



## **Funding the Extraordinary:**

An Evaluation of The Kresge Foundation Arts and Culture Program's  
Institutional Capitalization Grantmaking

**Conducted by Nonprofit Finance Fund®**

Evaluation conducted September 2013 - December 2014  
Report published October 2015

### **Acknowledgements**

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NFF® would also like to thank Alice Carle of The Kresge Foundation and Rebecca Thomas of  
Rebecca Thomas and Associates for their thoughtful guidance and partnership in the creation of this report

## Contents

|                                                                                |    |
|--------------------------------------------------------------------------------|----|
| Institutional Capitalization Grantmaking at Kresge                             | 1  |
| Capitalization Overview: Philosophy & Principles Applied in the Kresge Program | 2  |
| NFF Evaluation Framework                                                       | 4  |
| Summary of Observations: Facility Investment & Building Reserve Grantees       | 5  |
| Summary of Observations: Sector Leaders Grantees                               | 16 |
| Recommendations for Capital Grantmakers                                        | 20 |
| Recommendations for Nonprofits                                                 | 22 |
| <br>                                                                           |    |
| Appendix A:<br>Kresge Grant Application Requirements and Review Process        | i  |
| <br>                                                                           |    |
| Appendix B:<br>NFF Methodology: Individual Grantee Analysis                    | ii |
| <br>                                                                           |    |
| Appendix C:<br>Unrestricted Net Assets (URNA) Tool and Net Asset Tracking Tool | iv |
| <br>                                                                           |    |
| Appendix D:<br>Grantee Cohorts                                                 | v  |

## Institutional Capitalization Grantmaking at Kresge

In 2010, The Kresge Foundation introduced the Institutional Capitalization Program as part of its Arts and Culture grantmaking. The goal of the program was to promote the widespread application of sound capitalization and facility management principles to strengthen organizations and advance capitalization practices in the arts and culture sector as a whole. Kresge posited that well-capitalized arts and cultural organizations are in a better position to execute their missions and provide effective and relevant programming that contributes to the vitality of their communities.

Between 2010 and 2012, the Arts and Culture Program at The Kresge Foundation made 36 grants under Institutional Capitalization, which included two tracks:

- 1) **Facility Investments and Building Reserves:** This grant opportunity prioritized the proper maintenance of physical assets, within the context of comprehensive institutional capitalization. Organizations could apply for grants to fund facility renovation or repair projects and reserve funds for long-term maintenance of their fixed assets, or for reserve funds alone. Applicants could request that a grant be structured as a match or challenge. The Foundation completed four requests for proposals from 2010 to 2012 and awarded 32 grants with one- to three-year investment periods. Grantmaking began in November 2010 and concluded in September 2012. Grants ranged from \$250,000 to \$1 million and the majority required at least a 1:1 match from the grantee toward the portion of funding designated for the reserve.
- 2) **Sector Leader Investments:** This initiative made strategic grants to support shifts in organizations' business models and capitalization. Kresge sought to provide the field with examples of leadership in the implementation of sound capitalization principles from organizations undertaking transformational change in response to field-wide pressures. Between 2010 and 2011, the Foundation awarded \$1 million in grants to four organizations. Grant periods began in January 2011 and concluded in December 2014.

In both tracks, grants were designed to help grantee organizations understand their capital situation and take steps to improve their financial health.

In mid-2013, The Kresge Foundation sought assistance from Nonprofit Finance Fund (NFF) to assess the effectiveness of its investments. Kresge asked NFF to assess whether grantees had become more knowledgeable about capitalization principles, more effective in capitalization planning and more financially resilient as a result of the foundation's investment. This assessment sought to answer the following questions:

### Facility Investment & Building Reserve grantees:

- **Evidence of Learning:** Did organizations adopt a "capitalization mindset"? Has the process of planning for and monitoring capitalization improved among board members and managers?
- **Evidence of Operational Health:** Did grantees budget to and achieve surpluses? How did their operating performance fare against projections?
- **Evidence of Balance Sheet Health:** Are grantees' balance sheets healthier? Did they use and replenish building reserves (in line with board-approved policies)?
- **Evidence of Impact:** If grantees have healthier balance sheets, are they more flexible and nimble in response to changes in audience demand, cash flow fluctuations, and other unexpected changes in the environment? As a result of the Kresge investment, did organizations secure additional flexible capital funds in alignment with their strategic goals?

### Sector Leaders grantees:

For this cohort, NFF explored the same research questions as above, with the addition of the following:

- How did the grant support a shift in each organization's business model?
- Did grantees make any adjustments over the course of the grant?

## Capitalization Overview: Philosophy & Principles Applied in the Kresge Program

Capitalization is the accumulation and application of financial resources to support the achievement of an organization's mission over time. A well-capitalized organization has access to the cash necessary to cover its short- and long-term obligations, weather downturns in the external operating environment and take advantage of opportunities to innovate in ways that advance its goals. Historically, however, capitalization concepts have been narrowly applied in the cultural sector—and primarily considered the purview of organizations undertaking facility expansion and endowment-building efforts.

The relationship of the business model to the balance sheet is critical to a thorough understanding of capitalization. While capitalization is represented on the balance sheet, in the composition of an organization's assets, liabilities and net assets, it is typically built by realizing surpluses on the income statement. This requires a sound business model, defined as how an organization makes and spends its money to advance its mission.

In practice, a comprehensive capitalization plan takes into account an organization's mission and vision, its business model drivers, time horizon and life-cycle and its role in the marketplace. With this information, the capitalization plan outlines the various types of funds required for a given organization. It then articulates the amount of funds needed, the timing of specific needs and the methods for obtaining the required resources.

Kresge's Institutional Capitalization program acknowledged that capital serves many purposes and that every cultural organization requires different kinds and amounts of capital at various stages of its life-cycle. In structuring the program, the foundation developed common definitions of capital as part of an effort to build a field-wide understanding of how capital connects to need. At the outset of its grantmaking, Kresge defined the following five types of capital:

**Working Capital** – funds to maintain ordinary business operations during cash flow challenges that arise from predictable business cycles. Each organization is unique in its need for working capital due to annual patterns of cash inflow and outflow. A working capital fund allows an organization to borrow internally when expenses are made before the income is received.

**Operating Reserves** – “rainy day” funds held in order to protect against unexpected downturns. Frequently, such reserves are designed to cover operations for a specific period to survive disruptions to ordinary income or respond to changing circumstances. Unlike working capital, an operating reserves fund cannot be satisfied with a line of credit, as the source of the revenue to pay back the line is not often clear in the event of the fund's use.

**Innovation Fund/Risk Capital** – funds that give an organization the freedom to try out new ideas, such as product extensions, earned income ventures, major growth or a new strategic direction. Risk capital also is used to address large environmental shifts that demand a change in strategic direction.

**Facility Reserves** – also called capital improvement reserves or capital replacement reserves, these funds are held by organizations with facilities to realize long-term facilities replacement plans.

**Endowment** – a fund that ensures the longevity of organizations with long-term time horizons through investment earnings dedicated to ongoing costs, such as maintenance of a collection or historic building. In general, the endowment corpus is composed of permanently restricted donations, although boards can create quasi-endowments not restricted by donor intent.

Kresge's program acknowledged that while capitalization approaches are not one-size-fits-all, unrestricted cash for working capital and operating reserves are typically the most critical needs for arts and cultural organizations. It

assumed that long-term health is predicated on a business model that consistently covers operating costs, funds long term facility costs, and generates surpluses that provides the cash needed to fund reserves. Yet, Kresge also recognized that organizations need periodic infusions of capital from funders to jumpstart reserve funds, especially those that are large in scale or have been historically underfunded.

Based on the foundation's long history of supporting facilities, it chose to focus the bulk of its one-time capitalization investments on what was, at the time, a direly stated financial need of many organizations: facility reserves. Such reserves were a central component of the 32 Facility Investment & Building Reserve grants described on page 1. Kresge also offered four \$1M grants for business model change through its Sector Leaders Program as a new endeavor.

As a condition for funding, applicants to the Kresge program were required to submit comprehensive capitalization plans tying program and business dynamics to capital needs. These plans outlined the types and amounts of capital needed (using Kresge's defined types of capital), the timing of specific needs, and the methods for obtaining required resources. Organizations were asked to make the case for how an investment in a facility reserve or business model change was the next appropriate step in achieving a comprehensive capitalization plan.

Kresge required applicants to have positive liquid unrestricted net assets, which was calculated by subtracting the net value of fixed assets from the total value of unrestricted net assets. This measure ensured that the organization had at least a modest amount of working capital available as it entered the program.

A more detailed description of Kresge's application process and requirements is included as Appendix A.

## NFF Evaluation Framework

In undertaking an assessment of Kresge's Capitalization Program, NFF applied its own high-level framework to help answer Kresge's primary research questions and assess the progress of each grantee in meeting its stated capital targets.

