Nonprofit Finance Fund

Capital Structure Counts

THE BUSINESS ROOTS OF CAPACITY AND MISSION AT NONPROFITS

Capital structure is in and of itself a powerful force in the success or failure of nonprofit enterprise. Although nonprofits exist to fulfill their missions, there comes a point in their development where the quality of their services must be matched by the quality of their business management and an appropriate capital structure. When nonprofits focus single-mindedly on the delivery and expansion of program and neglect the business side, program is eventually undermined. Therefore, most nonprofits work hard to improve their business operations and management. Many do so without thinking about how their overall capitalization needs, in other words, the size and mix of their long- and short-term assets and liabilities, affect their capacity and programs. Capital structure is related to but distinct from program management or operating capacity, but it has a strong effect on both.

We know intuitively that capital structure is central to the success or failure of any enterprise, and that good products, services or management systems alone don't guarantee success. The best-located restaurant with the world's best chef, up-to-date technology and a skilled maitre d' won't succeed without enough well-timed cash and the right number of tables. Moreover, when growth or change occurs, the resource mix at a successful business must change as well. The large number of startup small businesses that fail often do so when they *grow*, and a prime reason is low liquidity (no cash!) due to inappropriate capital structure. The same holds true for nonprofits.

In this paper we will illustrate our observations about the effect of capital structure on nonprofits and the relationship of capital structure to program and capacity-building. We will do so by distinguishing nonprofit organizations' missions from their underlying businesses, then explore a few examples of typical capital structures for these businesses, using graphs. The graphs show that these organizations' assets are distributed in similar patterns as a percentage of total assets regardless of the mission of the organization that owns them, when underlying businesses are similar. We have observed that the pattern in which reasonably healthy nonprofit organizations hold assets is also predictable, within certain businesses, depending on the development stage (i.e., startup, regular operations, growth). This knowledge is

useful for the field in planning growth, making decisions about facilities projects or endowments, and understanding their financial implications.

The allocation of assets (e.g., cash, investments, receivables, plant and equipment) on the balance sheet is used to illustrate the concept here, not to explore the entire potential of this kind of analysis. We do not examine liabilities and net assets, operating finance and other aspects of financial analysis that would provide more richness, including insights into organizational health and cost structure. However, the quick assessment one can gain from looking at asset allocation graphs is a first step toward revealing our basic point about capital structure, and its distinctive influence in nonprofit enterprise.

We have drawn our examples from among healthy nonprofits now in operation with which Nonprofit Finance Fund has had a lending or other financial relationship. The examples provide a useful reference point for defining a few common core businesses and introducing one of a range of indicators of capital structure. Eventually, however, a wider range of data collected and categorized based on typical core businesses can describe ranges of capitalization which, when coupled with program indicators, can help the field form a picture of adequate and optimal capitalization. The theory here is that the ranges of existing capitalization in the field will begin to answer questions such as, "how much does it take to capitalize a (theater, charter school, youth center, workforce development program)?" and to help funders, intermediaries and managers meet needs better.

What does a typical capital structure look like?

Of course, one size does not fit all! Truly useful models of capital structure cannot be static or overly prescriptive. They describe a number of underlying businesses and operating phases (start-up, growth and regular operations) which can be used in combination to describe individual organizations. And they reflect the dynamic nature of organizations by helping predict the impact of change and growth. Not everyone needs to agonize over capitalization, although it is critical when either growth and change is being contemplated, implemented and digested. And no one model applies to all organizations; these are simply principles we have observed in analyzing financial statements. Here are three basic principles, illustrated.

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I. NONPROFITS' CAPITAL STRUCTURES VARY DEPENDING ON THEIR UNDERLYING BUSINESSES.

Different business types in the nonprofit sector have typical balance sheet patterns (something like bar codes). The proportions and relationships of items such as cash, receivables, or plant and equipment as a percent of total assets, tend to be fairly constant, or at least change in predictable ways with changes in or additions to core business.

