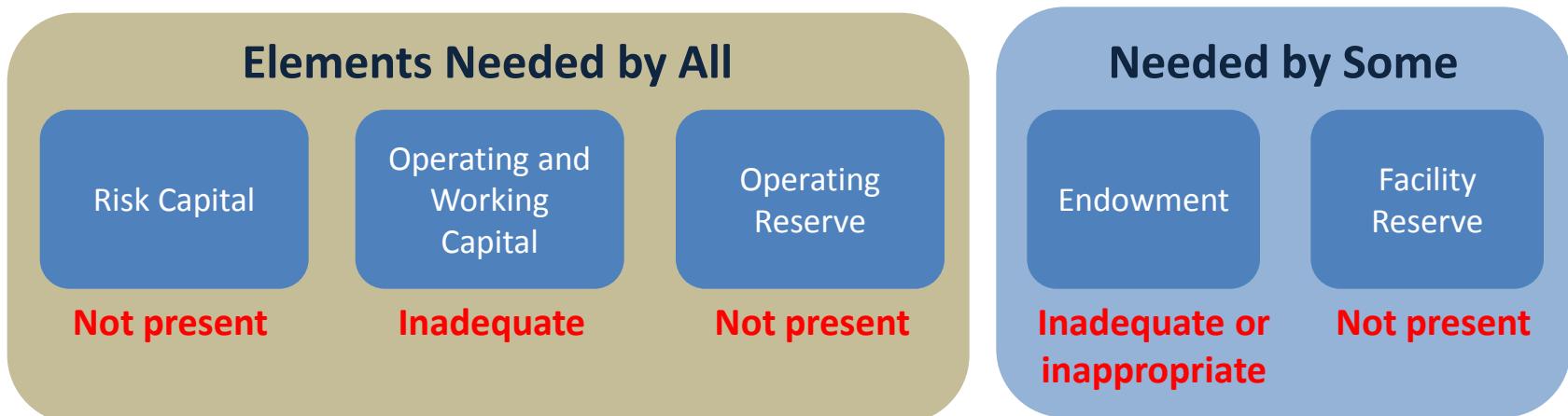
- Commissioned by the Pew Charitable Trusts and William Penn Foundation in 2008/2009
- Assessed PACDP data of 150 organizations and interviewed a subset of 60 leaders
 - Are organizations capitalized to achieve their missions?
 - Do leaders understand the relationship between capital structure and mission? Is that evident in their actions?
 - How can the system help to improve the financial health and capitalization of cultural organizations?