NFF has found that effective capitalization in the nonprofit sector requires attention to three key financial priorities: liquidity, adaptability and durability:

**Liquidity: Does the organization have adequate cash to meet its operating needs?** Liquidity is critical for managing the cyclical and seasonality of cash flow. It can be measured in a number of ways, including by "months of cash" and "months of liquid net assets," and is the flexible amount of unrestricted net assets available to support operations. Liquidity may include working capital and board-designated operating reserves, when those funds are readily available to leadership. *Working Capital and Operating Reserves, as defined by Kresge on page 2, both function to provide liquidity.*

**Adaptability: Does the organization have flexible funds that allow it to make adjustments as circumstances change?** Periodically, organizations need access to flexible capital to innovate, experiment, grow, collaborate and/or change how they do business and create art. These resources may include reserves or other funds intended to support artistic risk-taking, special opportunities, business model change and organizational growth. *The Innovation Fund/Risk Capital as defined by Kresge on page 2 supports an organization's adaptability.*

**Durability: Does the organization have sufficient resources to address the range of needs that it may face in future years?** Durability is typically manifest in the presence of fixed assets and long-term investments. An organization's facility reserve or endowment can be integral to its long-term durability, provided that any funds tied up in investments are large enough to generate meaningful annual operating revenue. Having resources available to support the regular care of fixed assets helps to ensure that programming does not suffer from facility disrepair. *As described on page 2, both Facility Reserves and Endowment funds support long-term durability needs.*

Among these three financial priorities, both NFF and Kresge agree that there is a hierarchy of need. In nearly every case, there is a strong argument for organizations to prioritize building liquidity first. Most organizations also periodically need access to funds for adaptation, especially the pursuit of organizational change and artistic risk-taking. Generally, organizations do not reap mission benefits from investments in durability if they have not already secured funds that ensure their liquidity and adaptability. Many small and mid-sized organizations may never need to build durable balance sheets that prioritize endowments or facility ownership.

As such, NFF's review of Kresge's grantees sought to assess capitalization by looking for evidence of organizational progress in building liquid funds for immediate operating needs, as well as longer-term balance sheet savings for adaptability and durability.

NFF's evaluation of grantees involved a combination of data analysis and interviews. The methodology is described in detail in Appendix B.

What follows, and comprises the bulk of this report, is an aggregation of NFF's findings for each of the grantee cohorts mentioned on page 1. Also included herein is a set of recommendations for the consideration of Kresge and other grantmakers pursuing capitalization as an investment strategy, as well as recommendations for nonprofits seeking to build a culture of capitalization within their organization.

## Summary of Observations: Facility Investments & Building Reserve Investments

### Grantmaking Goals

As a longstanding funder of arts and cultural facilities, the Kresge Foundation has used its expertise to help arts and cultural organizations effectively steward their physical assets. Three key lessons from past grantmaking practice strongly informed this grant opportunity:

- Many organizations do not accurately plan for the costs associated with operating new or expanded facilities.
- Many organizations do not plan for or set aside reserve funds to maintain their buildings and other fixed assets.
- As a result, organizations felt significant impact on their ability to stabilize operations at the level envisioned in their new or expanded buildings.

Drawing on this experience, Kresge sought to help organizations properly maintain their mission-critical physical assets. The foundation made 32 grants to support the renovation of existing fixed assets and the creation (or growth) of reserves to support facility maintenance and replacements. While this grant opportunity emphasized solidifying the durability of facility owners, Kresge's broader intention was to "foster the examination and understanding of comprehensive organizational capitalization" among grantees.

### Evidence of Learning:

#### Did organizations possess or adopt a "capitalization mindset"?

Improving capitalization starts with a change in organizational mindset. Organizations that understand and embrace capitalization principles are far more likely to set comprehensive capitalization goals as part of their annual and longer-term planning. They tend to be more comfortable engaging board members and supporters in dialogue about long-term needs for flexible funds. They are more likely to make choices that strengthen their financial health in the service of their artistic programs.

As such, NFF specifically sought to understand the knowledge each organization possessed before and after the Kresge program, inviting each grantee to state in its own words what it meant to "be well capitalized" and to describe how the organization incorporated capitalization into decision making.

To assess whether knowledge about capitalization principles translated into concrete plans for long-term health, NFF also evaluated financial management practices and how they changed over the course of the Kresge grant period. NFF looked for evidence that organizations developed savings and reserves goals to match their most pressing needs, and examined the role of their governing boards in capitalization planning.

NFF observed the following trends about capitalization learning and planning:

- **For the most part, leaders of organizations that received Kresge funding can now clearly articulate the principles of capitalization and how they apply in their organizations.**

Nearly all grantees made it clear to NFF that their understanding of capitalization—and their appreciation for its connection to long-term artistic health—had greatly improved during the period of the Kresge program. For many organizations, the educational materials provided by Kresge, which included definitions and a vocabulary for describing distinct types of capital, were critically important in fostering conversations at the board level. They gave grantees the confidence to broach the topic with trustees who were unfamiliar with these concepts, and validated reserves as a legitimate organizational priority.

As one example, leadership at the Center of Creative Arts (COCA) said that the information provided through Kresge's application process gave its staff and board members the language they needed to start a dialogue about how capital could transform their organization. Although COCA's board had previously engaged in robust discussions about funding for risk and innovation, the Kresge opportunity gave them permission to think beyond the endowment and holistically plan for a range of ongoing capital needs. As a result, COCA added \$3.9M to its capital campaign fundraising goal for capital projects, operating reserves, building reserves and an endowment.

➤ **The grant's impact on organizational culture correlated closely with grantee budget size.**

The largest shifts in organizational learning and culture occurred among mid-sized organizations (with an average budget size of \$3M). For these groups, the Kresge award was meaningful in relation to the grantee's budget size and provided a strong incentive to shift organizational planning behaviors in favor of longer-term balance sheet priorities.

For the six largest grantees (with budget sizes ranging from \$19M to \$73M), the size of the Kresge award was not meaningful enough to shift organizational culture or mindset about capitalization broadly. The largest grantees already had an array of permanently restricted and/or board designated endowments in place prior to the grant program, and some also had more flexible rainy day funds, operating reserves and risk reserves. Most of the largest grantees continue to target their capital campaigns primarily toward raising funds for fixed assets and long-term investments. These organizations typically described the Kresge award as a "facility grant," although many provided examples of how the systems replacement planning requirement (described below) has positively impacted their thinking about the need to develop longer-term master plans for their facilities.

**Did grantees convert this knowledge into planning for and monitoring balance sheet health, at the executive and board levels?**

➤ **Grantees are more likely to plan for a range of reserves that address their long-term needs as a result of the Kresge program. Boards are increasingly setting policies governing the use and replenishment of savings.**

While some organizations had robust capitalization strategies prior to the Kresge program (approximately 12 of the 32 grantees), most did not. As such, the application process helped many grantees clarify, prioritize and reach consensus about the resources needed for the health of their organization. All 32 facility program grantees have capitalization plans in place that clearly articulate the breadth of their reserve needs, and many organizations can now articulate the timing, amounts and kinds of capital needed to achieve their strategies. Many organizations report that their trustees now expect to see capitalization prioritized in strategic planning and financial management.

While a handful of organizations remain focused on endowment growth, many are prioritizing more flexible reserves, such as program innovation funds or risk capital. This shows that grantees are thinking critically about how to safeguard their mission in the short- and long-term.

Michigan Theater Foundation is one example of a grantee now focused more intentionally on building and effectively managing its assets. The organization's comprehensive capitalization plan, developed as part of the Kresge application process, included targets for growth in working capital and the development of an operating reserve, innovation fund, and board-designated endowment. Progress has been made in all categories except the endowment, which leadership expects to secure over time through an increased focus on planned giving. Whereas historically the theater managed to its income statement, leadership is now building the strength of the balance sheet. The theater's executive director shared, "I can say unambiguously that this is the most important grant that we ever received in terms of organizational transformation."

All grantees were required to develop—or submit existing—policies that govern the use and replenishment of facility reserve funds. Some went further, creating policies for other kinds of savings. Several grantees cited the grant application process for creating an incentive to quantify clear targets for savings and reserves and establish board-designated reserve policies.

NFF is not able to independently verify under the scope of this evaluation whether grantees have in fact regularly monitored progress against their capitalization goals. However, a majority of organizations reported regular monitoring activity, and nearly all grantees provided NFF with reserve policies upon request, signaling board involvement at least in the early stages of the program. Anecdotally, in interviews many organizations described the ways that their board, finance and/or executive committees are engaging management in discussions about raising and replenishing capital in accordance with their plans.

- **Using systems replacement plans, organizations are almost uniformly planning more thoughtfully for upcoming facility reinvestment needs. As a result, they are more likely to budget each year for major facility investments.**

Depreciation, an accounting convention that approximates the wear and tear of fixed assets, is a very real cost of doing business for facility owners. But for many, funding the calculated annual depreciation expense may not realistically be possible each year. This number can seem overwhelming and is easy to ignore when it is largely divorced from the true useful life and condition of major assets.

As such, Kresge required that grantee organizations conduct and submit customized, 20-year systems replacement plans that mapped out anticipated expenditures for fixed assets repairs, replacements and improvements. They were encouraged to think critically about the growth and replenishment of their facility reserves relative to a more accurate, realistic view of their anticipated facility needs.

As a result, nearly all grantees (even larger organizations) are now more methodical about mapping and prioritizing future investments in their facilities and fixed assets. In fact, *the promise of a Kresge investment visibly strengthened the depth of planning for long-term facility health more than any other organizational practice*. Many grantees specifically credited the Kresge requirement for a 20-year facility maintenance and replacement plan as a catalyst for this practice.

By and large, grantees are thinking about how they can grow the facility reserves seeded by Kresge and replenish reserve funds as they are spent. The general manager of the Cleveland Public Theatre stated, “I can’t think of another grant that we’ve ever received that has so transformed the organization. I don’t think of the building as something that I’m managing in a three-month period; I think of it over a five-year period.”

### **Evidence of Operational Health:**

#### **Did organizations achieve annual surpluses? Did grantees’ operating performance match their projections?**

Sustaining healthy capitalization over time requires recurring surpluses. When surpluses are converted to savings, organizations strengthen their liquidity and capacity to adapt. Organizations applying to the Kresge program submitted six-year financial projections demonstrating how they would achieve surpluses during and after the investment period.

As part of the evaluation, Kresge sought to understand whether its grantees realized planned surpluses. As a way of assessing the quality of financial forecasts, NFF also analyzed whether grantees achieved bottom line results (revenue less all expenses) in line with their original proposals.

A summary of NFF’s observations about trends in operating performance follows.