These "bar codes" exist regardless of sector and discipline, and are roughly identifiable by characteristic distributions of elements of the financial statements, such as assets or earned income. (Many, if not most, nonprofits are hybrids which are made up of combinations of two or more of these business types). Clearly, the balance sheet "codes" are driven by the revenue and expense patterns and vice versa. Patterns are related to mission, but not dependent on it. Other influential variables include income source, size and development stage.

The following chart depicts two sets of organizations by business type and mission type. Each graph summarizes the asset side of the balance sheet by showing what percent of total assets falls into each of five categories: 1) operating cash, 2) endowment, 3) receivables and other, 4) inventory and 5) fixed assets. Operating cash includes all cash, cash equivalents and investments that are available for general use, as distinguished from endowment which represents funds which carry permanent restrictions imposed by the donor. The "receivables and other" category includes accounts, grants and pledges receivable, prepaid expenses, deferred revenue and any miscellaneous assets. Inventory refers to goods held for future sales. The fixed asset category is divided into "land and buildings" (including construction in progress and leasehold improvements), "equipment" (which encompasses program and office equipment, computers, and vehicles), and "accumulated depreciation." In these graphs, accumulated depreciation has not been subtracted to provide a "net" fixed asset total as is commonly used, but has been added to total fixed assets, to reflect the full value of buildings and equipment, providing greater comparability among organizations with facilities of varying ages.

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Those organizations which have similar businesses have similar distributions of assets on their balance sheets, even when they have divergent missions and operate very different programs. And those in the same mission/program area display marked differences because their underlying businesses are not the same.

The three organizations grouped in the first column of the the following chart are in the business of selling (or renting) seats; those grouped in the second column are in the business of deploying people to provide a service. They are paired under three program areas (i.e., arts and culture, education and social services). One common variance from this rule, shown intentionally within this example, is that receivables dominates the social services example, not cash. This is because it receives most of its income from government or other third-party payors who reimburse, and generally slowly, after the service is rendered.

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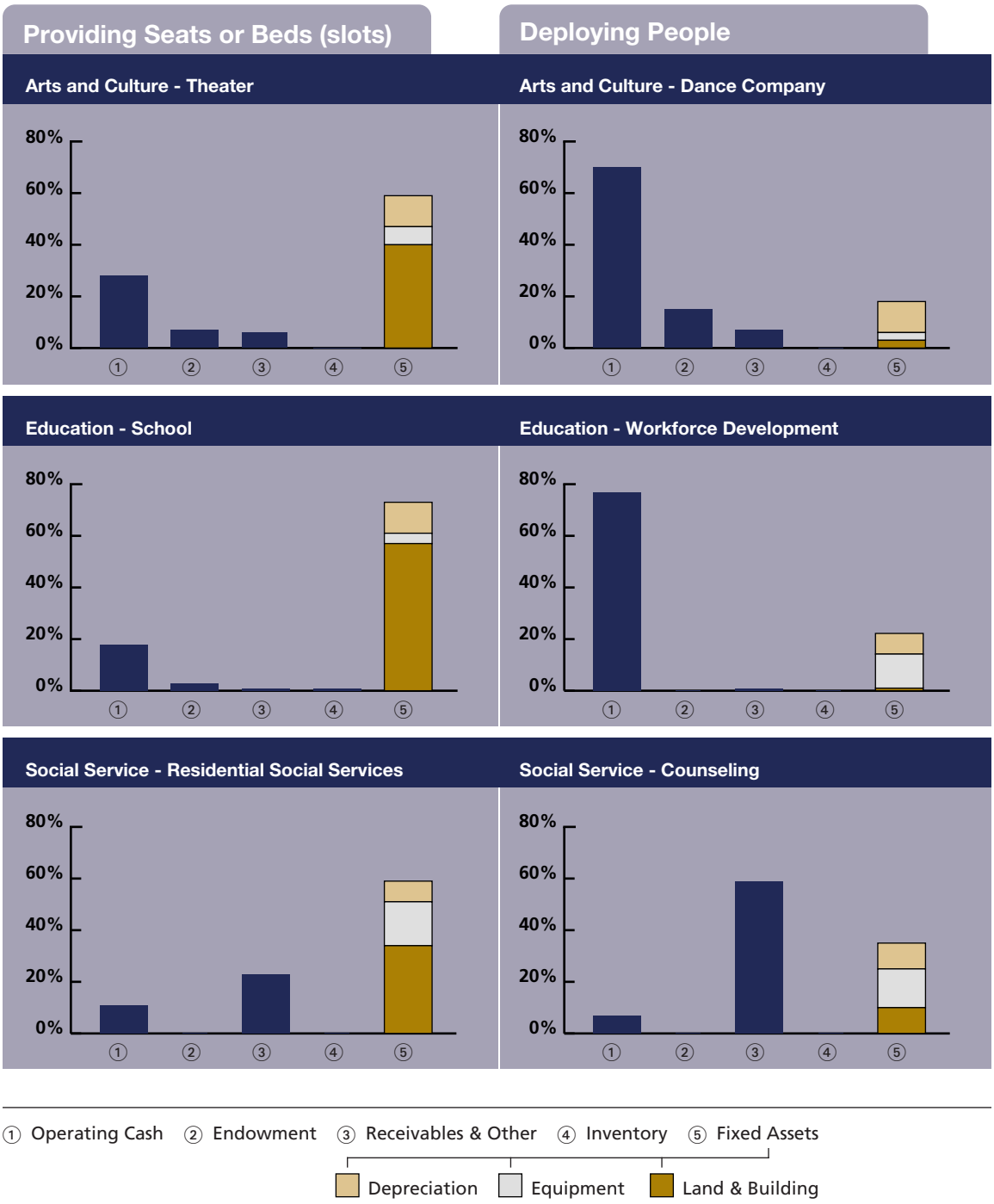
Asset Allocation by Business and Mission



