National Capitalization Project 2010 Summary

A project of Grantmakers in the Arts

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Grantmakers in the Arts
Supporting a Creative America

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Background

In January of 2010, Grantmakers in the Arts (GIA) launched its National Capitalization Project (NCP). Formed in response to the observation that it has been the norm for the nonprofit arts sector to be poorly capitalized, the project convened representatives from 16 regional and national funders of the arts (some of whom had been in conversations about capitalization for nearly two years before convening), five subject experts and GIA staff in two intensive working sessions to learn together, and to begin a conversation about what funders might do individually and collectively to address this long-standing condition. The first of these sessions was held at the Ford Foundation in April 2010 and the second at the Hewlett Foundation in July 2010.

At the end of the first session, participants agreed that foundations do not have all of the levers to institute sweeping change nor the requisite funds to capitalize the arts and cultural sector as a whole. They do play, however, a pivotal role as leaders and key supporters of this sector regionally and, for some, nationally. The group made note of an important and timely opportunity to promote knowledge and, more importantly, changes in funding practices amongst themselves and, thereby, behavior amongst their grantees. Such a shift in behavior and practice could lead to striking changes in the capitalization and financial sustainability of individual institutions and the sector more broadly. Several agreements about possible actions that arts funders might take emerged during this first working session:

- Emphasize the importance of the balance sheet in how we fund.
- Promote the efficacy of a surplus to capitalize an organization, and not penalize those that create surpluses or build reserves.
- Distribute the knowledge and tools that have been developed over the past twenty years to the field, and support our own and grantees' effective use of them.
- Improve arts and cultural organizations' and arts funders' own knowledge of markets — both capital markets at play in the sector as well as local and regional marketplaces for the arts, and
- Promote mature conversations with grantees about the relationship between artistic vision, key programmatic strategies, capitalization and financial sustainability.

To prepare for the second session, all the participants were queried as to desired outcomes. Importantly, there was a clear call for actionable steps with respect to strengthening arts and cultural organizations' capitalization and financial sustainability. This call to action was echoed by the experts the group had consulted, who reminded us that there is much knowledge and experience upon which to build. They also encouraged us to focus first on the role that arts' funders play in the field. As such, we challenged ourselves for the second session to consider simple, collective steps that funders could take (before asking what our grantees should do) that could have a profound impact on the financial health of arts institutions and the strength of the field as a whole. What emerged from our work together is a set of strategies that are both basic – what we hope every funder could agree to implement – and aspirational, those that we hope all will consider. Both types of strategies are outlined in this paper. They are the result of several days of concentrated learning benefitting from a broad ranging literature review and vigorous discourse and debate. We are eager to share our ideas with our colleagues, and begin what we hope will be an ongoing and vibrant conversation about capitalization at the GIA, one that we hope will result in broad reaching change for the field.

What Did We Learn?

Capitalization

First, a definition: capitalization is the accumulation and application of resources in support of the achievement of an organization's mission and goals over time. A well capitalized organization has the ability to access the cash necessary to cover its short- and long- term obligations, to weather downturns in the external operating environment, and to take advantage of opportunities to innovate. All capitalization is represented on the organization's balance sheet, which encapsulates the record of an organization's financial performance as net assets and measures the magnitude of its assets and liabilities. By building their net assets through years of surplus operations, organizations develop the capacity to plan for the future, react quickly to new opportunities, and support missions that require major fixed assets and a long term view. An organization's appropriate scope and scale of capital structure can only be determined after an examination of an organization's time horizon, core business model drivers and lifecycle stage, which are interwoven. A clear understanding of an organization's market provides critical context which informs how these factors play out.

Why does capitalization matter? While the National Capitalization Project has been framed in terms of financial matters, all of these issues ultimately link back to an organization's mission, and to fulfilling an artistic vision. At the simplest level, we concluded that to pursue its artistic mission most effectively, an organization requires two main supporting financial elements: a sustainable business model and the capitalization needed to support it. A sustainable business model must align to the mission. Clarity about mission helps to focus leadership's attention and the organization's resources on the products, services and projects that align to that mission. And of course, without a sustainable business model, nonprofit arts and cultural organizations will steadily eat into their capital reserves over time, putting their survival at risk.