➤ **Many organizations now set surplus goals as part of the annual budgeting process.**

Leadership from nearly every organization shared examples of how the Kresge investment has shaped annual budgeting practices. Most notably, the majority of boards now feel comfortable approving a pre-depreciation surplus budget, knowing that surpluses feed the growth and replenishment of reserves. As a direct result of the Kresge investment, some boards now *require* a pre-depreciation surplus budget. These practices are effective for most organizations in the cohort: 26 of the 32 grantees (81%) reported pre-depreciation surpluses in the final audited year analyzed.

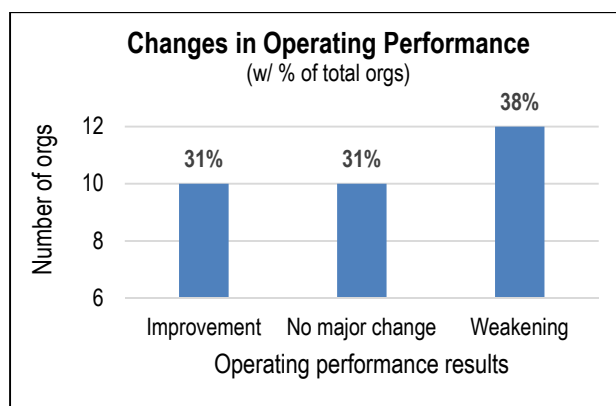
As mentioned on page 7, many facility owners are unable to achieve a post-depreciation surplus, while still generating enough cash for allocation to additional reserves. They find it more practical to pay for facility reinvestments through a combination of savings and capital campaigns/special fundraising, such as was provided through the Kresge program. These organizations often keep one budget for normal operations and routine facility maintenance, and a separate budget to cover major, extraordinary, replacement/construction projects. So, while only 15 of the 32 grantees (47%) report post-depreciation surpluses in the final analyzed year, this metric may be moot for many grantees, depending on internal budgeting practices.

Again, small and mid-sized grantees experienced the greatest shift in budgeting behavior. Most reported that they had historically managed to their income statement, with a primary focus on covering operating expenses. Now, they are setting their sights above the break-even mark and planning for reserves as part of the annual budgeting process. One example is Merrimack Repertory Theatre (MRT). Rather than budgeting to cover the organization's program and fixed expenses, the process now begins with a new organizing question: "Based on the artistic and programmatic impact that MRT seeks to produce, what are our true financial requirements?" This allows MRT leadership to get out of the "day-to-day mindset" of worrying about cash flow and securing funding for operations so it can devote more time and conversation to planning for the long term.

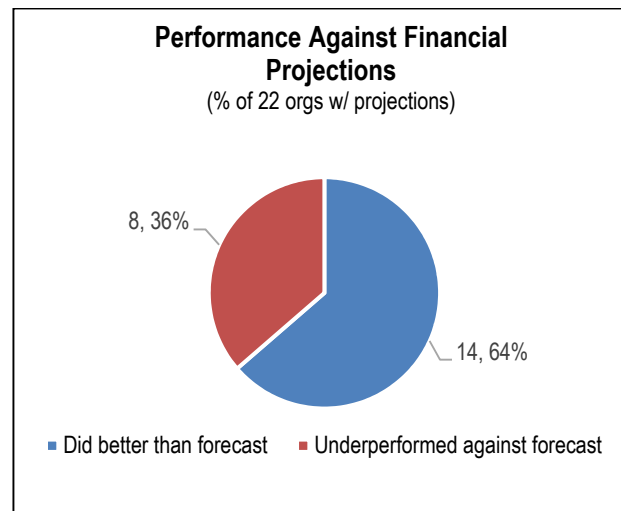
➤ **Grantees showed mixed results in operating performance over the grant period.**

Operating revenue is regular, recurring, and generally a part of normal operations (e.g. grants that are reliably received every year, an organization's track record securing individual donations). This is funding to "keep the lights on" and pays for an organization to maintain its normal programs and operations. Conversely, non-operating revenues are one-time, episodic sources of income. (The grants deployed by Kresge under this initiative are non-operating revenue to grantees, referred to as capital. Bequests also fit this profile.) When possible, NFF removed non-operating revenue from its analysis in order to show true operating performance.

As depicted below, operating performance (i.e. regular revenue less expenses) was closely divided across the three main outcomes, with slightly more organizations showing weakened operating performance:



While most grantees did not experience improvement in operating performance, a majority performed as well as or better *than they expected* against their multi-year financial projections. NFF received financial projections for 22 organizations, which were originally submitted to Kresge as part of the grant proposal. Of these, the majority of grantees performed better than their forecasts:



Ultimately, the charts above depict a work in progress. The Kresge program was structured to promote learning about the relationship of surpluses to long-term financial health, and significant learning occurred. Moreover, a majority of grantees translated that learning into action and outperformed their forecasts. In assessing why operating performance did not improve for 38% of the cohort (which was even the case for some grantees that hit their proposed projections) it is not helpful to generalize. There are many underlying factors at play, not least of which is the impact of the grantees' ongoing capital campaigns—and the havoc that a campaign can often wreak on an organization.

It is clear, however, that achieving consistent, year over year improvements to operating results requires a shift in attitudes and behaviors regarding operations and program management; perhaps more importantly, it requires a cultural shift in how decisions get made. In NFF's experience, organizations often implement sound budgeting practices but lack a culture that embraces hard choices in the service of financial health. This culture can only shift when financial management is seen as a tool to help leaders achieve, rather than undermine, artistic objectives. An example of this shift in thinking is described on page 8, in the way that Merrimack Repertory Theatre now approaches its budgeting process.

### **Evidence of Balance Sheet Health:**

#### **Did the Kresge investment lead to overall unrestricted balance sheet improvement?**

Organizations strengthen their long-term financial health by running recurring operating surpluses, supplemented by periodic infusions of capital for liquidity, risk management, experimentation, growth, and change. To assess whether grantees in the Kresge program improved their balance sheet health, NFF reviewed trends from each grantee's audited financial statements prior to and across the grant period—typically three to six years. The analysis was supplemented by a review of the Net Asset Tracking Tool (Appendix C) that Kresge asked each grantee to complete as part of its proposal, and throughout the grant period. This tool categorized net assets according to donor-imposed restrictions (i.e., unrestricted, temporarily restricted and permanently restricted funds) and board designations to determine assets that are truly available for management's use.

A summary of NFF's observations about trends in grantees' balance sheet health follows.

- **Although capitalization planning is now widespread among the grantee cohort, many of the program’s intended financial health outcomes will take time to be fully realized.**

Most grantees experienced balance sheet growth over the period analyzed (in part due to an influx of capital for facilities expansion, improvement or preservation); however, the majority of organizations did not become “financially healthier” as measured by an increase in liquidity and other forms of flexible savings. This is to be expected, as the Kresge investment was not earmarked for general liquidity; rather, it was targeted to fixed asset repair and replacement. Balance sheet change is a long-term endeavor, achieved through steady efforts to generate and set aside surpluses while identifying opportunities to secure one-time capital gifts.

NFF looked at levels of liquidity to assess balance sheet health. While NFF tracked growth in cash and investments overall, these assets can be restricted by donors or earmarked to future programming or liability reduction. Therefore, NFF’s analysis focused primarily on how many months of expenses could be covered before and after the Kresge grant period by unrestricted liquid net assets—defined as resources that can be easily accessed for operating needs, which did not include the facility reserve in almost all cases. (For more information about NFF’s determination of truly “liquid” and accessible funds for each organization, please see Appendix B.)

NFF’s analysis found that:

- The median level of liquidity for the cohort was 1.5 months at the start of the grant period and 1 month at the time of NFF’s analysis, which corresponded with the end of the grant period for most grantees.
- Liquidity increased for 14 of the 32 grantees (44%). This group showed a median increase of 1.2 months of expenses.
- Liquidity declined or remained flat for 18 grantees (56%). This group showed a median decrease of 1.4 months of expenses.

| <b>Liquidity</b><br>(Shown in Months) |                     |               |                          |               |
|---------------------------------------|---------------------|---------------|--------------------------|---------------|
|                                       | Increased (14 orgs) |               | Decreased/flat (18 orgs) |               |
|                                       | <i>Mean</i>         | <i>Median</i> | <i>Mean</i>              | <i>Median</i> |
| Starting months of liquidity          | 0.70                | 0.69          | 2.20                     | 1.50          |
| Ending months of liquidity            | 2.21                | 1.50          | 0.79                     | 0.60          |
| <b>Difference</b>                     | <b>1.50</b>         | <b>1.20</b>   | <b>-1.55</b>             | <b>-1.35</b>  |