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The graphs of asset allocation are comparable for all the organizations in the "seat selling" and all those in the "people deployment" business whether they have programs in the arts, social services or education. In other words, sample organizations within a business type are more similar to one another than those within the same programmatic area. (Clearly, those with a similar business and program would be most similar). But sector alone is not an indicator of similarity of underlying business. *Therefore, financial decisions and management support for these organizations—as opposed to program, mission or market aspects—must be undertaken from the perspective of the underlying business or businesses*. Most of the field's capacity building and financing programs group them only from the point of view of mission.

In the preceding chart, the arts and culture organizations are, respectively, a theater company and a dance company, both performing arts organizations. The former owns and operates its own theater, meaning that it has made a large investment in plant and equipment to house these seats and other parts of its operations. This is reflected in the large bar that dominates the right hand side of the asset allocation graph and represents about 60% of assets for the theater. Its business is dominated by the number of seats it can fill, or from another perspective, the degree to which it can bring in revenue driven by its dominant asset, real estate. Because the real estate houses a leading theater company, its program is the main attraction to the seats. Like all audience-driven organizations, productions must attract audiences or risk losing revenue. But unlike those that don't own seats, the theater bears the fixed expenses of those seats whether they are filled or not.

From another perspective, the theater's need for subsidy—in the form of grants or income from other sources—comes from the cost of the seats it cannot sell. When added to the cost of productions (which is more variable), the unsold seats begin to illustrate the effect of capital structure on sustainability. For example, because the cost of real estate is fixed (e.g., debt, repairs, security, utility bills, cleaning), while income from seat sales is variable, the real estate cost must be paid whether there is income from ticket sales or not. This in turn affects the amount of funding available for productions—it comes from the net available from ticket sales, plus fundraising income. If the theater is highly dependent on ticket sales for net revenue because of this high fixed cost load, it may affect the ability or willingness of the organization to take audience risk. Nonprofits that own real estate and have grasped this relationship often mine their real estate for income: parking garages, shops, restaurants, rehearsal space rentals are examples. However, each of these businesses comes with

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its own costs and adds to management complexity, and operating more of them increases the degree to which the nonprofit is in the real estate business.