The group's immersion into the literature surfaced a few overarching observations about business models and sustainability that both informed and guided our thinking:

- By their very nature, nonprofits are not naturally profitable because they have arisen from a failure in the private sector market (Nonprofit Finance Fund 2009). In essence, if it were possible to cover the full costs of producing a certain good or service, the private sector would have stepped in. Performing arts organizations lend themselves particularly well to the nonprofit form, given their high fixed costs and a limited audience (Hansmann 1981).
- An organization's business model is not static, causing its funding and capitalization needs to change over time. Clara Miller's case study, we found, on how the Steppenwolf Theater's business model shifted in response to a new facility is an example of this point.
- A sustainable business model is likely one that generates a surplus rather than simply breaking even each year. Organizations require an annual surplus in order to build fund reserves (Tuckman 1991).

This final point is particularly important, we would observe, because it seems to run counter to what has for many years passed for the conventional wisdom among arts funders as well as grantees of striving for breakeven budgets. This observation, as well as others, served to shape key elements of the platform from which group participants constructed their recommendations for change.

The group spent considerable time reviewing different kinds of markets which impact the nonprofit arts and cultural sector. One type of market is for the provision of cultural activities in a community or the "arts market." We noted that the total number of arts organizations has grown dramatically in recent years, as has the size of many individual organizations. The growth in the sheer number of organizations has, in many communities, outpaced the public demand meaning that groups have not benefitted from an increase in public interest and attendance. Where individual institutions have grown in size without fully understanding the marketplace for the art, it has compounded the issue of oversupply. This is particularly challenging in the current economic climate where neither the public interest nor the financial resources exist to fully support an organization's activities. Organizations facing such situations need to seriously consider their appropriate scale and scope. In general, however, organizations must consider their arts market and size themselves appropriately, an action the group agreed funders should encourage.

The group also delved into the question of capital markets within the nonprofit sector, and arts funders' relationship to them. The literature review highlighted the fact that much of the writing about capitalization and nonprofit capital markets borrow terms like "equity investors" or "equity investments" that may not apply to nonprofits. Borrowing from Clara Miller's work, we discussed two types of investments that may be more applicable to nonprofits. Among arts funders there are those who invest to "build" an organization and those who "buy" a product or service. Grants used to build can be seen as *capital*, and the support an organization receives in exchange for its products or programs should be viewed more appropriately as *revenue*. Both are needed, but they are essentially different strategies.

Finally, in our conversation about capital markets we repeatedly came back to the fact that the most common source of capital is accumulated surpluses. We agreed that getting organizations to achieve a surplus would require encouraging a significant shift in nonprofit practice and culture, a challenge we thought well worth undertaking.

Seeding A Change

Why Now?

Grantmakers in the arts have a timely opportunity to address the capitalization of arts and cultural institutions. Why now? After all, persistent undercapitalization has existed for some time.

Of course, the current economic climate has thrown the ramifications of poor capitalization into sharp relief, underscoring the need for strong balance sheets that are able to withstand economic downturns. The same market downturns that have damaged grantees' endowments also hammered donors' portfolios, with repercussions on contributed revenue as well. But, the economy is not the only factor that urges us to act. Another important factor is the changing behaviors of arts patrons, particularly their level of demand. At a time of flattening demand there is increasing supply, as noted above, in terms of both the sheer number of organizations and the supply of product. Neither the audience nor the public or philanthropic sector can support this level of oversupply. Taken together, this situation is pushing organizations into hyper-competition. In the process, their balance sheets are stressed to keep up with their agendas.