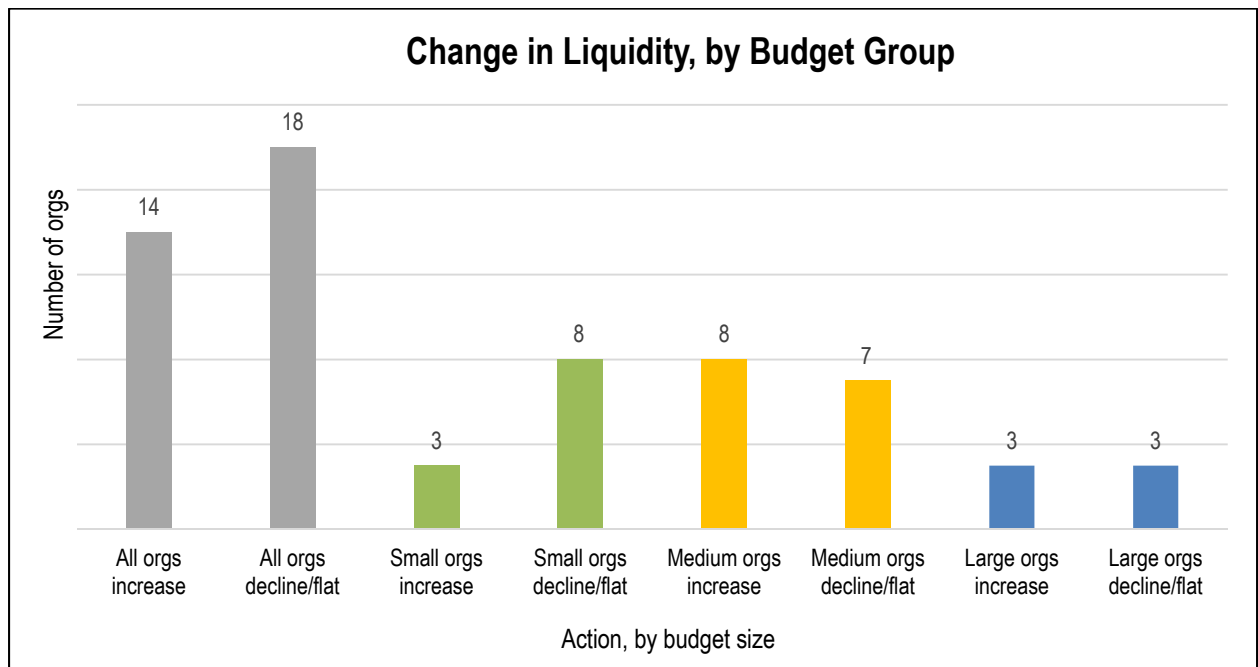
- **Important distinctions emerge, however, when segregating grantees by budget size. Smaller organizations were much more likely to report decreases in liquidity at the close of the grant period.**

To further explore changes in liquidity over time, NFF divided grantees into three groups, based on budget size.

| <b>Budget Group</b> |                       |        |                |
|---------------------|-----------------------|--------|----------------|
| Group               | Budget Range          | # Orgs | Average Budget |
| Small <sup>1</sup>  | \$0-2,999,000         | 11     | \$ 1,849,407   |
| Mid-size            | \$3,000,000-9,999,000 | 15     | \$ 4,957,576   |
| Large               | \$10,000,000+         | 6      | \$37,625,189   |

<sup>1</sup> Note that while the sector may commonly define small arts organizations as those with budgets under \$1M, the categorization of “small” organizations here is relative to the size of the rest of the grantees in the cohort.

As demonstrated in the graph below, during the term of the Kresge grant an equal number of organizations experienced increases vs. decreases in liquidity for both the large and mid-size cohorts. However, nearly three quarters of smaller organizations reported decreased liquidity. This is likely due to capacity: smaller organizations typically do not have the staff resources to pursue fundraising for operations, while also focusing attention on raising capital. The example of Jose Mateo Ballet Theatre in the next section, on pages 11-12, may offer additional insight into why smaller organizations may have become less liquid as a result of the program.



Also of note, the mid-sized and larger organizations had more liquidity than smaller organizations: 2.6 months of liquid net assets vs. 1.1 months, on average. Moreover, they were more likely to have investment reserves and endowments intended for long-term use -- additional forms of capital not captured in NFF's analysis of liquidity.

Again, it is important to note that improvements in financial health do not happen overnight. Improved attention to financial planning and management should not be expected to show up in financial statements for several years. Organizational learning and changes in practice are promising, and it is simply too soon to know the full financial impact of the Kresge investment. Moreover, extenuating economic circumstances and an organization's local market dynamics can complicate the relationship between capital investment and improved financial outcomes; without infusions of capital from other institutional and individual donors, it is unlikely that organizations will realize their capitalization goals.

- **Grantees have benefitted tremendously from investments in critical fixed assets and the creation of reserves to finance ongoing repairs and replacements. For some grantees, however, a facility reserve may not have been the most pressing capital priority.**

Grantees undertook repairs, upgrades or expansions that were critical to the advancement of the mission and to the safety of staff and patrons. Many grantees provided examples of how they *proactively* paid for facility projects that other donors hadn't found compelling. These projects often resulted in substantial cost savings and are likely to have prevented emergency situations that often drain precious capacity and cash.

Moreover, reserve funds from Kresge played a critical role in helping organizations establish a baseline of savings dedicated to the priorities they mapped out in their systems replacement plans.

For organizations with only a few weeks of cash or negative liquid unrestricted net assets, the most urgent capital need may not be long-term savings for facility care. Rather, the priority is usually working capital—and/or cash for a designated operating reserve. Leadership at the Jose Mateo Ballet Theatre (JMBT) noted that the Kresge investment enabled the organization to attract additional funds toward a meaningfully sized facility reserve; however, management reported that the project likely compromised its ability to raise much-needed funds for operations and other, more flexible reserves. As a result, liquidity decreased, which may explain many of the decreases shown in the chart on page 11. Management at JMBT acknowledged that in a perfect world, given its organizational life cycle and stated priorities, working capital and risk capital would have been raised first since these funds represented the most urgent needs. Nonetheless, Kresge funding for the facility reserve was “an opportunity that we couldn’t pass up. We knew it wasn’t going to come around again.”

### **Evidence of Impact:**

#### **Are grantees ultimately more flexible and nimble in response to changes in audience demand, cash flow fluctuations and other unexpected changes in the environment?**

A well-capitalized organization has the ability to pay its bills, weather downturns and changes in the external operating environment, and take advantage of opportunities to innovate. As such, NFF sought anecdotal evidence of newfound resilience or creative risk-taking among the grantees. Following is a summary of the trends that emerged:

- **With newfound facility savings in place, small organizations experienced greater freedom to deploy existing cash toward program investments.**

For smaller and mid-sized organizations, the grant size was quite meaningful, and could therefore have a more substantial impact on organizational flexibility. Several organizations reported that they no longer worry about the need to shuffle or reconfigure programming at the end of the year due to unplanned facility expenses; the reserve provides assurance that they can handle those costs. For example, GALA Theatre explained that a soundboard failed before a large performance at the end of the year. The building reserve was vital to managing through that crisis because staff could immediately draw funds to make the replacement, without considering the impact of the replacement on other programs or budgets. Leadership from the Mississippi Museum of Art summarized it well: “Those of us responsible for the money get more sleep at night knowing that if the HVAC unit goes out, it won’t severely detract from the programs that are our primary mission.”

- **For large organizations, the Kresge investment’s greatest impact was to enable the completion of a much needed, typically deferred facility project.**

For large organizations, the Kresge grant was too small and facility-focused to substantially alter internal cultures around risk-taking and change. The funding still had significant impacts, however, due to the infrastructure upgrades that it allowed. For example, the Boston Symphony Orchestra (BSO) was able to install a new sewage system, which was not as attractive an investment for other donors as perhaps a new stage. Yet, installing the system is financially prudent and will save the BSO \$100,000 per year in operating expenses. Similarly, leadership from The Henry Ford reported that the Kresge grant generated momentum for the organization’s much needed electrical upgrade project. Staff members directly attribute unexpectedly high attendance at both “Driving America” and “Titanic” to the upgraded electrical infrastructure—neither production would have been possible under the previous electrical set up.

- **Numerous organizations reported a willingness from leadership to take greater risks based on the perception of financial stability that resulted from new reserves. In many cases, however, the newfound perception of stability was not tied to a measurable gain in liquid or flexible funds.**

NFF heard repeated examples of grantees taking new creative or operational risks that they often attribute (at least in part) to the stability provided by the facility reserve from Kresge. In these cases, two profiles emerged:

- Risk taking occurred alongside measureable, tangible improvements to the organization's balance sheet.
- Risk taking occurred because of the *feeling* of stability that the facility reserve provided; financial health did not immediately improve.

Organizations that fit the first profile have a cash cushion to fall back on if risky new creative works or untested revenue strategies should fail. For example, the management team at the Walker Art Center is quick to point out that their rainy day fund acts as a cushion against external risk, such as an economic downturn. It also holds an array of board designated funds for programming and acquisitions. Moreover, the Walker's sizeable \$171 million endowment, which contributes a third of annual operating revenue, can be relied on to support riskier, but mission-critical exhibits that fall outside of the mainstream—exhibits that even its strongest individual donors and corporate partners are reluctant to fund. While endowments may not be appropriate for all organizations, the Walker serves as an example of an organization that has successfully incorporated an endowment into part of a larger capitalization strategy.

Likewise, leadership at the National Dance Institute of New Mexico (NDI-NM) became more confident about expansion plans once reserves were secured as part of its capital campaign. At the campaign's start, leadership was cautious not to "bite off more than the organization could chew" when scaling programs to serve more children in their new facility. Once working capital grew to cover three months of expenses and an operating reserve was in place, leadership accelerated growth plans. As a result, NDI-NM's goal to triple the number of children served has nearly been achieved in three years, rather than the initially anticipated five.

Other examples include:

- Jacob's Pillow Dance reported that its comfort with resources available to invest in its campus has enabled The Pillow to thoughtfully grow its programs, leading to more commissions and more residencies.
- GALA Hispanic Theatre reported a major artistic risk in staging *DC-7: The Roberto Clemente Story*, a bilingual sports musical that moved GALA's programming in a new direction. The play successfully attracted new audience members across diverse backgrounds, ethnicities, ages, etc.

Grantees that fit the second profile report greater creative risk-taking *despite experiencing no meaningful improvement in their liquid financial cushion*. Yet, the feeling of stability provided by the facility reserve is real and informs organizational decision making. These grantees typically have limited staff capacity, and raising capital funds is just one of many priorities competing for the attention of the senior team. When a reserve exists to mitigate facility risk, leadership can shift time and energy to other purposes—instead of scrambling to raise dollars for fixed assets in an emergency.