The point here is not that real estate is bad, simply that making the decision to put cash resources into it affects capital structure and, therefore, cash availability, management capacity needs, and programming choices. Because cash availability is the primary hedge against risk (or enabler of risk-taking), putting resources into fixed assets changes an organization's risk profile, financially and programmatically. The financial decision to allocate assets toward real estate in turn affects the ability of an organization's programs to take risk in the form of productions that are expensive or potentially have narrow audience appeal.

The graph on the preceding page is of a dance company that presents dance in leased venues, with bookings in its home city and elsewhere around the country and the world. While it needs some fixed assets, such as leasehold improvements for its office and rehearsal space, it concentrates on providing people to perform dance and, therefore, cash (to pay people) dominates its balance sheet. Its risk becomes that of not being able to find venues or keep its company together if revenues do not cover the fixed cost of employing dancers. However, it does not have as high a "nut" of fixed costs for the dance production revenues to cover, and in very straitened circumstances it may be more possible to lay off personnel temporarily than to reduce fixed cost of real estate. Its risk becomes, much more narrowly, audience risk.

These two organizations have similar revenue patterns, with substantial portions of earned revenue from, for example, ticket sales reflecting that their revenue is audience- or market-driven to a larger extent than some other nonprofits. This in turn affects cash, receivables and other aspects of the balance sheet. While the interrelationships here are complex, one possible indicator of the effect of the differences in facility-derived fixed cost is the differences in percent fundraising (subsidy) as opposed to earned revenue. Both operate at approximately break even, but the theater gets 45% of total revenue from public support (55% earned) while the dance company raises 30% (70% earned). The dance company is in one business—people deployment—while the theater company is in two—people deployment and selling seats, and the latter has come to dominate its financial picture. This comparison between the theater and dance company shows that differences in the pattern and level of capitalization of these two organizations means that they face very different

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financial and capacity-building challenges, and that their decisions about how to deploy assets can create financial risk quite apart from the risk inherent in market.

The other program areas represented in the example have similar patterns, areas of risk and challenges. The elementary school depicted in the graph has assets dominated by school buildings, which it must carry whether children are enrolled in the school or not, and whose desks parallel the theater's seats; and the residential social service agency is similarly facility-intensive because it provides beds and social services for developmentally disabled people. Whether it is a theater seat, a desk or a bed, these organizations do not receive revenue unless it is filled, and that means there are real similarities in certain funding, financing and management needs.

Among the organizations that have a preponderance of cash on their balance sheets, those analogous to arts organizations in education and social services are, respectively, a workforce development (job training) program and an organization that provides social workers for counseling. Their asset allocation graphs are virtually the same as the dance company, and from a business perspective (not market or mission), they are similar. They deploy people—to dance, to be trained, to train others, and to counsel people. One key difference is that one of them, the counseling organization, has a tower of receivables rather than cash on its balance sheet. This is because they receive most revenue from government sources (which pay for services on behalf of people who cannot afford them). This almost invariably means that the organization in question swaps the dominant cash bar for a dominant receivables bar on the asset allocation graph, because the government and other third-party payors providing this revenue pay their bills slowly. Organizations with revenues from ticket sales or tuition are less likely to have very high operating receivables because the user pays for the service before or at the time that it is provided (but on the liability side of the balance sheet they are likely to have deferred revenue representing advance ticket sales or tuition income, indicating an obligation to provide a performance for which they have already been paid).

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II. WITHIN AN UNDERLYING BUSINESS GROUP, CHANGES IN PATTERNS OF CAPITALIZATION ARE PREDICTABLE AND DIFFERENCES EXIST WITHIN A RANGE.

