



Grantmakers in the Arts

GIA national capitalization project

Literature Review on Capitalization

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Grantmakers in the Arts

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1. Nonprofit business models and sustainability

Ideally, an organization has both a sustainable business model as well as solid capitalization. Without a sustainable business model, organizations will steadily eat into their reserves over time, putting their survival at risk. The flip side of this is that it is not worthwhile for funders to address a nonprofit's capitalization needs if the business model is not sustainable – otherwise the dollars will be for naught. William Foster and Gail Fine note that not having “a sustainable funding model” can be a “deal breaker” for funders deciding where to put their money (Foster 2007).

The issue of financial sustainability is particularly important in light of research indicating that arts organizations fail at a higher rate than other nonprofits. The overall failure rate of all nonprofits from 1984 to 1992 was 2.3%. In contrast, failure rates for ballet (25.1%), opera (22.7%), dance (22.3%), theater (20.3%) and museums (9.8%) were markedly higher. Only job training nonprofits failed at a higher rate (26.5%) (Hager 1989).

Furthermore, there is agreement that it is important for funders to understand a potential applicant's business model and the potential impact that a funder's giving may have on the business model (Miller 2002; Buechel, “Capital Ideas” 2007). An analysis of an organization's capital structure and sustainability must include an understanding of its core business or businesses (Nonprofit Finance Fund 2001).

We should note that “sustainability” means different things to different people. As Burd notes, funders sometimes think of “sustainability” specifically as nonprofits reducing reliance on foundation funding, while nonprofits may think of it as a funding strategy with sufficient capital to enable long-term operations (Burd 2009).

We would note that there are a few overarching observations about business models and sustainability:

- 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; Miller, “The Equity Capital Gap” 2008). 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. Henry Hansmann demonstrates that performing arts organizations lend themselves particularly well to the nonprofit form, given their high fixed costs and a limited audience (Hansmann 1981). Based on this, we may conclude that a nonprofit's equilibrium is often financial fragility.
- A sustainable business model must align to the mission. Having clarity about the mission helps to focus resources on projects that align with mission, leaving more time for financial management (Rosenberg and Taylor 2003).

- Many nonprofits at their core are “multi-product” organizations with a portfolio of services that can serve to cross-subsidize each other (Young 2004). Within one organization, a multiplicity of business models may be at play (Levere, “Capital Ideas” 2007), which implies multiple revenue streams. [Organizations with similar missions may have different business models (Miller 2002), which may differ from the programs. The Nonprofit Finance Fund provides an example: two organizations might both be dedicated to the work of a choreographer, but one may achieve that mission by starting a dance school, while the second may assemble a performance group. Or, a single organization could run a mix of these different business activities (Nonprofit Finance Fund 2001)].
- Organizations may have multiple business model drivers that are associated with their missions and organizational time horizons (Nelson 2009).
- An organization's business model is not static, causing an organization's funding and capitalization needs to change over time. Clara Miller's case study on how the Steppenwolf Theater's business model shifted in response to a new facility is an example of this concept.
- Business models must account for market realities. In writing about financial management at arts organizations, Rosenberg and Taylor notes that managers often have “an intuitive understanding of the total market size” in areas such as earned income and individual donations (Rosenberg and Taylor 2003).
- For some smaller arts organizations, it may be acceptable to live at the edges of sustainability given their artistic goals (Nelson 2009).
- Helping an organization become sustainable is not the same as helping the organization grow, and in fact may occasionally be in conflict (Miller, “Equity Capital Gap” 2008).
- 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).