If our goal is to ensure the artistic vibrancy of the sector over time, then focusing our attention and that of our grantees on these issues, as well as the importance of a strong capital structure, is critical. We recognized that for efforts to encourage better capitalization practices to be successful, such practices must be embraced sector-wide. Doing so will require a change in the culture of nonprofits where institutional leaders have been neither accustomed nor encouraged to achieve surpluses or better than breakeven budgets. It will require ongoing attention to the balance sheet, for there is no end point for capitalization; rather organizations must always consider the interaction between operations and the balance sheet and how a change on one side impacts the other. We believe that organizations must drive their own efforts to become better capitalized. We would wish that organizations would be able to articulate their own unique needs and circumstances and demonstrate the importance of capitalization in their conversations with grantmakers, but recognize that we have a role in allowing them to do so.

The Funders' Role

Of course, we recognize that nonprofit arts and cultural organizations reside in an ecosystem in which arts funders and other arts supporters play important financial and influencing roles. If we envision that encouraging better capitalization practices requires sector-wide acceptance and change, then arts funders too have a significant role to play. We asked ourselves: How might we best respond?

While arts funders have enough money to address the capital needs of many organizations, they do not have the resources to capitalize the sector as a whole, nor would it be appropriate, we believe, for them to do so. Nonetheless, while funders, individually or collectively, may not be able to nor wish to contribute the amount of capital required by the sector, we agreed that we are able to change, through our interactions with and requirements of organizations, how grantees think about and behave with respect to capitalization.

The working group also considered the practices that arts funders have adopted over time which have inadvertently contributed to the chronic undercapitalization of the sector. Some of these practices include:

- Funding projects without full consideration of their impact on the whole organization's budget or capacity;
- Encouraging organizations to run breakeven operations, thus discouraging the generation of surpluses or even penalizing the accumulation of reserves; and,
- Underfunding or not funding overhead in project grant budgets.

Within our funding community, we see a great deal of diversity. Each of us is characterized by a set of values articulated by our founding charters, our original donors or by subsequent boards of trustees. Some of us are regional in scope; others are national or even international. And, we each have somewhat different interests in the arts — some supporting the sector broadly and others focusing on particular disciplines or subsectors. These various philosophies underpin the types of grants we make and the relationships we establish with grantees. How then, we asked ourselves, might we change the capitalization picture among arts and cultural organizations? Ultimately, we agreed that key to improving capitalization and financial sustainability is for funders to change the conversations they are having with their grantees, and to shift away from certain practices.

Ultimately, our discussion of this complex set of circumstances and influences resolved into the following synthesized statement of intent.

Our Hypothesis

If we agree:

- that arts and cultural organizations are undercapitalized which leads us to be concerned about their sustainability and the financial health of the sector as a whole, and that persistent undercapitalization has the strong potential to erode artistic vision and quality;
- that there is an oversupply of product in some marketplaces, and that current funding practices do not address this issue;
- that within the nonprofit system, both funders and grantees have not made significant progress in addressing either issue;
- that behaviors need to change on both sides of this relationship;
- that funders have influence beyond their actual dollars; and,
- that tools, education, and technical assistance are useful but not sufficient to address the issue.

Then:

- Funders need to hold themselves and grantees to a updated set of standards with respect to capitalization, and adopt a new set of practices and incentives in grantmaking.

Further:

- In order to impact the sector, it will not be enough for individual arts funders alone to promote these principles. Rather, <u>success will only be achieved by a group of funders coming together to understand and promote a common set of principles and behaviors in their grantmaking and by agreeing to have a different conversation with grantees</u>.

What Might Success Look Like?

We posit that if we change the conversation, funders and grantees would have a mutual understanding of what it would take to achieve the annual operating goals or project goals in the context of the larger organizational agenda. This does not mean every funder needs to make direct balance sheet investments, but rather creates an expectation of raising or evaluating the issue as a part of their grantmaking agenda. By posing these questions, funders would engender conversations between executive directors and their boards that consider capitalization strategy and how it supports artistic mission and vision. Arts funders' boards and their leaders would be having similar conversations. A mutually reinforcing system of education, tools, data and incentives that would promote effective capitalization would result.

How might we do this? What might be the common set of practices that we could share?