Findings confirmed in other areas

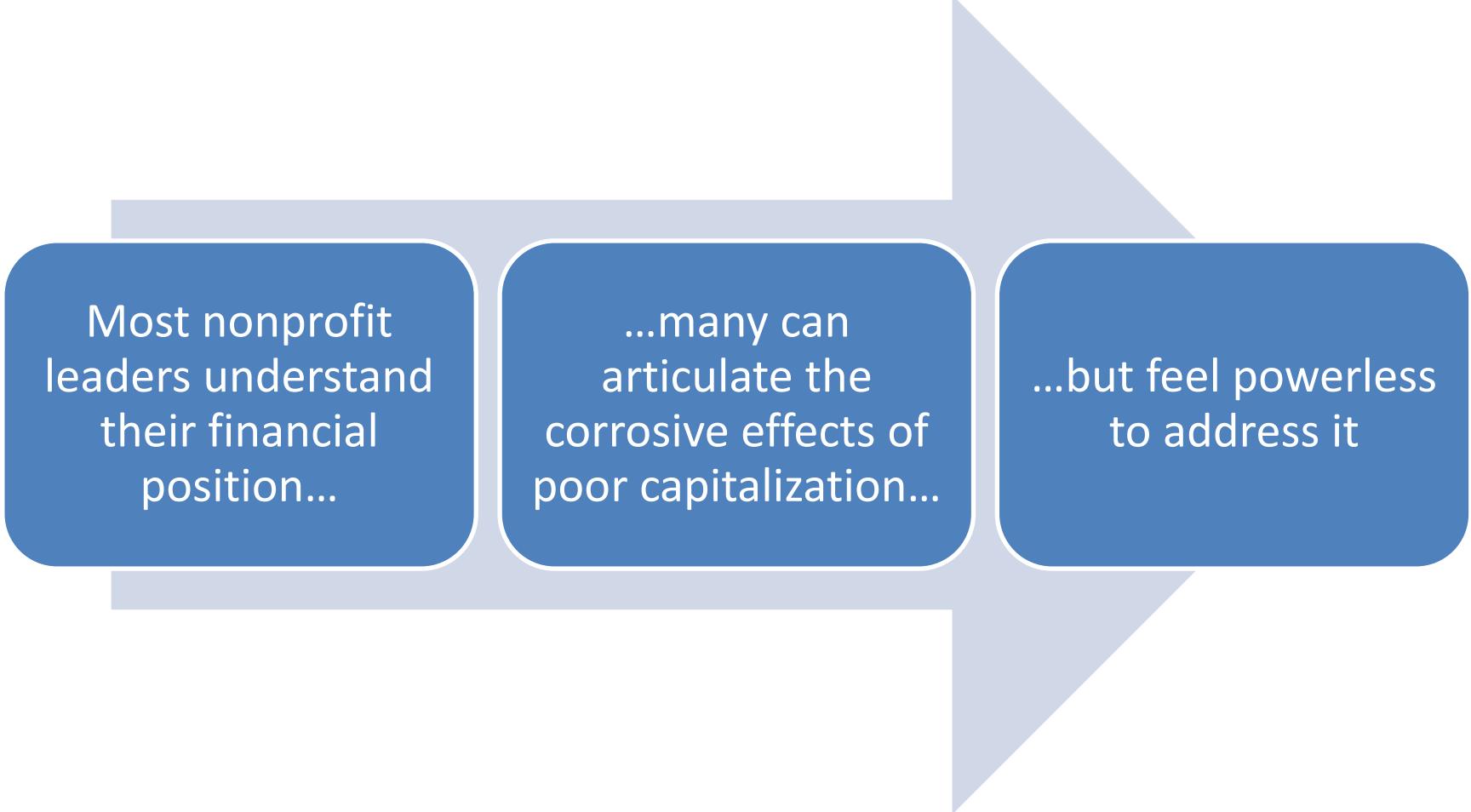
- Massachusetts Cultural Data Project funders' consortium
- Kresge & Erb Foundations – Detroit arts ecosystem
- McGregor Fund – Detroit human services sector
- Barr & Klarman Family Foundations – midsize arts & youth arts organizations
- Flinn Foundation & Virginia Piper Trust – Arizona arts & culture organizations

Research shows a sector in distress

- From our research in several cities, we have found that the large majority of organizations have highly constrained capital structures
- Factors often correlated with weakness include:
 - Capital Campaigns
 - Facilities/Debt
- Typically, we find:



It's not about knowledge!



Most nonprofit leaders understand their financial position...

...many can articulate the corrosive effects of poor capitalization...

...but feel powerless to address it

Where's the disconnect?

Planning

- is internally focused and lacks market context

Financial assistance

- is not fully integrated into strategy

Funders and supporters

- create incentives that undermine larger goals of solid capitalization

Planning is not contextualized

Benchmarking

- is substituted for market testing, without audience feedback or competitive analysis

Lack of external validation

- leads to unrealistic demand projections, poor decision-making and lack of effective contingency planning

Financial assistance is not integrated

Financial analysis

- is not tied to a larger strategy for response

Recipients are frustrated

- “So I have a bad balance sheet. I know that. What do I do about it?”

Incentives are not aligned

Funders and supporters

- focus on breakeven annual budgets or success of isolated projects

Organizations do not want to appear weak

- and worry they will be seen as “unfundable” if they are honest about undercapitalization

Reserves and endowment are under-emphasized

- and often deleted from capital campaign goals because they can make projects look impossible

How do we change this?

Understand current capitalization

Determine long term capitalization needs based on market-tested strategy

Communicate differently with board, funders and stakeholders

CONCEPTS OF CAPITALIZATION STRATEGY & PLANNING

Capitalization – it's all about risk

Can you invest in
the programs?