This sentiment was expressed repeatedly:

- One grantee described significant investments in audience engagement efforts and the hire of an additional development officer—expenses that would have been too risky if they had to use other savings for facility stewardship.
- Another grantee reported that due to its small size and historical liquidity constraints, it has always been forced to shift programming in response to audience demand and community needs. Despite having no liquid financial cushion (i.e. savings) to support the risk associated with these types of changes, leadership reports that the facility reserve provides a certain level of security to deal with unplanned building emergencies. As a result, the team has an improved ability to focus on longer-term program priorities.
- Of note, the two aforementioned organizations held an average of just 0.7 months of unrestricted liquidity at the end of the Kresge grant period.

While it is true that facility reserves provide some organizations with more breathing room to use their cash for program innovation or new audience engagement, current liquidity levels (as shown on page 10) by no means point to a cohort that can rest easy, or think much beyond the day-to-day. Although examples of creativity and resiliency are inspiring, risk taking and organizational adaptation cannot occur on a more sustained basis absent

higher levels of savings. Despite having more facility resources in place, many organizations in the Kresge cohort still live in survival mode.

Longer term, NFF would expect to see risk taking that is supported by liquidity and adaptive capacity if organizations truly make headway toward realizing their broader capitalization goals.

### **As a result of the Kresge investment, did organizations secure additional flexible capital funds in alignment with their strategic goals?**

- **Nearly every grantee stated that the Kresge brand proved to be a powerful catalyst for securing additional funding from institutional and individual donors, including board members, for facility projects and the facility reserve match.**

By and large, grantees reported that it is still very much a struggle to secure funds for cash reserves earmarked to fixed asset preservation, and for “less sexy” fixed asset repairs and replacements. To help overcome this field-wide obstacle, a number of grantees sought to leverage Kresge’s reputation and match requirement to raise capital through campaigns and other special fundraising initiatives. Of the 19 grantees that requested a match requirement, only one organization was unable to achieve it outright.

Many grantees cited the Kresge award as a powerful “seal of approval” of their capitalization planning efforts. They used their newly articulated capitalization plans and the requirement of the match to explain to donors that special capital gifts earmarked for facility preservation were just as necessary as program revenue—and critical to the health of these programs.

- **For a few grantees (generally smaller organizations), the match requirement from Kresge detracted from their ability to raise funds for more urgent needs, such as for annual operations or more liquid reserves.**

Several organizations reported that raising the match potentially distracted from other, more pressing efforts to raise working capital or operating reserves. Their boards and lean development staffs were challenged to step up donations and solicitations for facility-related funds at the same time that they were trying to generate enthusiasm among the same donors for other priorities.

For organizations with limited fundraising capacity, including those that typically struggle to achieve “annual fund” goals, the impact of a capital campaign or special fundraising effort to secure the facility reserve match meant tapping the same donor base multiple times—and typically to the detriment of raising operating funds. Leadership at Street-Level Youth Media, for example, shared that their ongoing, large capital campaign cannibalized some contributions to the organization’s operations. A few grantees exhibited declines in liquidity as a result of designating their liquid funds toward other, longer-term balance sheet priorities (particularly the new facility reserve in order to meet the match requirement).

Large capital campaigns tied to ambitious plans for growth also created disruptions for some of the small and mid-sized organizations. For example, The East Bay Center for Performing Arts was focused on closing a structural deficit that opened when the capital campaign ushered in a period of growth. Likewise, another grantee’s operating performance suffered throughout the course of a capital campaign that coincided with the end of the recession. In both cases, fundraising for operations competed with the need to meet goals for the capital campaign and facility reserve match.

- **Grantees have sophisticated capitalization plans but are unsure how they will finance them. Most institutional funders are not actively supporting capital priorities, and many individual donors are not familiar with the broader definition and value of capitalization.**

With comprehensive capitalization plans in place, grantees are theoretically in a better position to seek capital in a range of forms. Significant time and resources have been invested to create the language and policies that would strengthen communications about capitalization needs with supporters.

A few organizations experienced success in attracting additional capital to address broader organizational needs. These are worth calling out since their stories and strategies may be helpful to others. Generally speaking, NFF observed that organizations were more likely to be successful fundraising for flexible forms of capital for operations or risk taking when integrating these asks into a more typical capital campaign (i.e., packaged alongside exciting facility projects or an organizational milestone, like an anniversary gala). Both the Rhode Island Philharmonic Orchestra & Music School (RIPOMS) and Center of Creative Arts experienced fundraising success using this tactic. After successfully fundraising more flexible types of capital, RIPOMS' Executive Director stated, "We all know that raising money for an operating reserve or to reduce the debt is not the sexiest thing; the fact that we can now tie that need into our mission and our vision as part of a comprehensive plan makes it much more feasible to raise that money."

As part of its capital campaign the Center of Creative Arts created an infographic (see Recommendations for Nonprofits, page 23) depicting the organization's capital needs for the next five years. Staff used this key communication tool in fundraising for the facility and operating reserves, and staff members credit these communications with helping to transition a \$250K pledge for fixed assets to a pledge for operating reserves. In changing the purpose of the gift, the donor noted that she wanted to set an example for others to give to the operating reserve. Similar strategies were employed by other grantees, which have been successful in allocating a specific percentage of campaign funds to reserves.

A few organizations described leveraging the Kresge gift to increase board giving to reserves, citing the board as a group of individual donors that were most apt to give to special gifts earmarked for more flexible capital. Overall, however, grantees reported significant challenges in selling their overall capitalization plan to their institutional and individual supporters. Very few funders are making capital grants for purposes other than facility acquisition and endowments. The critical knowledge, attitudes and behaviors adopted through the Kresge grantmaking process will only be retained if the funding community (both foundations and individuals) steps up to continue supporting them.

### **Key Findings: Facility Investments and Building Reserve Grantees**

In summary, NFF observed that organizations are largely thinking in multi-year cycles and taking great strides to plan for their long-term financial health as a result of the Kresge investment. They are increasingly:

- Budgeting for surpluses
- Developing capital budgets based on systems replacement plans
- Planning to create or grow cash reserves
- Developing policies for these reserves
- Asking for flexible reserves as part of capital campaigns

Although some organizations were previously engaged in these practices, many have adopted them due to Kresge grant requirements. Yet, despite these gains, for many grantees in the cohort achieving improvements in financial health will take some time to materialize. Many organizations struggle with difficult choices about the size and scope of the organization given the demand of their audiences and the propensity of their donors to give. Moreover, institutional and individual donors rarely provide the flexible capital that would support grantees in their efforts to right-size and adapt.

## Summary of Observations: Sector Leaders Investments

Capital that allows organizations to reinvent aspects of their programs and operations is standard in the for-profit sector but is a rarity in the nonprofit sector. Kresge's Arts & Culture Program embraced this kind of flexible long-term funding through its Sector Leaders grants. It made a small number of investments (four grants of \$1 million each) to organizations that sought to shift their business models and improve overall capitalization in ways supportive of continuous organizational and program adaptation. These grants were also intended to serve as field-wide examples of leadership in the implementation of capitalization principles.

### Context

Kresge's Sector Leader Investments were driven by the hypothesis that a properly capitalized balance sheet enables organizations to pursue innovation and take risks, both organizationally and artistically. NFF's extensive work with arts and culture organizations over nearly four decades provides numerous examples supporting this hypothesis. As part of its assessment of Kresge's Sector Leaders program, NFF analyzed individual grantee progress against stated goals. This included a thorough review of financial performance, as well as changes in organizational practice, as outlined in Appendix B. However, the small cohort size (four grantees), the diversity of the cohort (very different missions and market dynamics) and individual extenuating circumstances (including leadership transition and recession) make it difficult and inappropriate to broadly generalize about the financial impact of the Sector Leader grants on organizational health and balance sheet strength, and therefore are not included in the public report.

As such, the following is a distillation of high-level trends that have wide applicability to the field, with the inclusion of specific anecdotes when helpful.

### Evidence of Learning & Planning:

**Did organizations adopt a "capitalization mindset"? Has the process of planning for and monitoring capitalization improved among board members and managers?**

- **All four Sector Leaders had capitalization plans prior to the Kresge investment, with varying degrees of utility. The planning requirement associated with the Kresge award expanded and distributed knowledge about capitalization across staff, and in some cases, boards of directors.**

Generally, success in meeting the goals of the Kresge grant correlated closely with leadership tenure and stability. Opera Philadelphia, the sole grantee with no major turnover during the grant period, experienced the most widespread adoption of capitalization principles and practices. Says the organization's general director, "We are betting our store on capitalization. [...] Without it, even the most successful organizations will be dead." Through the Kresge grant award period, the entire board became more aware of capital needs and is now better able to "talk and think about capital in different ways." Opera Philadelphia's finance committee is intimately involved in financial and capitalization planning, leading to board materials that are more focused on balance sheet health. Management noted that the board had not historically approved surpluses, and credits the recent attitude shift to the receipt of two large capital grants, which validated their approach to capitalization planning.

Jazz at Lincoln Center, Inc. shared that the Kresge application process strengthened collaboration among departments. Staff members work together more intentionally to achieve capitalization goals in support of a new business model. For example, the development and program teams discuss the greatest opportunities for revenue growth and cost savings and determine how the business segments can collectively meet mission and financial goals. The organization now maintains a three- to five-year, forward-looking plan that drives annual operating decisions and measures progress toward measurable balance sheet targets. It also benefits from a very engaged board and committees that are dedicated to ensuring the long-term sustainability of the

organization through a strong capitalization structure. Accordingly, members of the board of trustees were first to come forward with donations of capital to support their Campaign for Jazz.

As explored further below, the impacts resulting from leadership transition were also apparent in other areas. In cases where leadership change during the grant period was significant, grantees often struggled to maintain buy-in around capitalization goals from new leadership and/or board members—both conceptually and through their individual giving.

