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:

Elements Needed by All

- Risk Capital
  - Not present
- Operating and Working Capital
  - Inadequate
- Operating Reserve
  - Not present

Needed by Some

- Endowment
  - Inadequate or inappropriate
- Facility Reserve
  - Not present
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?

<table>
<thead>
<tr>
<th>Planning</th>
<th>• is internally focused and lacks market context</th>
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<tbody>
<tr>
<td>Financial assistance</td>
<td>• is not fully integrated into strategy</td>
</tr>
<tr>
<td>Funders and supporters</td>
<td>• create incentives that undermine larger goals of solid capitalization</td>
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</tbody>
</table>
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.

Elements Needed by All

- Risk Capital
  - Design, test, and refine effective programs
- Operating and Working Capital
  - Deliver high quality and effective programs
- Operating Reserve
  - Maintain adequate supportive infrastructure

Needed by Some

- Endowment
  - Ensure appropriate longevity of programs
- Facility Reserve
  - Steward necessary fixed assets and collections
## Transitional capital funds

<table>
<thead>
<tr>
<th>Recovery Capital</th>
<th>Change Capital</th>
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<tbody>
<tr>
<td>• Pays off past debt</td>
<td>• Required to test a new business model</td>
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<tr>
<td>• Provides interim working capital</td>
<td>• Required to execute new business model</td>
</tr>
<tr>
<td>• Moves URNA out of the red</td>
<td>• Funded by people who love you</td>
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<tr>
<td>• “Can’t function until you clean it up” capital</td>
<td></td>
</tr>
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<td>• Funded by people who love you</td>
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</table>
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

PREPARED BY TDC
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

**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

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

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

PREPARED BY TDC
Are you at an inflection point?

- 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

- **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...

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<tr>
<th>Recovery</th>
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<tr>
<td>Broken Business Model</td>
<td>Negative URNA</td>
<td>Structural Deficits</td>
<td>Negative Cash</td>
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<th>Transition</th>
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<tbody>
<tr>
<td>Weak Operating Model</td>
<td>Thin Balance Sheet</td>
<td>Breakeven or Deficit</td>
<td>&lt;1 Month Cash</td>
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<th>Strengthen</th>
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<tbody>
<tr>
<td>Working Operating Model</td>
<td>Thin Balance Sheet</td>
<td>Breakeven or Better</td>
<td>Undercapitalized</td>
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<th>Deploy &amp; Maintain</th>
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<tr>
<td>Stable Operating Model</td>
<td>Healthy Balance Sheet</td>
<td>Regular Surpluses</td>
<td>Well capitalized</td>
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... and the capitalization stage dictates the types of capital funds required
Risk in the context of capitalization

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

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

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RISK MANAGEMENT

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