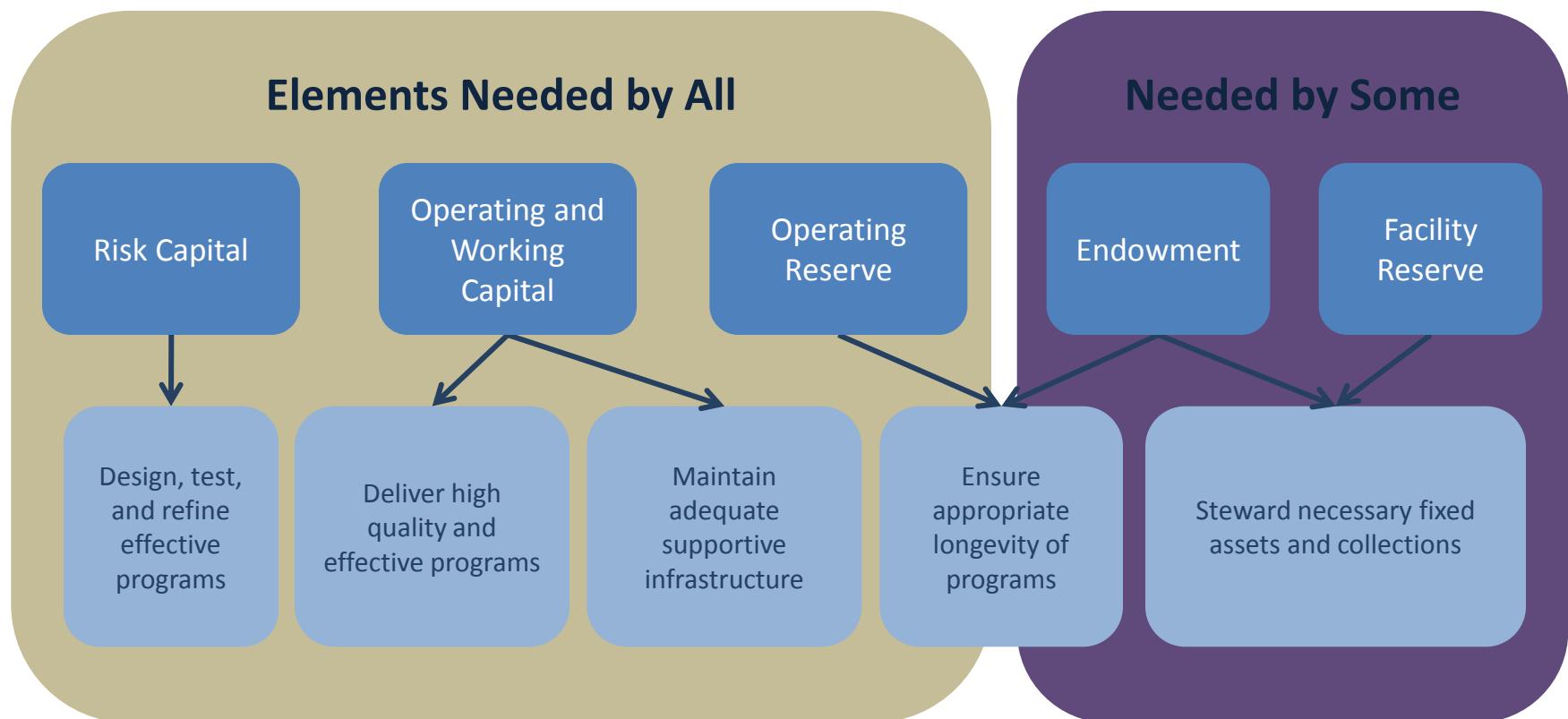
Can you invest in
audience?

Can you respond
to external
forces?

What are the
long term effects
if you can't?

What is capitalization?

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



Transitional capital funds

Recovery Capital

- Pays off past debt
- Provides interim working capital
- Moves URNA out of the red
- “Can’t function until you clean it up” capital
- Funded by people who love you

Change Capital

- Required to test a new business model
- Required to execute new business model
- Funded by people who love you

Assessing capitalization

- Availability of **operating cash**
- Evidence of **borrowing from restricted funds** or future earned revenue
- Flexibility as measured by **unrestricted net assets** for working capital and reserves
- Adequate **liquidity**
- Impact of **facility ownership**
- Impact of **debt**

Determine capitalization based on market-tested strategy

- There are no cookie cutter answers!
- The organization's overarching strategy must integrate its:
 - Mission and vision
 - Business model drivers
 - Time horizon and lifecycle
 - Marketplace

Mission and vision

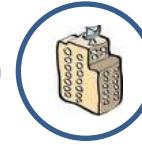
- Organizations must have a clearly articulated mission and vision.
- They should also have a well-defined approach and methodology to fulfilling the mission.
- Board and staff must agree upon the mission and approach.
- Once defined, the mission and vision must be considered through the following lenses.