Revenue diversification

There is another complex conversation taking place about the extent to which revenue diversification can be a way to ensure long-term sustainability. The argument in favor of revenue diversification is that it provides an income hedge: If one source of revenue dries up, other sources of revenue will continue to come in (Pratt 2002), and it is assumed unlikely that all income lines would go down at the same time (Tuckman 1991; Emerson 1999). However, there is also some agreement that various adverse macroeconomic trends have the potential to simultaneously affect both contributed income as well as earned income. Certainly the recent downturn seems to have demonstrated that it

is possible to see declines in multiple sources of funding at the same time. (In his 2009 article "The Recession and US Museums," Adrian Ellis describes the impact that the simultaneous decrease in all funding sources may have on the museum world.)

It appears that there is a movement away from the belief that revenue diversification is inherently better:

- Larger organizations have one dominant type of funding, rather than a mix (Foster 2003). Foster, Dixon and Hochstetler further assert that "Organizations are unlikely to achieve significant scale with a balanced mix of government, corporate, individual and foundation funding" (Foster 2003). In a similar vein, "NFF research shows that organizations with one or three major revenue sources are typically less profitable than those with two" (Burd 2009).
- A few authors argued that a better way to think about risk associated with revenue lines is to look at the predictability or variability of income sources as well as overall sensitivity of income to longer-term business cycles (Rosenberg and Taylor 2003; Bollerer, "Capital Ideas" 2007). Certain types of funding may be less reliable than others, or due to restrictions placed on funds, may limit an organization's autonomy. Organizations that strive for a mix of highly reliable and highly autonomous funds are often more secure (Pratt 2002).
- Revenue diversity may imply that the organization is quite complex organization and hard to manage (Bollerer, "Capital Ideas" 2007). Foster, Dixon and Hochstetler similarly note that narrowing focus may allow an organization to deepen its skills in cultivating a few income streams (Foster 2003).

At the same time, the role of revenue diversification as a factor in ensuring financial health may be more complex within the arts and culture sector. Hager found that the presence of a high revenue concentration "was found to be useful in predicting the death of visual arts organizations, theaters, music organizations, and generic performing arts organizations" (Hager 1989).

More specific conversations are taking place as to whether certain types of revenue are inherently more risky and should therefore be avoided as part of any sustainable organization's business model. Some authors had clear opinions as to types of revenue that should be dialed down. However, when we pulled together all the authors' viewpoints for each revenue stream, there were compelling arguments as to why any particular source of revenue posed a risk and should be avoided as part of a sustainable business model.

Given this, we would now like to briefly walk through how the field sees contributed income, earned income, endowment income, overhead and cost structure as playing into a sustainable business model. For all revenue streams, nonprofits are encouraged to "size the market," meaning

to understand trends in demand or consumer/community needs (Rosenberg and Taylor 2003; Levere, "Capital Ideas" 2007). Rosenberg and Taylor offers helpful ways of thinking about how arts organizations can size the market for both earned and contributed income (Rosenberg and Taylor 3-4).

Contributed income

The literature voiced concerns about the role of contributed income in the business model. Contributed income is perceived as being not a sustainable or scalable model (Bollerer, "Capital Ideas" 2007), as being an inefficient way to raise funds (Bradley 96), difficult to rapidly increase in the face of immediate financial stresses (Tuckman 1991), and too subject to changes in donor tastes, economic downturns and tax law (Tuckman 1991).

Solid levels of contributed income are also seen as potential public perception problem: "Ironically, an organization with a solid fundraising base often looks unattractive to funders, who wonder whether the organization is already too rich and well established. Yet this kind of financial health is what a philanthropist must demand if a grant is truly going to fuel substantive and sustainable impact" (Foster 2007). The F.B. Heron Foundation believes that by providing general operating support to improve "financial management systems," a foundation can make the organization more attractive to other donors (F.B. Heron 2006). On the flip side, contributed income can be considered a sign of weakness: Ryan quotes J. Gregory Dees as saying that "many nonprofit leaders 'consider extensive dependency on donors as a sign of weakness and vulnerability'" (Ryan 2001).