When two underlying businesses are similar, asset allocation graphs and other balance sheet and income statement factors tend to be similar as well. When the patterns vary within the same business grouping, they usually vary within a predictable range, and the differences tell a story. An organization's place within these ranges gives stakeholders insights into changing management and financial needs, probable impact of growth (or another stage of development), undercapitalization or both. Additional information on a group of like organizations can reveal where individual organizations stand in relationship to their peers from a *business* point of view.

The application of some straightforward ratios (such as amount of cash per person served) can provide insights into the impact of those relationships on program. Moreover, this kind of information can help identify patterns of undercapitalization and disinvestment not only in one organization, but also throughout a mission-related group. Data of this kind can answer the question, "what does a well-capitalized youth server, school or theater look like, given the same business strategy?" This establishes a baseline for managers, funders and people advocating on behalf of the end users. The following chart shows the asset allocation graphs for four financially healthy organizations with the same underlying business: providing youth services. They are of varying sizes and have different markets ranging from inner city to suburban. Their buildings, which they all own, are an important part of their strategy for youth development and include some combination of game rooms, gyms, theaters, pools, computer labs and study areas.

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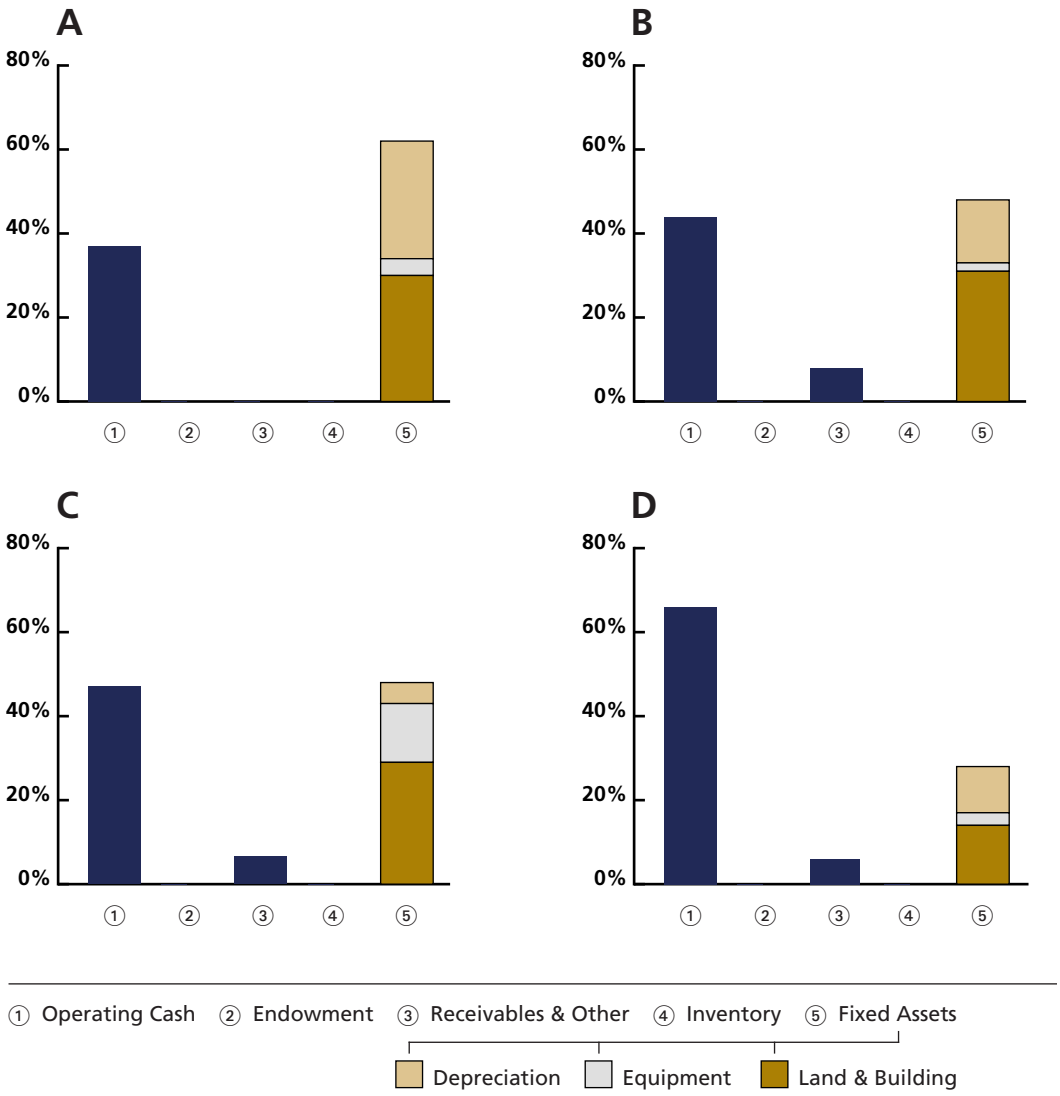
Asset Allocation for Youth Centers