A Common Set of Practices

Encourage surpluses and operating reserves

Good capitalization hinges on the generation of surpluses which can be used to create the various capital funds that an organization may need for successful mission achievement. For example, a theater that is committed to innovative works that are artistically ambitious but that does not have a cushion – be it in the form of a risk capital fund or even operating reserves – can be hamstrung when selecting shows to perform. If its survival is dependent on a financially successful season (high levels of earned revenue), it may not be able to fulfill its artistic mission which calls for taking risks. Reserves and/or accumulated surpluses can also help organizations weather downturns in their financial fortunes without compromising the art or impacting their internal capacity.

Organizations have varying needs, and we do not want to be prescriptive about how to spend surpluses. Rather, we can encourage the generation of surpluses and encourage organizations to consider their own capitalization needs even in the midst of challenging economic times.

There is, however, a perception that in the eyes of funders, the presence of surpluses or reserves is an indicator of low need. This is one perception that we can change.

We also understand that in the current economy, achieving a surplus can be difficult for organizations. While we may highlight it as a best practice or make it a requirement in the future, we understand the pressures that organizations face. The first step we can take is promoting the efficacy of surpluses and reserves through our own actions. These actions may include:

- Seeding a reserve fund;
- Budgeting for a surplus in grants by providing additional funds (ie, grant $15,000 if $10,000 is requested); or,
- If awarding a project grant, providing administrative overhead.

Take the long view and embed capitalization principles in conversations

Capitalization, by its very nature, takes the long view of an organization's financial health, since the balance sheet is the organization's historical financial record. By emphasizing the importance of an organization's balance sheet, we can encourage organizations to consider financial trends in determining their capital needs.

We are equally committed to a conversation among funders as well, both at the regional and national levels. By consulting with one another, sharing knowledge about the capitalization needs of grantees and local and regional ecosystems, and harmonizing our behaviors, we can address the arts field in a cohesive way that minimizes confusion for grantees. The emergence of the Cultural Data Project is one tangible example of how a consistent and streamlined reporting process can reduce the impact on grantees while better serving the needs of funders.

Encourage organizations to right-size

We mentioned above the asymmetry between the demand for arts in the marketplace and both the increased number and size of arts organizations. In part, this is a product of arts organizations and their supporters not fully understanding their marketplace. By encouraging organizations to right-size, (not simply to down-size) we are asking them to take a close look at their marketplaces and position and scale themselves accordingly. An adjustment in scope will necessarily have an impact on an organization's balance sheet, as it will bring into better alignment potential revenue (both earned and unearned) and expenses for activities that respond to marketplace interests. A funder can encourage this type of holistic thinking through both informal conversations as well as how they may structure their guidelines and requests for information.

Right-sizing should also take into account the organization's business model, which should be seen in the context of a clear market analysis. We would like to encourage organizations to think comprehensively about their place in their local arts market. The framework of zero-based budgeting can be helpful in encouraging organizations to continually evaluate the relevance and effectiveness of their activities. It eliminates the assumption that existing programs and activities will continue, regardless of evidence that they have found an audience or meet unique needs in the market.

As funders, we are asking not only organizations to think about their appropriate size and scope. We too can be aware of these issues when evaluating grants to ensure that our grants do not exacerbate existing misalignment in a way that may eventually negatively impact an organization's balance sheet. At the same time, we need to acknowledge that the speed at which organizations can reposition may be challenged by fixed costs such as buildings and collective bargaining agreements.

Offer general operating support

We all agree that healthy capitalization requires unrestricted operating support. Providing such support, often in a multi-year context, is the most directly effective means of enabling the operating surpluses that will build capitalization. Operating support provides organizations with the flexibility to address what they determined to be their highest need and allows them to respond to changes in their environments.

However, not all funders have the ability to offer unrestricted support, or find they have conflicting goals that must be addressed. In these circumstances, it is important to consider how project-based funding will impact the balance sheet position, as described more fully below. The shared commitment is to ensure that all types of support further the mission and capitalization strategy of the organization.

Project support should be targeted to core mission and fully funded

We made a key distinction when discussing the state of capitalization of arts organizations: in some cases, the level of capitalization has been out of alignment with activities and mission, rather than simply a matter of too little capital. In other words, problems have arisen when organizations are asked to do too much for the resources that they have. To address this, we must first ask ourselves: whose goals are we funding?