Earned income

The literature included some interesting perspectives on how and when nonprofits seek earned income, because not all income-generating opportunities result in a profit, and some require subsidies. For example, Yetman notes that it is easier to charge consumers for "private" goods such as entrance fees to an aquarium than it is to charge for "public" goods such as soup kitchens (Yetman 2006).

In his article "The Role of 'Earned Income' in Nonprofit Revenue," Dennis Young examines the situations in which nonprofits are more justified in engaging in profit-seeking behavior (Young 2004):

- Contract failure – Consumers "fear exploitation" and will not consume the good or service unless they find "trusted suppliers." As long as nonprofits offer the good or service in a high-quality and trustworthy way, there is no reason for nonprofits not to seek a profit.
- External benefits – Society is better off when individuals consume the good or service, but would not unless there is a subsidy. Nonprofits "may be justified in charging something" in this situation, but it is "reasonable" to run the operation at a loss if a source of subsidy can be found.

- Economies of scale – Nonprofits can “offer marketable services that are complimentary” to mission and incur little extra cost. Here, nonprofits may set prices relative to demand.
- Social enterprise – Nonprofits sometimes operate businesses in order to advance their social mission, such as job training in a sheltered work setting. These enterprises may generate some profit, but may require some form of subsidy to achieve the mission.

The concept of a self-sufficient social enterprise that generates revenue to support the mission (as opposed to a subsidized operation) is another area of interest in the literature. However, Ryan quotes Dees as noting that over 70% of business startups fail within eight years (Ryan 2001). Another wrinkle on the issue of earned income is that organizations sometimes regard facilities as a source of sustained revenue because a facility will attract more program participants, but this does not necessarily occur (Ryan 2001).

Endowment income

Some organizations rely on endowment income as a part of their business model. As Taylor notes, endowment is seen as both providing consistent income and lessening the need for annual support, and ensuring organizational perpetuity. While the theory is that endowment income will lower risk by steadying income, endowments are often restricted to specific purposes and therefore can create risk by limiting an organization’s flexibility (Taylor 2006; Miller 2003).

Overhead costs

Until relatively recently, the conventional wisdom has been that high overhead costs are a sign of a poorly run nonprofit, and therefore one that was unlikely to be sustainable over time. However, several authors note that organizations require adequate levels of infrastructure in order to be effective, build capacity, and achieve mission (Bedsworth 2008). Keating notes that a “current services trap” prioritizes delivery of high quality direct services today, which results in insufficient resources dedicated to “building organizational capacity and financial sustainability” (Keating, “Capital Ideas” 2007). A study by Hager found that low administrative costs were associated with the demise of both theater and music organizations (Hager 1989).

However, Frumkin and Kim’s study of donor responsiveness found that a low overhead to total expense ratio was not the primary determinant of donor giving. That said, they posited that low overhead costs may be a positive indicator of an organization’s ability to function efficiently and effectively in other areas (Frumkin 2000).

Other costs

The final component of a sustainable organization is its cost structure, and the impact that fixed expenses (i.e., mortgage payments) and “quasi-fixed expenses” (i.e., payroll, long-lead and multiyear commitments) have on sustainability.

Increasing budgetary pressures in the form of falling revenues or rising costs squeeze on discretionary spending and expansion because the organization cannot easily cut these fixed costs (Miller 2002). Woods Bowman reminds readers about the “liability of assets:” that some assets with high fixed costs, such as a building, can actually cost more than they are worth (Kevin Guthrie, as cited by Bowman 2007).