The graphs of asset allocation above reflect how much these organizations have in common: the graphs are dominated by operating cash and fixed assets. These youth centers need cash to meet their most significant expense, payroll, and they have made large investments in the buildings that draw youth to their programs.

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The centers fund their operations through a mix of private grants, contributions, and user fees, so they have little in the receivables column that would dominate the assets of a government-funded social service operation.

Graphs A, B and C illustrate the typical ranges for organizations with similar characteristics. Although the youth centers range in budget size from $500,000 to over $7 million, the shapes of the asset allocation graphs are similar. Fixed assets, including depreciation, range from 48% to 63% of total assets; cash represents 37% to 47% of total assets.

Graph D, however, has levels of cash and fixed assets which fall outside the typical range because of its particular, and temporary, circumstances. The graph for this center demonstrates how the phase of development—including startup, growth or regular operations—show graphically. In this case, the stage is growth. Graph D represents a youth center with 66% of its total assets in cash, but only 28% in fixed assets. It is, in fact, at the beginning of a capital campaign to renovate and expand its facility, holding cash that will be invested in its building. When this youth center has completed the capital project, it will need to return to its steady-state asset allocation with its balance sheet showing more fixed assets and less cash. Thus, it will once again fall within the typical range.

III. ORGANIZATIONS NEED TO MAINTAIN BALANCE TO BE SUSTAINABLE WHEN GROWTH, CHANGE IN BUSINESS OR BOTH OCCUR.

In our experience, nonprofit organizations exist in a kind of dynamic balance. Although they are changing constantly, and managing within predictable business cycles, they must maintain the balance between program and business, and balance the business itself to be sustainable.

Notwithstanding the crises and challenges of small organizations, our experience has been that they are remarkably stable *if they stay small*. Whether they have formal management systems or not, they can develop remarkable programs and survive over time on a combination of luck, grit, passion—very good things! Their capital structures are simple, related, quite straightforwardly, to paying a small group of program people. Adding a program, a building or a large investment in technology, however, throws them out of balance and this in turn permanently changes

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their cost structure, their need for unrestricted cash, and the net results of their operations. Some organizations grow, move toward becoming institutions and are bedeviled by the need to develop their capital base while building both program and management capacity.

When one part of an organization changes, other parts must change as well for the organization to maintain equilibrium. As organizations expand or contract their programs, these changes have a direct impact on their income and expenses, and most of the field recognizes and plans for these changes through straightforward budgeting. A youth organization providing educational enrichment that leases additional classroom space to serve more youth is one such example.

Analyzing the phase of development, therefore, on top of business type is especially powerful. Therefore, to project changes during growth, return to equilibrium, or to accommodate growth or a change in business, it is useful to map an appropriate balance sheet as well as income and expense. Not only can we project what the fully capitalized organization will look like when growth takes place (and in regular operations after it has taken place), we can project it with the additional business in its start-up mode.