### **Evidence of Business Model Transformation:**

#### **How did the grant support a shift in each organization's business model? Did grantees make adjustments over the course of the grant?**

Kresge's investment in business model change had mixed results within this small cohort. In some cases this was due to unanticipated internal or external changes. In other cases, grantee assumptions about the relationship between investment and new revenue generation were skewed. Issues related to mission alignment, market demand and organizational capacities derailed or delayed a number of business transformations. NFF observed the following trends:

➤ **Transitions in executive and board leadership were disruptive to business transformations.**

Leadership transitions are inevitable in any sector, but can be particularly daunting for organizations working with constrained liquidity, which is the reality for many nonprofits. Achieving healthy capitalization takes time and requires an ability to connect mission to strategy, strategy to a plan for the business and business planning to balance sheet goals. Grantee organizations preoccupied with major leadership transitions often prioritized immediate needs (such as maintaining existing levels of funding) over long-term goals that link capital investment to strategy. In some cases, leadership change also brought major shifts in direction or priorities, which is to be expected as new executives adjust to changing realities and seek to make their mark on the organization.

Even organizations that enjoyed continuity in senior management reported challenges dealing with turnover at the board level. In many cases, this turnover complied with mandatory term limits prescribed by board policies. While this may be the conventional wisdom of good governance, in reality, such limits make it very difficult to maintain a board that understands the complexities of nonprofit finance. For example, trustees may struggle to understand concepts like the impact of donor-imposed revenue restrictions on bottom line results, and accounting for capital as distinct from revenue on financial statements. Even board members who come from the world of finance often disregard business practices that are considered common sense in the for-profit sector, such as the necessity of prioritizing surpluses and setting aside funds for long-term savings.

➤ **Each of the Sector Leaders pursued new initiatives for growing earned revenue. But the reality remains: for most nonprofits, earned income ventures lose money. Grantees were most successful when they focused on mission-extending activities that leveraged existing core competencies.**

Amid uncertainty and change in the philanthropic marketplace, new ventures to grow earned revenue are often heralded as the key to financial sustainability. As the Sector Leaders sought to shift their business models in the face of field-wide pressures, each had strategies for growing earned revenue. Overall, NFF observed two primary types of expansion efforts among the grantees:

- Those that sought to increase earned revenue through strategic investments that build on existing strengths and mission priorities.
- Those that required the organization to embark on fundamentally new business lines or make significant changes to its core business.

Opera Philadelphia is an example of the first type. The organization used a large portion of its Kresge grant to build capital resources that could be invested in programming that is an extension of its current offerings. Through the creation and strategic deployment of a Risk Capital Fund, seeded with \$500K from William Penn Foundation and matched with \$500K from Kresge, Opera Philadelphia has co-commissioned higher risk, artistically acclaimed new works. The organization's leadership says the established reserves have been a "game changer" as the emphasis on new works has made the organization an attractive partner for leading opera companies and a magnet for top performers.

Essentially, the risk reserve functions as a revolving fund that has been used to co-commission one major new production each year for the past three years, providing the cash flow necessary to pay for these projects before box office revenue materializes. Because Opera Philadelphia knows its audience base and has examined market demand for its programming, leadership is confident in its ability to replenish the reserve over time, and has been successful in paying the reserve back each year thus far.

As an example of the second type of expansion: one grantee expanded into a brand new facility rental business with a focus on hosting weddings. It required significant new infrastructure investments (massive outdoor canopy tents, lighting, etc.) and time from staff members. The learning curve was steep and the investment of staff time had real costs, as the organization's primary fundraising staff member functionally became a wedding planner—at the expense of income for existing programs.

Contrast that experience with another grantee that also started a facility rental venture, New York Live Arts. This grantee was a performing arts venue that was already in the business of hosting live performances and events. Staff already understood the requirements and expense of hosting these types of events in the space and could incorporate rentals for similar functions into their daily work with much less disruption.

Even in situations where a new venture may ultimately make sense for both mission and financial reasons, it often takes time to iron out wrinkles and adjust to a learning curve in order to achieve reliable net revenue. In several cases, the start-up capital provided by Kresge was critical in covering early deficits as organizations sought to finance new ventures. Time and again, the most successful ventures used capital to invest in mission-aligned activities that drew on existing competencies in tested markets.

### **Evidence of Impact:**

**As a result of the Kresge investment, did organizations secure additional flexible funds in alignment with their capitalization goals?**

- **Kresge provided, and to an extent helped attract, the kinds of flexible capital resources that grantees otherwise found hard to raise from a donor community that still favors endowments.**

The power of the Kresge brand was cited by each of the Sector Leaders as an important factor in raising capital through special campaigns. Organizations spoke of how Kresge's endorsement helped engender donors' confidence in their long-term vision and strategy. Some grantees noted that Kresge's introduction of reserves to the capitalization conversation also helped build internal board support for more liquid funds.

Even when staff and board are aligned about capital priorities, however, they find it difficult to attract external supporters to untraditional capital asks. Almost all grantees reported that these types of requests have been nonstarters with major donors, or require significant funder education. Faced with this reality, two grantees reported that their boards have begun, once again, to embrace more conventional wisdom about the importance of the traditional endowment. In this environment, organizations that can consistently achieve and set aside modest surpluses will continue to make the most headway in building reserves and other forms of capital—but they will likely encounter challenges from the board.

Even Opera Philadelphia, an organization with a track record of success in raising flexible capital, reported that it is very challenging to find funders that will support its strategy. Notably, it was the only organization to make significant progress building its flexible capital in accord with the projections submitted to Kresge, although it did not hit the target anticipated in the original proposal. As described above, these types of resources are scarce and building them takes significant time. Funding for Opera Philadelphia's Risk Capital Reserve came solely from the Kresge and William Penn foundations. Its leadership notes that "One million dollars does not support risk in perpetuity." Opera Philadelphia further shared that current grantmaking trends in the larger sector do not "create a dynamic environment that allows organizations to deal with uncertainty" and address risk or unexpected change. Nonetheless, many organizations find themselves following these funder-driven trends.

## Conclusion

Very few funders are making capital grants outside of facility acquisition and endowment. Yet, these are the types of flexible resources that organizations truly need as they work to adapt to an environment in flux. Indeed, many of the Kresge grantees cited the Kresge award as "transformational."

NFF encourages grantmakers to consider the broad range of organizational needs—including the capital needed for extraordinary growth or change—when designing funding initiatives, and has included Recommendations for Capital Grantmakers on the following page. Likewise, many arts organizations can benefit from the experience of the Kresge grantees as they worked to plan and fundraise for special capital grants. A set of recommendations designed for nonprofits is included beginning on page 22.

## Recommendations for Capital Grantmakers

### Planning:

- **Start with education.** Trainings on capitalization best practices, strategies and vocabulary offered at the outset of a capital grantmaking program helps build a shared understanding among managers and staff. A terms sheet may be helpful to ground the vocabulary.
- **Include the organization's board.** Strong knowledge about capitalization at the staff level is not enough. Trustees influence fundraising priorities and serve as a pipeline to major donors. Board education and buy-in about capitalization (beyond facilities and endowments) should be a prerequisite to participation in any capitalization program.
- **Encourage realistic, integrated planning.** Consider supporting organizational planning that links vision to strategy, and strategy to a financial roadmap with balance sheet goals. A strong capitalization plan is grounded in a clear understanding of a grantee's historical and current financial situation. It sets targets for the types and amounts of capital resources needed to achieve long-term business and savings goals. Organizations undertaking business model change should also conduct a marketplace analysis grounded in evidence of demand among donors and audiences. For organizations with facilities and/or other fixed assets, a realistic assessment of long-term repair and reinvestment needs is a critical planning component.
- **Place and proximity matter.** It can be challenging for a national foundation to make a hyper-local investment without boots on the ground to regularly assess leadership strength, local market forces and other conditions favorable to the adoption of capitalization practices—even with site visits and ongoing contact. Proximity often strengthens this relationship. National foundations may want to seek local funders as partners.

### Making the Investment:

- **Tie your grant to the plan.** If an organization has prepared a thoughtful, data-driven capitalization plan with the board's involvement and approval, the most helpful investment is aligned with the priorities in that plan. Trust that organizations often know best what the most needed form of capital is for them—even if it means paying down debt or accessing recovery capital.
- **Match capital to need.** Organizations need different kinds of capital at different phases of their development. When making a capital grant, it's important to know the primary capital challenge. All nonprofits require working capital as a first order of business—to manage cash flow and handle everyday risk. Organizations in crisis also need capital to repair a structural deficit and pay off accumulated debts. Stable organizations may benefit most from cash reserves to navigate a rainy day and support periodic risk taking. Organizations embarking on any kind of business model change need flexible, multi-year capital to cover temporary deficits as they adapt their operating model.
- **Right size the investment.** Capital investments should be made in proportion to the scale of an organization's goals, as quantified in its capitalization plan. Funding discrete projects (for example: a critical facility repair) can be just as meaningful as larger capital investments. When seeking large-scale change, however, organizations need enough capital to cover the one-time cost of the change, as well as the temporary deficits incurred during the transition period. When ambitious change is intended, explore pooling resources with other funders.
- **Be flexible with match requirements.** Some organizations may be more successful raising flexible capital from their boards and other major donors if the investment is structured as a challenge. For organizations without a strong individual donor base, or those with too many competing priorities, a match requirement can be distracting and may detract from efforts to raise much needed operating support.

### Implementation:

- **Pair the investment with an advisor.** Balance sheet change—especially when it is associated with a plan to grow or adapt programs and operations, merge, or restructure—is not easy, even for the most sophisticated

organizations. While sound planning is critical, implementation requires a willingness to make data-informed decisions along the way. Grantmakers who make large, multi-year investments should consider providing resources for ongoing coaching and consulting with advisors who bring expertise in change strategy and management, market/donor analysis and financial modeling and reporting.