2. Capitalization

If these are the components of a sustainable business model, what are the components of nonprofit capitalization? There are multiple ways in which authors think about the meaning of nonprofit capitalization. We explore the four main ways in which we see authors think about capitalization:

- Existing long-term sources of funding
- Specific financing needs
- Theories of debt vs. cumulative net income as a financing source
- Facilities as a form of capitalization

It is impossible to start a conversation about nonprofit capitalization without drawing on the work of NFF and Clara Miller, who continue to lead the conversation on this issue. A few of their key insights are below, but NFF’s articles *Hidden in Plain Sight* and *Linking Mission and Money: An Introduction to Nonprofit Capitalization* provide a deeper examination:

- Capital structure exists for all nonprofits and is critical – there is no right kind. “Capital structure is central to the success or failure of any enterprise” and “good products, services or management systems alone don’t guarantee success” (Miller 2002).
- Capital structure is related to but distinct from program management or operating capacity, but it has a strong effect on both” (Miller 2002; Nonprofit Finance Fund 2001). For example, organizations with insufficient working capital often develop cash flow problems that end up starving discretionary activities such as program innovation, staffing or buildings (Miller 2003). Ignoring the balance between mission, capacity, and capital structure can upset an organization’s ability to function effectively (Nonprofit Finance Fund 2009).
- Healthy capital structures are hard to maintain in the nonprofit sector due to restrictions on assets. For any entity, cash is the primary hedge against risk and crises (Miller 2002; McLaughlin 2000). When most of an organization’s resources are placed into “fixed assets” such as facilities and restricted endowments, organizations lose their capacity to adapt (Miller 2002) and therefore can become more risk averse (Miller 2002). These fixed assets can appear to strengthen the balance sheet, however, it is not the total positive balance of an organization’s net assets that indicates its health and flexibility, but the liquidity of its net assets (Nonprofit

Finance Fund 2001). [*Hidden in Plain Sight* provides an example of a theater that was destabilized by a \$1M endowment.]

- Changes in the business model require changes in capitalization (Miller 2002; Nonprofit Finance Fund 2001), as do different stages of an organization's growth cycle (Miller, "Equity Capital Gap" 2008). Decisions about changes in program are implicitly capitalization decisions, since an organization's programs and capital structure are inextricably linked (Nonprofit Finance Fund 2001).
- A healthy capital structure – while defined differently throughout the literature – is increasingly being accepted as a necessary consideration for nonprofit organizations, and something that helps them achieve mission. As Ryan found, "Performance and capital are inseparable" (Ryan 2001).

Existing long-term sources of funding

Within the private sector, the concept of "capitalization" has a long-term context. The private sector definition is the amounts and types of long-term financing used by a firm, including stock, long-term debt and retained earnings, which are the cumulative profits generated by the company since its inception.

How might this translate to the nonprofit sector? Two elements of the private sector definition appear to easily translate to nonprofit capitalization: Long-term debt and "retained earnings," which is called "cumulative net income" in the nonprofit sector. We posit that for nonprofits, restricted endowment is a third type of long-term capitalization, because it is designed to be a long-term funding source (Taylor 2006).

From a technical standpoint, stock is not part of nonprofit capitalization (Salamon 2006). While some funders describe themselves as "investing" in a nonprofit, they are not owners of the nonprofit and therefore cannot issue or trade stocks. The literature does indicate, however, an attempt to find or develop an equivalent to equity for the nonprofit sector, which will be discussed in a subsequent section.

We will now take a closer look at conversations on long-term debt, endowment and cumulative net income.

Long-term debt

"Debt is a financial instrument that breaks the timing link between the consumption of a good and payment for the good. ... Interest is the miraculous device that lets us disconnect our consumption from our cash flows so that the two no longer have to be synchronized" (Yetman 2006). "Debt is most successful when it is used to match expenses over the useful life of an asset (such as a facility or residence), or to pay expenses before expected revenue is received" (Miller, "Equity Capital Gap" 2008).

Long-term debt is associated with the financing of facilities, housing and commercial real estate (Emerson 1999, Yetman 2006), and is most associated with hospitals, universities and nonprofits working in low-income housing. Most nonprofits receive long-term debt financing via the commercial markets (Miller, "Equity Capital Grant" 2008). Yetman found that municipal and bond debt account for 57% of the dollar amount of debt outstanding, although only 18% of nonprofits used municipal and bond debt (Yetman 2006). Yetman discusses the pros and cons of bond financing and its overall structure at length (Yetman 2006).