This analysis reveals the little-recognized but powerful impact of growth which occurs when an organization experiences *both* program growth *and* the addition of another business under its organizational umbrella. Examples abound: the acquisition by a "people deployment" business (such as home care or workforce development) of real estate that must be supported by seat or bed sales, or a theater that owns a facility and starts a touring company. Growth both creates and demands changes in capitalization that will appear as changes to the balance sheet, and these changes, if not taken into consideration, can be destabilizing. Here is an example of changes that might transpire in a balance sheet as growth proceeds.

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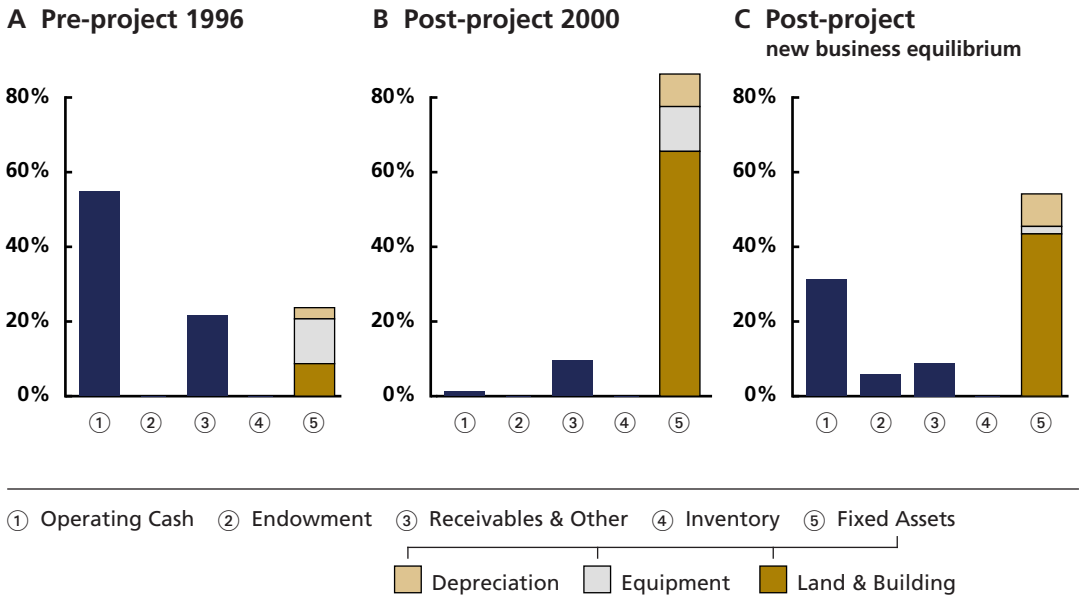
Asset Allocation through Phases of Growth



The example of growth illustrated in the three graphs above shows the impact of a major facility project on an organization's asset allocation. The organization in this example is a health clinic, which had operated from rented space with revenues drawn primarily from grant support and patient fees. The organization used debt to purchase and renovate a new facility, which allowed it to expand its level and scope of services, and more importantly, allowed the clinic to receive government reimbursement for patient services for the first time. By undertaking this project, this organization has not only increased its service level, but also added a new business -- government-reimbursed health care -- driven by filling "slots" at a facility. A progression of changes in the balance sheet maps the financial changes as they unfold.

Graphs A and B show the clinic's asset allocation in the year before the facility project began (graph A), and immediately after the facility project was completed (graph B). The total assets of the organization rose from $2.1 million to $11.5 million. The dramatic change the clinic experiences is reflected in the changing shape of the graphs – the organization begins with high levels of operating cash, and ends with a balance sheet dominated by its fixed assets.

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The post-project graph B reveals an organization that is at least temporarily de-stabilized by shifting its resources from cash to building. Having constructed a facility that will allow it to expand its services, the clinic needs to replenish its cash for working capital to sustain its operations and build additional cash reserves to care for the building. In this example, completion of the facility project actually marks a change in the clinic's business – in addition to its private funding sources, it now relies on a significant amount of government reimbursement for patient services, and it has become more real estate-driven.