- **Encourage peer-to-peer learning.** Many grantees benefit from having a safe space to discuss their business and capitalization challenges with organizations that are grappling with similar situations. To ensure grantees can prioritize this, consider setting aside grant funding for convenings and less formal one-on-one discussions.
- **Invite ongoing dialogue.** Encourage grantees to openly discuss their capitalization progress and challenges with you. Set the tone that these conversations are not an exercise in compliance but a forum for exploration and problem solving.
- **Be patient!** Capitalizing organizations is a long-term, often risky endeavor. Grantmakers should be aware that some investments may not achieve their desired results in the time expected, if ever. Economic downturns, leadership change and staff turnover—on the funder or grantee side—can have tremendous impact on grant outcomes. Patience is essential when assessing outcomes of a long-term strategy.

## Recommendations for Nonprofits: Building a Culture of Capitalization in Your Organization

### Planning:

- **Start with education.** Building a strategy is only possible when managers and staff share an understanding of capitalization vocabulary, best practices and strategies. (A terms sheet may be helpful to ground the vocabulary.) Artistic leaders are critical participants in planning sessions, given their understanding of the connections between program ambitions and financial health.
- **Include the board and other donors.** Strong knowledge about capitalization at the staff level is not enough. Trustees influence fundraising priorities and serve as a pipeline to the major donor community. As such, board education and buy-in about capitalization (beyond facilities and endowments) is necessary for the development of a solid plan. Since individual donors will be critical to the success of any capital investment, think about aiming your educational efforts at this audience too.
- **Revisit key concepts when onboarding staff and trustees.** Turnover and transitions are a given, but they can be disruptive if new leadership is unfamiliar with core capitalization concepts. Successful organizations incorporate capitalization strategy and vocabulary into the onboarding of new staff and trustees.
- **Engage in realistic, integrated planning.** Organizational planning efforts link vision to strategy, and strategy to a financial roadmap with balance sheet goals. A strong capitalization plan is grounded in a clear understanding of an organization's historical and current financial situation. It sets targets for the types and amounts of capital resources needed to achieve long-term business and savings goals.
- **Right size the plan.** Capital needs should be quantified in the capitalization plan. Organizations require enough capital to cover the one-time cost of any major change, as well as the temporary deficits incurred during the transition period. Organizations undertaking business model change should also conduct a marketplace analysis grounded in evidence of demand among donors and audiences. For organizations with facilities and/or other fixed assets, a realistic assessment of long-term repair and re-investment needs is a critical component.

### Fundraising:

- **Use the plan!** Organizations need different kinds of capital at different phases of their development. Grounding your asks in a focused mission and well-articulated plan helps donors understand the types of capital needed by your organization. All nonprofits require working capital as a first order of business—to manage cash flow and handle everyday risk. Organizations in crisis also need capital to repair structural deficits and pay off accumulated debts. Stable organizations may benefit most from cash reserves to navigate a rainy day and support periodic risk taking. Organizations embarking on business model change need flexible, multi-year capital to cover temporary deficits as they adapt their operating model.
- **Re-imagine the capital campaign, which can have utility far beyond bricks and mortar.** Organizations may be more successful fundraising for the flexible forms of capital mentioned above if the asks are integrated into a more typical capital campaign (i.e., an operating reserve is packaged alongside exciting facility projects or a major organizational milestone, with a traditional anniversary gala). The graphic on the following page, used by Center of Creative Arts, provides an example of succinct, effective messaging for a multi-layered capital campaign.
- **Explore the role of challenge gifts.** Raising capital is often easier when others are visibly on board. Some organizations may be more successful raising flexible capital—like an operating or risk reserve—from their boards and other major donors if the investment is structured as a match or challenge. Larger, one-time, institutional gifts are great for PR; they can be seen as a major “stamp of approval” and leveraged to rally individual supporters.



### Implementation:

- **Continue to monitor progress against the plan.** Balance sheet change—especially when it is associated with a plan to grow or adapt programs and operations, merge, or restructure—is not easy, even for the most sophisticated organizations. While sound planning is critical, implementation requires a willingness to make data-informed decisions along the way.
- **Engage in open dialogue with funders.** Frank conversations with funders and individual donors are key to helping supporters understand true financial needs. Using simple, clear terms and compelling graphics are excellent ways to frame conversations about capitalization progress and challenges.
- **Be patient!** Becoming a well-capitalized organization is a journey, not a destination. It is a long-term endeavor and unexpected events along the way (economic downturns, loss of a major funding source, leadership change and board turnover, etc.) can have tremendous impact on realizing balance sheet goals. Patience is essential to implementing a long-term strategy.

## Appendix A

### **Kresge Grant Application Requirements and Review Process: Facility Investment & Building Reserve Cohort**

Before undertaking the program, the Kresge Arts and Culture Program sought to bolster its knowledge and understanding of capitalization principles, as well as advice on how to apply those principles. It worked closely with TDC, a Boston-based nonprofit management consulting and research firm that provided counsel and guidance throughout the Capitalization Program design and implementation.

The grant application required arts and cultural organizations to examine their comprehensive capitalization plans and include the annual costs of operating and maintaining the physical infrastructure of their organizations, namely their facilities. Organizations could apply for a combination of both facility investments and building reserves, or building reserves only. Applicants could request that grants be structured as a match or challenge.

In the preliminary application, grantees were asked to analyze their organization's business drivers and capitalization plan and explain how the grant request serves as the next step in achieving a comprehensive capitalization plan. They were also required to submit an Unrestricted Net Asset Tool designed in partnership with TDC (see Appendix C). Kresge required applicants to have positive liquid unrestricted net assets, calculated by subtracting the net value of fixed assets from the total value of unrestricted net assets. This measure assured that the organization had at least a modest amount of working capital available as it entered the program.

Applicants that were invited to submit full proposals were required to provide significant evidence of planning (six-year revenue and expense projections and their planned balance sheet impact), documentation of long-term facility replacement needs (through a 20-year schedule of projected facility repairs and associated costs), and board-approved facility reserve policies outlining the use and replenishment of facility reserve funds.

Each applicant's proposal was evaluated against the following criteria:

- Alignment with Kresge's stated values.
- Evidence of a clearly articulated capitalization plan.
- Evidence of planning, including but not limited to external market research and analysis for earned and contributed revenue, benchmarking research and asset replacement plans.
- Evidence that the proposed request fits within the organization's larger capitalization plan and is the next appropriate step in that plan, and that the organization understands how the proposed request will affect its future operating budget and balance sheet.
- Evidence of a realistic fundraising plan, if appropriate to the request.
- Assessment of the unrestricted net assets available for operations as stated in the Unrestricted Net Asset Tool.

The reporting process required final grantees to submit annual reports that included:

- A narrative summarizing progress toward completion of the facility renovation project (if applicable).
- A report detailing the progress toward securing matching funds to the building reserves (if appropriate).
- A report that describing the activity (use, replenishment, and growth) of the building reserves fund. Kresge expected funds to be used and replenished at the rates or schedule projected in building reserves policy submitted with the application or subsequent policy revised or updated with permission by Kresge.
- Internally generated income statements and balance sheets to confirm appropriate tracking and use of Kresge grant funds. While Kresge grant funds and consequent reserve were not required to appear in segregated funds in the audit, Kresge encourage organizations to reflect these funds in a board-designated reserve, building reserve, or other reserve fund per the organization's building reserve policy. A completed Net Assets Tracking Tool (see Appendix C) helped illustrate progress toward each of these funds.
- Current fiscal year's budget and most recently updated financial projections.
- Any board reports/minutes since the start of the grant that explicitly address capitalization planning/reserve policies and/or existing reserve policies if they had been updated since the beginning of the grant.
- An audit of the organization's most recently completed fiscal year.

## Appendix B

### NFF Methodology: Individual Grantee Analysis

NFF evaluated the impact of The Kresge Foundation's Institutional Capitalization award for each of the 32 grantees in the Facility Investments cohort and 4 four grantees in the Sector Leaders cohort. NFF primarily evaluated financial performance, while recognizing that data alone provides an incomplete story. As such, our assessment drew from a quantitative and a qualitative analysis of each grantee in assessing key knowledge, attitudes and behaviors. This cover provides key notes about the process and methodology supporting NFF's analysis.

#### Process

NFF created individual grantee reports for Kresge, which are a reflection of the following data points as available for each grantee, which were provided by Kresge or direct grantee follow up. The quantitative analysis (first four bullets below) provided the data to calculate key financial health metrics and to compare actual results with the projections and benchmarks of the original proposal. In addition, a qualitative assessment of each grantee (final three bullets) enabled NFF to fully address Kresge's research questions pertaining to a "capitalization mindset," financial management and governance practices, and enhanced adaptability and artistic risk-taking.

- Audited financial statements
- Internal financial statements and budgets for years when audits were unavailable
- Net Asset Tracking Tool
- Projections and benchmarks included in the original proposal
- Original proposal (including attachments such as the capitalization plan and facility analysis)
- Interim and final grant reports
- Board designated reserve policies
- One-hour telephone interviews with each organization including the CEO, CFO/COO, and the Development Director, although not all organizations were able to provide this exact staff team

NFF brings decades of experience working directly with nonprofits across the country. This on-the-ground experience informed the financial analysis through which each grantee was evaluated. At a high level, the analysis looked at balance sheets to assess the composition of assets and how those assets are financed, i.e., through liabilities or through net worth. Specifically within each organization's net assets, or net worth, the analysis focused on understanding how resources contributed to the organization's liquidity, adaptability, and durability.

Using the income statement, NFF sought to uncover the organization's unrestricted operating performance in order to assess strength of the underlying business model, which will ultimately contribute to the health of the balance sheet. As noted above, this analysis was informed by interviews with each grantee to understand the "How?" and "Why?" behind these financial metrics. Interviews were also a space to share lessons learned and reflections on the grant and application process.