Overall, nonprofits' understanding of debt markets is seen as mixed. Salamon posits that many nonprofit organizations have a limited understanding of "significant sources of investment capital" at their disposal, such as pension funds and insurance companies (Salamon 2006), but Miller cites a study by Yetman showing that nonprofits use similar levels of debt as private sector companies and at similar levels of sophistication (Miller, "Equity Capital Gap" 2008). Salamon did find that after foundations and individual donors, organizations were most familiar with commercial banks, credit unions and venture philanthropists (Salamon 2006).

Permanent endowment

Some organizations have permanent endowment as part of their capital structure. By permanent endowment, we mean funds in which nonprofits may not use the principal, but may draw on interest. Taylor notes that that there is no reliable information on how much "capital" is being held by arts and cultural organizations.

In their most positive form, endowments can be seen as creating a "stable floor of income" (Rosenberg and Taylor 2003). However, there are two caveats to this point. Miller notes that while the presence of endowments (especially restricted endowments) gives the impression of a well resourced organization, these funds are highly illiquid assets that cannot be easily deployed by the organization to the highest and best use (Miller 2003); Taylor equates this to being "trust fund poor," by having an asset that cannot be accessed (Taylor 2006). However, some authors note that there are particular situations in which endowment may be appropriate from a mission perspective, such as museums' needs to care for collections over generations (Taylor 2006; Nelson 2009).

A key concern about endowment is the extent to which the process of creating an endowment can destabilize organizations. Taylor points out that devoting energy to building the endowment can deplete unrestricted funds, making the organization less flexible and more susceptible to risk. Therefore, pursuit of endowment funding is best considered in relation to other types of reserves and funds, and in the context of an organization's overall strategy (Taylor 2006).

A number of authors point out that in order for the endowment to provide stability to the organization, it must be

sufficiently large enough to generate revenue that can be spent without encroaching on the principal (Hager 2006).

Cumulative net income

Over the long term, a key way that private sector companies finance their operations is through “retained earnings,” or the net income that is retained by the corporation rather than distributed as dividends.¹ Within the nonprofit sector, the closest analogy would be net income, or the difference between the organization’s income and expenses.

Generating a surplus is one way for nonprofits to access greater amounts of the capital necessary to function (Ryan 2001). Additionally, in his study of an organization that successfully manages cash flow issues, McLaughlin points out that profits allow the organization to both “weather crises and seize opportunities” (McLaughlin 2000). Generating surpluses was also identified by Keating in a study for the Boston Foundation as a “method to grow [an] organization’s resource base” (Keating, 2008).

There are different perspectives on whether nonprofits can regularly generate surpluses. Ryan notes that a 1983 study by Tuckman/Chang that examined IRS 990 filing for more than 4,500 nonprofits found that more than 86% of them reported a surplus, and a later 1986 study confirmed the finding (Ryan 2001). Others believe that nonprofits by their nature are not well positioned to generate cumulative net income. Nonprofit managers use funds to support current operations (Emerson 1999) and funders discourage net income due to a belief nonprofits should not be making a profit from their activities (Miller 2003). However, Miller notes that the tax exempt status given to nonprofits is meant to “reliably subsidize healthy operations, and this means surpluses” and funders should be pleased when organizations generate surpluses (Nonprofit Finance Fund 2009).

Additionally, nonprofits have traditionally been thought of as labor-intensive, not capital-intensive (Salamon 2006) and rarely expect to have cash available (McLaughlin 2000). This drive toward a zero profit margin is not unusual, but leaves organizations ill-equipped to meet challenges (Keating, 2008).