Ideally, we will fund where organizational and arts funders' interests align and organizational capacity exists. If a program supports our goals as funders but would be a programmatic or mission stretch for an organization, we must support it adequately, to ensure that core commitments are not compromised. Arts funders' guidelines should reflect the following in this regard:

- Understand the total cost of projects and the real cost to organizations. Promote honest conversations with grantees about funding needs to encourage a mutual understanding of real costs.
- Fund at the full request or in partnership with firm funding sources so that the work can be fully realized, or do not fund at all. Inadequate funding may result in organizations shifting funds from another part of the organization, which has an overall negative impact on the balance sheet. A strong balance sheet is the goal of capitalization.
- Provide the appropriate overhead to ensure that full costs are supported, without creating new burdens.
- If we initiate projects, then we must endeavor to fully fund them.

This is not to say that there are not certain projects which may be unrelated to an organization's mission, but still central to financial health. For instance, constructing and running a parking garage may not be an organization's mission, but could be important as a revenue stream or a service to audiences. In these cases, we must consider the proposal in the context of the overarching goal, to strengthen organizational capacity, rather than diminish it. Judgments about grants can be made accordingly.

Be clear about the structure and timeline of grants

We recognize that in the course of conversations with grantees, we may be clear and explicit about the grant agreements, but that our behavior may send a different signal. Many of the strategies above are about addressing both our conversations and our actions. We must understand the impact of each on grantees' expectations and be thoughtful when changing direction. For example, by giving single year grants year in and year out, a funder will become, de facto, a core supporter. Withdrawing that support in a single year may be shocking to an organization, despite spoken and written agreements.

We owe organizations consistent notice. We must be responsible and understand how grantees plan to use our funds. In the case of new ventures or facilities, we can ask organizations to have an exit strategy for the end of the grant period. This will require planning and a clear understanding of an organization's own capitalization strategies.

Extending Our Conversation

The ultimate goal of the National Capitalization Project is to ensure the continued artistic vibrancy and strengthen the financial health of the individual arts institutions that comprise the nonprofit arts sector. Our intensive review and study of the history and current state of capitalization practices among arts organizations, and our subsequent discussions about the influential and contributing role that arts funders can and currently do play with respect to the capitalization picture has encouraged us extend the conversation to more of our colleagues.

We are looking forward to beginning this conversation at the GIA meeting in October in Chicago.

At the conference we will have the opportunity to immerse ourselves — to learn, to debate and test the impacts of changing those practices which undermine effective capitalization. This topic will be reviewed at a plenary session, and at facilitated small group discussions and workshops; resources will also be available. As you consider the materials we have shared, and attend these important working sessions, we would ask that you reflect on your own practices and funding strategies as well as your grantees and the communities in which you work. Consider how shifting capitalization practices might change the picture you would paint.

Project participants of course recognize that by shifting arts funders' practices, the state of capitalization among arts organizations will not change overnight. As we have noted, strengthening the balance sheet requires taking the long view, and building asset strength over time. We believe, however, that by educating ourselves and our trustees, by starting the conversations with grantees, asking the right questions, changing key policies and practices and removing disincentives, we can contribute to changing practices among nonprofits, which will build a healthier arts sector nationally and in our communities.

NOTES

1. For more detail on capitalization and the balance sheet, see the attached Glossary of Terms.
2. See the Grantmakers in the Arts National Capitalization Project Literature Review (April 2010) for a full review of the subject.
3. There are six distinct types of capital funds (operating funds, working capital, operating reserves, capital improvement reserves,

endowment, and risk capital) that managers can use to maintain organizational health. For more on these, please consult the attached Glossary of Terms

4. The group's immersion in the literature and research was supplemented by participants' recognition and understanding of the lessons learned from the National Arts Stabilization Fund which was supported by the Ford Foundation and others.

Key Capitalization Terms and Definitions

Capitalization is the accumulation and application of resources in support of the achievement of an organization's mission and goals over time. A well capitalized organization has the ability to access the cash necessary to cover its short- and long- term obligations, to weather downturns in the external operating environment, and to take advantage of opportunities to innovate. All capitalization is represented on the organization's balance sheet, primarily in the Net Assets section. An organization's appropriate scope and scale help determine its capital needs and capital structure.