Graph C shows what a new, sustainable equilibrium for the clinic might look like. Imagine that the clinic financed most of the cost of its facility project with debt, but also conducted a capital campaign to generate funds to sustain the increased scale of its operation. Its receivables are higher, reflecting the new revenue that comes in, slowly, from government reimbursement. But, since the clinic has a higher level of available operating cash in this new equilibrium, it can avoid cash flow crises when it has to wait for government payment received long after services have been delivered. The clinic has also built its operating cash in preparation for the increases in its fixed costs that the new facility entails, to meet the debt service payments it will make and the costs of ongoing care and maintenance for the building. The clinic has prepared for the future by including in its capital campaign funding for an endowment designated to care for its building. Graph C shows an organization that has successfully avoided the potential pitfalls of several, simultaneous, major changes.

It is striking, also, to consider the similarity of the graph of the dance company on page 5 and the resident theater company on page 5 to the clinic before and after the project. If the dance company were to acquire a theater, its equilibrium, for healthy operation, would probably resemble "graph C" of the health clinic on the preceding page.

How might we develop and apply these concepts and principles?

In start-up, growth and the regular operations stages of nonprofits, capitalization ranges will aid in decision-making and resource allocation. Understanding the impact of money, especially capital funds, on programs can relieve some of the pressure on leaders of nonprofits to "manage better" when the root cause of some of the challenges they face lies in imbalances in the distribution of assets. Managers can

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use the capitalization ranges to answer funders' perennial question, "how much do you need?", without resorting to the dart board, wild overstatement or similar time-honored techniques. For funders, understanding the implications of nonprofits' underlying business and capital structure can help in decision-making by separating program and mission-related analysis from the critical analysis of how money will affect that program.

Capitalization data can provide "industry norms" to the field which, when coupled with program indicators, give a sense of how resources are spread in relationship to program needs. It can be useful to grantmakers and managers alike to address questions such as, "is the capitalization of this organization unbalanced and in need of bolstering in a specific area?", or "what kinds of program should we expect from an organization with a capitalization at the top of the heap?"

The research and development business within a for-profit corporation may not be expected to turn a short-term profit—or become "sustainable"—but contributes to the ongoing innovation and improvement of the products and services of the more profitable sides of the business. All nonprofits do some research and development, but some do it as their primary business: advocacy, basic research, experimental theater, for example. Capitalization models can show optimal versions of these organizations, test programmatic indicators and help them avoid taking on an inappropriate or distracting business for the sole purpose of growth or institutionalization.

Scale is difficult to attain for for-profits; it is a major undertaking for nonprofits. Business models that set out the reality of growth, and the limits to certain growth models with respect to program quality, can help us manage expectations, and avoid expensive missteps on the path to growth. An understanding of capitalization can be particularly helpful to the mid-sized nonprofits that comprise the fastest-growing segment of the sector. This segment boasts savvy, resourceful managers who operate in a highly complex environment where rapid growth is the rule. This environment, like that of the sector as a whole, is complicated by the fact that growth almost always reduces profitability, even though their growth is often a direct result of program excellence. Growth tends to put the most stress on these programmatically excellent organizations. Not surprisingly, such organizations are the focus of countless capacity-building programs, most of which ignore capitalization.

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Conclusion

None of the principles outlined in this paper is even faintly radical to management practitioners in the for-profit sector. Industry "comparables," optimal capitalization models and a consciousness of capital structures are commonplace tools for managers and contribute to the for-profit sector's ability to grow, manage and get results. These are difficult challenges for any enterprise, nonprofit or for-profit. It is, therefore, even more remarkable that in the nonprofit sector, where the challenges of growth, management and capitalization are formidable, that this knowledge and these tools, are by and large absent, indifferently analyzed or studiously ignored.

By focusing here on the underlying businesses and capital structure in the nonprofit sector, we are taking a first step toward illuminating another vantage point from which to examine nonprofits and develop the potential for more comprehensive funding and capacity-building practices for the field.

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