Specific financing needs

While these are the core components of capitalization, the concept of capitalization is also framed in terms of organizations’ specific financing needs. These include:

- **Working capital reserve** to cover routine short-term cash flow needs arising from the timing of income and expenses (Rosenberg and Taylor 2003; Bowman 2007; Ryan 2001; Yetman 2006). Some authors refer to “working capital” in ways that imply funds that also function as operating reserves; we will distinguish between the two for purposes of clarity.

- **Operating reserves** to supplement income during a downturn. Rosenberg and Taylor notes that an operating reserve helps organizations to create a stable revenue stream across business cycles (Rosenberg and Taylor 2003; Bowman 2007).
- **Risk funds** to enable organizations to test new ideas or approaches, or, in the case of performing arts groups, to take artistic risks and fail on occasion (Taylor 2006).
- **Board-designated funds** that are set aside to act as an informal unrestricted endowment that supplies income to smooth revenues over time (Rosenberg and Taylor 2003). Board designated funds are sometimes building reserve funds that are meant to pay for major repairs to the facility over time. (Ryan reviews capital for facilities more explicitly in his 2001 study “Nonprofit Capital: A Review of Problems and Strategies.”)

The terms used to describe dollars that can function in the ways described above vary throughout the literature. Some authors call out each type of functional need separately, others refer to them collectively as an “endowment” or an “asset reserve” that includes both restricted and unrestricted funds, and still others think of it as a “quasi-endowment” or “large and flexible working reserve” of purely unrestricted dollars distinct from restricted endowment.

Bearing these definitions in mind, Hager reviewed information on performing arts presenters’ “asset reserve,” and found that only 53% of them had some type of “asset reserve.” Those organizations were more likely to have an “asset reserve” when they had larger budget sizes, large boards and a high number of institutional donors (Hager 2004). Only 10% of the organizations in the study had an “asset reserve” greater than or equal to 200% of annual expenses, which is the level recommended by National Arts Stabilization (Hager 2004).

Theories of debt vs. cumulative net income as a financing source

An organization can use either debt or cumulative net income to meet these particular financing needs. There is not a clear consensus on when debt financing is most appropriate (Yetman 2006) relative to cumulative net income. The choice to use one financing source over another often depends on the organizational and project context (Yetman 2006).

Some authors prefer that organizations be able to address these needs through a large set of unrestricted funds that are not financed via debt – meaning that they would presumably be acquired through cumulative net income. There are several advantages to using cumulative net income: “funds are available when needed, the organization does not have to disclose information to outsiders and accountability is managed through normal board oversight” rather than “intensive relationships with high-engagement funders” (Ryan 2001). However, the use of such “free cash”

does create an opportunity cost if organizations do not deploy funds to their best use or if new, higher value projects emerge at a later date (Yetman 2006).

Debt may or may not be the best vehicle to meet needs. As noted earlier, debt allows a nonprofit to better control the timing of when it consumes certain goods. However, Yetman notes that “by borrowing, a nonprofit necessarily invites a for-profit party into its managerial decision-making process,” and as such, runs the risk that the lender’s profit-seeking goals may directly impact its own activities. For example, lenders may require covenants that restrict spending levels or appropriate cash balances that “bind a nonprofit manager’s choices” (Yetman 2006). In addition, lenders have a financial incentive to recommend the use of debt, and therefore may not have the motivation to consider when debt “might not be in the nonprofit’s best interest” (Yetman 2006). Both Yetman (2006) and Nelson/Curtis (2007) offer recommendations for how nonprofits can work more effectively with lenders.

Yetman discusses the impact of debt on a nonprofit’s fund-raising capacity. He notes that when a nonprofit expects to use donations to repay a debt, donations “represent an anticipated payment for the use of someone else’s money in order to invest in the project sooner rather than later,” and therefore “current debt becomes a substitute for future donations, effectively crowding out the future donations stream” (Yetman 2006). In addition, future donors may not see these past projects as highly, or may have a preference for funding current or future projects (Yetman 2006). Perhaps for these reasons, nonprofits relying on donations as a revenue source have less debt (Yetman 2006).