Time Horizon is the projected length of time for an organization's operations and is a key determinant of capital needs.

- Short-term: organizations dedicated to address current-day needs or realizing a single person's innovative idea or artistic vision. May be low budget and require more flexible capitalization.
- Medium-term: organizations invested in a logic model, brand, or regular audience or membership.
- Long-term: organizations committed to the stewardship of buildings and collections and that are investing to meet the needs of future audiences. These organizations require permanence and stability, which impacts their capitalization needs.

Capital Funds — There are six distinct types of capital funds that are used to maintain organizational health. Each of these funds addresses a distinct need. A capitalization strategy will have identified the appropriate funds for an organization.

- **Operating Funds**: funds that are used by organizations use to pay for their reasonable, planned day to day expenses during the year to run their programs as stated in their current strategy.
- **Working Capital**: funds that are used to maintain ordinary business operations through cash flow bumps that arise from predictable business cycles. Each organization is unique in its need for working capital due to annual patterns of cash inflows and outflows. Having a working capital fund allows the organization to borrow internally when expenses are made before the income is received. When the income is received, the working capital fund can be refilled, much like a line of credit. In fact, for organizations with access to a line of credit, use of that line is an acceptable substitute for working capital, as long as the line is not used to finance debt. While there is no single standard benchmark level for working capital, organizations should maintain enough working capital to address the potential low points in cash flow.
- **Operating Reserves**: funds held in order to protect against unexpected downturns, i.e. the "rainy day." Frequently, such reserves are designed to cover operations for a specific period should ordinary income be disrupted, to survive the disruption 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.
- **Capital Improvement Reserves**: also called building 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.
  - The **endowment ratio** measures the level of endowment relative to an organization's operating expenses by dividing total endowment by total expense. An increase in the ratio over time indicates endowment growth at least in proportion to the growth in operations.
- **Innovation Fund/ Risk Capital**: funds that give organizations the freedom to try out new ideas, such as product extensions, earned income ventures, major growth, or a new strategic direction. Risk capital is also used to address large environmental shifts that demand a change in strategic direction.

Net Assets are an organization's net worth. Net assets are most frequently explained mathematically, as the difference between an organization's assets and liabilities. Net assets are an important indicator when determining an organization's level of capitalization, for two reasons:

- Net assets represent net worth as a result of an organization's cumulative surpluses (and deficits) since its inception. This makes the net assets an indicator of past financial success, stability and resources for the future.
- Net assets can provide a more accurate picture of an organization's financial position than the budget. Determining the net assets available to support organizations takes into account organizational capital that is locked up in illiquid investments, and is therefore not readily available to support the organization's operations. This is 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.

Net asset mix is an indicator of the degree to which an organization has flexibility over the use of its cumulative surpluses and the resources it has accumulated for specific purposes. Net assets are classified into three broad categories--unrestricted, temporarily restricted, and permanently restricted. These categories reflect intentions of the donor, rather than any decision internal to the organization. Except for endowment, which is often permanently restricted, sources of organizational capital usually reside within the unrestricted net assets. Specific uses may be identified through board-designated funds within unrestricted net assets, although not all organizations formally partition their unrestricted net assets. While these designations can be set aside by board action, they can function effectively to instill discipline, and remind board and staff of the importance of honoring the principle of maintaining capital reserves.

- **Temporarily Restricted** (TR) activity includes TR contributions that are restricted by the donor for a specific purpose or specific time. Some examples of temporarily restricted contributions are gifts for specific programs or productions, pledged gifts for operations for future years, and capital campaign gifts for facilities that are not yet built. When the restriction is fulfilled, the net assets are released to the unrestricted operating statement. "Net TR Activity" is the sum of all new TR contributions minus those released to unrestricted.
- **Permanently Restricted** (PR) activity includes PR contributions that are restricted by the donor in perpetuity. The most common example is a gift to an endowment fund.

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