Informing this methodology is a set of core terms and key definitions, included on the following page.

## Key Definitions

**Unrestricted operating performance** – A healthy business model is characterized by reliable revenue that covers operating expenses and contributes to surpluses. However, in the nonprofit world all revenue is not created equal. For a clear picture of revenue dynamics, NFF makes two important distinctions: unrestricted vs. restricted revenue and operating vs. non-operating revenue, as defined below.

- Unrestricted revenue is available to sustain day-to-day operations. This includes revenue received without funder-imposed time or program restrictions as well as revenues that are released from restriction once the obligation on those funds has been met. Temporarily and permanently restricted revenue is not included in this analysis as those funds are not available to cover operating expenses in the given year.
- Operating revenue is regular, recurring and generally a part of normal operations. Conversely, non-operating revenues are one-time, episodic sources of income. *The grants deployed by Kresge under this initiative are non-operating revenue to grantees, referred to as capital.* Capital supports extraordinary, time-limited investments that contribute to an organization's liquidity, adaptability and durability. Other examples of non-operating revenue include capital campaign receipts, realized/unrealized investment gains and losses, gains from sale of property, bequests, and/or other extraordinary items.

When possible, NFF removed non-operating revenue from its analysis in order to understand true operating performance. In some cases, it was not possible to segregate and remove non-operating revenue (when detail was not available in financials and/or grantees could not or did not provide that detail).

**Liquidity** – For the purposes of this report, NFF employed a key metric targeted at understanding if an organization has adequate access to the funds needed to meet operating needs: months of liquidity. This metric is important to help make comparisons across the cohort. However, it is equally important to recognize that each organization's balance sheet is unique, and that common metrics can obscure the nuance in the way an organization is resourced. To the extent possible, NFF held every grantee to a common standard when defining liquidity:

- Months of liquidity is the number of months of expenses that can be covered with the liquid portion of unrestricted net assets. This metric, derived from net assets on the balance sheet, measures those assets that are owned by the organization and *available* without restriction, an off-setting liability, or certain designations. NFF's analysis seeks to include only those resources that can be easily accessed for operating needs. Thus, board designated reserves are only included in the measure of liquidity when those reserves could be accessed by the executive director as needed, generally without board approval. As such, this metric often includes operating reserves but in no instance includes facility reserves as those funds cannot be utilized for operating needs. This metric carries a level of subjectivity as it is often based on leadership's reflection on ease of access to reserves in addition to the policies governing those board designated reserves.

## Appendix C

### Unrestricted Net Assets (URNA) Tool

Kresge used the URNA Tool, developed by TDC at the outset of the Kresge grantmaking program, to aid in the foundation's due diligence process when reviewing grant applications.

Organization:

Year end date:

*Unrestricted net assets available to support operations* are calculated by subtracting the net equity position in fixed assets from unrestricted net assets. Net equity is the net fixed assets (capitalized assets less accumulated depreciation) less associated debt; this represents the amount of organizational capital that is locked up in illiquid investments, and is therefore not readily available to support the organization's operations. Organizations that have a positive fund balance are better-positioned to think about their capitalization structure and needs when the baseline financial needs of the organization are being met. For these reasons, The Arts and Culture Team believes that its investments can have the greatest impact in organizations with positive fund balances. Should your unrestricted net assets available to support operations be negative, Kresge will not accept a grant request.

Enter from Audited Balance Sheet:

|                                                           |            |
|-----------------------------------------------------------|------------|
| 1 Total Net Assets                                        | 15,738,449 |
| Permanently Restricted Net Assets                         | 10,489,557 |
| Temporarily Restricted Net Assets                         | 3,622,088  |
| Unrestricted Net Assets                                   |            |
| 2 Net investment in capitalized fixed assets:             |            |
| Total Fixed Assets                                        | 6,994,634  |
| Accumulated Depreciation                                  | 5,400,378  |
| Net Fixed Assets                                          |            |
| 3 Debt associated with fixed assets:                      |            |
| Long term debt associated with fixed assets               | 768,443    |
| Current portion associated long term debt                 | 56,788     |
| Total debt associated with fixed assets                   |            |
| Equity invested in capitalized fixed assets               |            |
| 4 Unrestricted Net Assets available to support operations |            |

To determine Unrestricted Net Assets, available to support operations, the functions will perform the following calculation: A-B+C = D

|                                                                  |                   |
|------------------------------------------------------------------|-------------------|
| Total Net Assets                                                 | 15,738,449        |
| less Permanently Restricted Net Assets                           | (10,489,557)      |
| less Temporarily Restricted Net Assets                           | (3,622,088)       |
| <b>A Unrestricted Net Assets</b>                                 | <b>1,626,804</b>  |
| Total Fixed Assets                                               | 6,994,634         |
| less Accumulated Depreciation                                    | (5,400,378)       |
| <b>B Net Fixed Assets</b>                                        | <b>1,594,256</b>  |
| Long-term Debt                                                   | 768,443           |
| Current portion, Long-term Debt                                  | 56,788            |
| <b>C Total associated debt</b>                                   | <b>825,231</b>    |
| less Net equity in capitalized fixed assets                      | (769,025)         |
| <b>D Unrestricted Net Assets available to support operations</b> | <b>\$ 857,779</b> |

#### Instructions:

This worksheet supports organizations to calculate their Unrestricted Net Assets available to support operations, as defined above.

There are four steps to consistently calculate this figure: three are pulled from audited financial statements; the fourth is the product of the first three.

For most organizations, inputs should be available from the audited balance sheet. Please use data from the most recent fiscal year.

In some cases, notes to the audit may contain necessary detail to complete the worksheet.

Greyed cells will calculate automatically; cross-check with audits to ensure that inputs are correct.

Enter all values as positive numbers; calculations will be performed automatically and display to the right.

### Net Asset Tracking Tool

Kresge then asked grantee organizations to report progress on their capitalization plans through interim and final reports, and provided them with another tool to help distinguish between unrestricted, board-designated, temporarily restricted and permanently restricted funds. Below is a sample version of the tool developed by TDC.

| Net Assets Tracking Tool                             |             |              |                        |                        | FY 2012          | FY 2011          |                     |
|------------------------------------------------------|-------------|--------------|------------------------|------------------------|------------------|------------------|---------------------|
| Net Assets                                           | Description | Unrestricted | Temporarily Restricted | Permanently Restricted | Total Net Assets | Total Prior Year | Current Year Change |
| Unrestricted                                         |             | 8653497      |                        |                        | 8,653,497        | 5,880,021        | 2,773,476           |
| Unrestricted, for Fixed Assets                       |             |              |                        |                        | -                |                  | -                   |
| Board-Designated - Cash/Operations                   |             |              |                        |                        | -                |                  | -                   |
| Board-Designated - Operating Reserves                |             | 135879       |                        |                        | 135,879          | 412,228          | (276,349)           |
| Board-Designated - Program Reserves                  |             |              |                        |                        | -                |                  | -                   |
| Board-Designated - Facility Reserves                 |             |              |                        |                        | -                |                  | -                   |
| Board-Designated - Risk Capital                      |             |              |                        |                        | -                |                  | -                   |
| Board-Designated - Functioning as Endowment          |             |              |                        |                        | -                |                  | -                   |
| Temporarily Restricted - Time Restriction/General    |             |              | 1673979                |                        | 1,673,979        | 2,544,308        | (870,329)           |
| Temporarily Restricted - Time Restriction/Program    |             |              |                        |                        | -                |                  | -                   |
| Temporarily Restricted - Purpose Restriction/Program |             |              |                        |                        | -                |                  | -                   |
| Temporarily Restricted - Functioning as Endowment    |             |              |                        |                        | -                |                  | -                   |
| Permanently Restricted - Endowment: General          |             |              |                        |                        | -                |                  | -                   |
| Permanently Restricted - Endowment: Program Specific |             |              |                        | 164121                 | 164,121          | 164,121          | -                   |
| Permanently Restricted - Endowment: Facility Support |             |              |                        |                        | -                |                  | -                   |
| Permanently Restricted - Endowment: Other Purpose    |             |              |                        | 2536808                | 2,536,808        | 2,434,308        | 102,500             |
| Total Net Assets                                     |             | 8,789,376    | 1,673,979              | 2,700,929              | 13,164,284       | 11,434,986       | 1,729,298           |

## **Appendix D**

### **Grantee Cohorts**

#### **Facility Investment & Building Reserve Grantees**

Arden Theatre Company  
Ballet Theatre of Boston, Inc. (dba Jose Mateo Ballet Theatre)  
Boston Symphony Orchestra, Inc.  
Center of Creative Arts  
Children's Museum of Pittsburgh  
Citi Performing Arts Center  
Cleveland Public Theatre, Inc.  
Coastal Maine Botanical Gardens  
East Bay Center for the Performing Arts  
EdVenture, Inc.  
Fells Point Creative Alliance  
Florida Studio Theatre, Inc.  
Flynn Center for the Performing Arts, Ltd.  
GALA Hispanic Theatre  
Guthrie Theater Foundation  
Jacob's Pillow Dance Festival, Inc.  
KDHX  
Levine Museum of the New South  
MacDowell Colony, Inc.  
MASS MoCA Foundation, Inc.  
Merrimack Repertory Theatre  
Michigan Theater Foundation, Inc.  
Mississippi Museum of Art  
National Dance Institute  
National Dance Institute of New Mexico  
New York City Center, Inc.  
On the Boards  
Penland School of Crafts  
Rhode Island Philharmonic Orchestra & Music School  
Street-Level Youth Media  
The Henry Ford  
Walker Art Center

#### **Sector Leaders Grantees**

Hancock Shaker Village, Inc.  
Jazz at Lincoln Center, Inc.  
New York Live Arts  
Opera Philadelphia