Another issue with debt is that it is easier to secure debt financing for “projects that produce cash benefits,” while it is harder to secure debt when it is used for a project in which opportunities for revenue from fees is limited. The greater availability of debt for revenue-generating projects “could easily cause a nonprofit to expand its fee producing activities and contract its more intangible outputs, although this behavior may be inconsistent with its mission or maximizing social value” (Yetman 2006).

Facilities as a form of capitalization

In the strictest sense, buildings are not part of an organization’s financial capitalization. Long-term debt in the form of mortgages and bonds are often used to finance facilities (Yetman 2006). In addition, facilities are considered to be a key asset, and are used as collateral to secure debt financing (Salamon 2006). Within this context, facilities are referenced as a potential source of funds in the form of a loan, mortgage or sale (Tuckman 1991; Emerson 1999).

Facilities also play into the issue of nonprofit capitalization due to their profound impact on an organization’s business model, and therefore its financial sustainability. NFF has led this conversation, and has described how the long-term

financial demands of a building (mortgages and facilities maintenance) have an impact on an organization’s willingness to take risks. At a basic level, the fixed costs associated with facilities ownership (mortgages and facilities maintenance) become core to an organization’s overall business model, especially since facilities ownership is often accompanied by program expansion (“Capital Ideas” 2007; Miller 2002). In Ryan’s study, organizations that consider a facility a potential revenue source often do not fund the facility’s maintenance – thus masking the true cost of ownership (Ryan 2001).

3. Options for funders to impact capitalization

Funders most clearly impact capitalization through the forms of their funding choices. To simplify, we see five basic ways in which funders provide dollars to individual nonprofit organizations in ways that affect their business models and capitalization:

- Project-based funding
- Operating support
- Debt
- Endowment
- Direct funding of balance sheet

Project-based funding

The foundation community has historically focused on restricted funding, such as dollars for a specific project. In recent years, a consensus is emerging that the prevalence of restricted grant making may have a negative impact on an organization’s long-term sustainability because it creates “mission drift” as groups attempt to tailor themselves to each funder’s interests (Foster 2003; Young 2002). Pratt observes that organizational shifts are often in response to shifts in revenue, not intent (Pratt 2002).

Aside from mission drift, restricted funding puts the business model under strain in several other ways:

- Project-based funding pushes organizations into the “current service trap” in which groups prioritize the current delivery of services rather than focusing on long-term sustainability (Keating, “Capital Ideas” 2007).
- Donor restrictions create risk and expense because they are more likely to create demands on capacity and program beyond what was initially envisioned or planned for the program (Miller 2003). Rosenberg and Taylor recommends “capital budgeting” for projects, meaning that organizations should look at the financial implications of projects and how to fund them over the long haul (Rosenberg and Taylor 2003).
- Restricted funding generally does not include an allocation for overhead expenses. Young notes that large gifts from donors frequently do not cover the full costs of a project (particularly facilities-related projects) and

rarely take into account increased operating expenses that may occur as a product of the project. The organization is thus often left scrambling for additional funds, and Young argues that it is possible that both the additional money and staff or board time spent obtaining them may be better spent (Young 2002).

- Organizations that pursue project-based funding may receive support from a variety of donors, all of whom may have different desired outcomes. Adhering to the expectations of too many masters can dilute an organization's impact (Pratt 2002; Burd 2009).

Funders who plan to continue program support are being encouraged to take account of organizations' overhead needs; advice to funders on factoring in overhead is included in a later section.

Operating support

Another option for funders is to provide operating support. The drawbacks of restricted funding have led to a push towards unrestricted or general operating support, which now accounts for about 19% of all grants in the US (Foster 2007). The F.B. Heron Foundation, which supports organizations that build wealth within low-income communities, focuses 77% of its grant making dollars on general operating support. In the paper "Core Support," the Foundation argues that "you can't have strong programs in weak organizations."