What are your business model drivers?

Audience



Audience + facility



Audience + high fixed costs



Audience + facility + high fixed costs



High flexibility
Low capital intensity

Low flexibility
High capital intensity



What is your time horizon?

Immediate (Individual View)



Highly specific artistic expression – often focused on a particular artist



Rented or borrowed facilities



Highly flexible with limited fixed costs

Medium Term (Organizational View)



Artistic expression fulfills established brand identity



Facility ownership may or may not be supportable



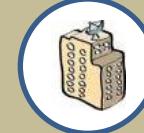
Fixed costs must be tightly controlled

- Higher risk tolerance may be appropriate
- Requires coverage of basic needs – working capital, risk capital, and operating reserves.

Long Term (Institutional View)



Obligation to persist as civic anchor or long-term stewardship of collection or an art form.



Facility ownership often necessary



Fixed costs extensive and multi-faceted

- Level of obligations calls for low risk tolerance
- Requires larger scale of basics and, often, plant reserves and endowment to meet all obligations.

Are you at an inflection point?

Start-up

Growth

Decline

Renewal

- Organizations need more risk capital and reserves at moments of change.
- Organizations can use periods of stability to grow reserves.

Importance of the marketplace

- A thorough understanding of the marketplace tests the mission and vision and predicts the resources available:
 - Definition of Audience
 - 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
- Donors
- 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.

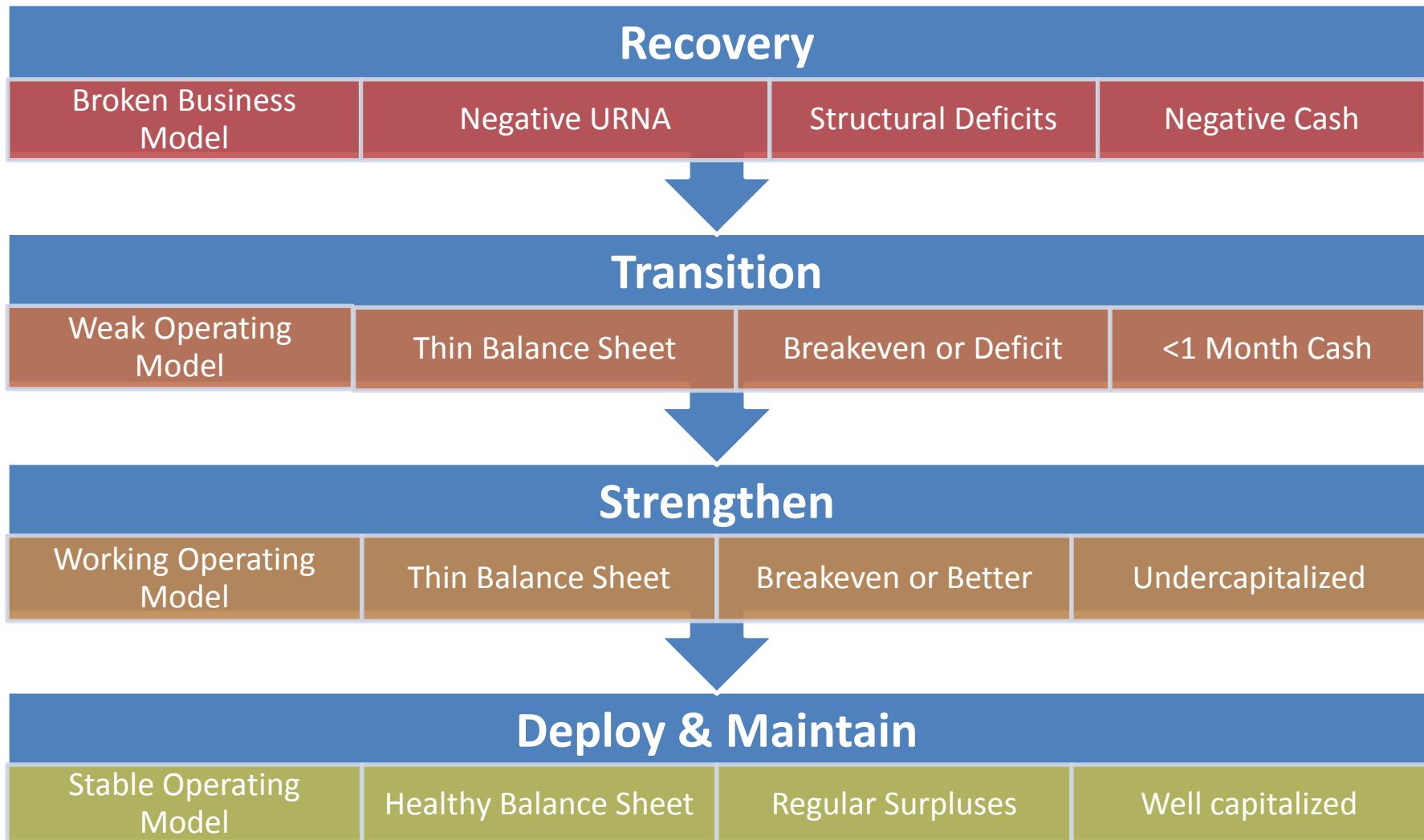
Integrated Strategy

- **Programmatic strategy** maximizes artistic 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

Determine capitalization based on market-tested strategy

- The organization's capitalization strategy
 - includes the types of funds required
 - articulates the necessary size of the funds
 - identifies the timing of the need
 - dictates the method for obtaining the required resources

Strategy aligns with organization's capitalization stage...



... and the capitalization stage dictates the types of capital funds required

Recovery

Recovery Capital

Change Capital

Working Capital

Transition

Change Capital

Working Capital

Endowment
(if applicable)

Strengthen

Working Capital

Operating Reserve

Facilities Reserve
(if applicable)

Endowment
(if applicable)

Risk or Opportunity
Capital

Deploy & Maintain

Working Capital

Operating Reserve

Facilities Reserve
(if applicable)

Endowment
(if applicable)

Risk or Opportunity
Capital

Risk in the context of capitalization

Operational Risk

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



RISK MANAGEMENT

Strategic Risk

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



RISK TAKING

Risk in the context of capitalization

Risk management is about...

- the liquidity and flexibility of the balance sheet, and the role of reserves in achieving the organization's mission.

Risk taking is about...

- change through thoughtful planning, research and development, and making investments.

Risk in the context of capitalization

Risk aversion is about...

- living in the recovery stage, paralyzed and unable to think about change...stalled or diminishing vision
- living in the transition stage, on the cusp, hoping but now knowing if the market is there for you...stalled vision
- living in the strengthening stage, overly cautious because of the communal memory of scarcity...stalled vision

HOW TO RESPOND?

Improve skills on both sides

Expect integrated planning

- Look for links between business model, market context, and strategy
- Focus on results, not expenses
- Understand the role of patient recovery and change capital in implementation
- But do not fund change without an integrated viable plan

Improve skills on both sides

Encourage capitalization planning

- Review balance sheets to assess current capitalization
- Ask grantees about their capitalization strategies

Assess holistically, target strategically

- Remember that revenue is essential
- Capitalize organizations rationally (liquidity first!)
- Acknowledge that change requires flexible, multi-year capital

Change the conversation

Redefine norms

- Reward surpluses
- Promote reserves
- Recognize risk and accept failure

Encourage honest dialogue

- Assess and clearly communicate respective goals, preferred investment strategies, and appetite for risk
- Model and provide incentives for honest conversations between yourself and grantees

Lead by example

Understand your role in the market

- Recognize that as market-makers, your behaviors, assumptions, and strategies have far-reaching impact
- Leverage your leadership role to encourage evolution of funding practices amongst funders of all types

Collaborate to transform culture

- Work to establish shared principles in your community, regardless of programmatic goals
- Share your experiences with your peers nationally

QUESTIONS & DISCUSSION