Operating support is seen to be beneficial for a variety of reasons:

- Operating support is seen as an investment in an organization's mission (GEO 2007).
- It aligns with the fact that most nonprofits are attempting to address deeply complex problems that can be best addressed by taking a longer-term perspective (Schwartz, "Capital Ideas" 2007). As a result, funders are being encouraged to make multi-year grants (Burd 2009).
- Operating support provides flexibility to organizations in the event that funds need to be spent differently than originally intended (GEO 2007; F.B. Heron 2006). The lack of restrictions also allows organizations to take risks (GEO 2007).
- Operating support can free up staff time spent on smaller program-related grant proposals, which are occasionally a result of organizations chasing funding (GEO 2008; GEO 2007).
- Operating support increases the likelihood that organizations will generate net income, which can help improve an organization's balance sheet and make the organization more attractive to additional funders (F.B. Heron 2006).
- Improving an organization's financial health allows it to not only "react to changes, but anticipate them" (F.B. Heron 2006).

Operating support is not without challenges. The New Hampshire Charitable Foundation reports that when it attempted to increase general operating support, only a small number of groups applied for funding (Feldstein, "Capital Ideas" 2007). This parallels Rooney's study, which reported that despite organizations' claims that their overhead needs are not being met, foundations say that they are indeed funding overhead (Rooney 2007).

At the same time, the F.B. Heron Foundation and other authors make the following observations about the role of funders and operating support:

- Some funders are concerned that organizations may spend the funds in a way that is incompatible with the foundation's mission (F.B. Heron 2006). Some authors point out, however, that negotiating the terms and desired outcomes of the operating support can mitigate this concern (Brest 2008), as can rigorous selection of grantees (F.B. Heron 2006) and the creation of "viable metrics" for determining "whether [the foundation's] objectives are met." (GEO 2007).
- Funders are also worried that providing ongoing operating support may make an organization "overly reliant" on a grant maker (GEO 2007). The F.B. Heron Foundation mitigates this concern by raising expectation for organizations as the "period of support lengthens" (F.B. Heron 2006).
- Funders giving general operating support often want organizations to demonstrate a capacity to "invest wisely and efficiently and to deliver results over time." However, nonprofits often lack the resources to build the capacity to demonstrate these qualities, which creates a "chicken and egg" situation in which grantmakers then become reluctant to offer operating support (Burd 2009).

As noted earlier, foundations are encouraged to factor in overhead as part of their grantmaking (Burd 2009). From a funder's perspective, overhead often comes up within the conversation of general operating support because operating support is considered to be one way of ensuring that organizations are able to cover the non-program costs essential to achieving the mission (GEO 2007; Bedsworth 2008).

Rooney notes that organizations that rely more heavily on foundation support were less likely to report to funders the true costs of overhead due to perceptions of funder interests at play: Organizations in these instances believed that foundations were hesitant to pay overhead costs for fear of embedding themselves long-term, and because they were more interested in investing in innovative programs, rather than overhead. Still, Rooney did find that large and local funders were more likely to pay for overhead, and for all funders of all sizes the request was more likely to be entertained if the overhead costs were included in a program budget and request (Rooney 2007).

Organizations are also being encouraged to state their overhead needs more clearly for funders. Bedsworth, Gregory and Howard encourage organizations to develop strategies that recognize infrastructure needs (Bedsworth 2008), and to plan for and request the appropriate levels of overhead costs. Burd also notes that the lack consistency among nonprofits as to how to report functional expenses also leads to underreporting (Burd 2009).

Debt

The provision of debt is another way in which funders impact sustainability and capitalization. Miller posits that the “overwhelming majority” of the funds provided to nonprofits aside from grants are in the form of debt (Miller, “Equity Capital Grant” 2008). Salamon sees the use of debt as an opportunity for funders to “move beyond making grants – a 19th century approach to using their assets – and begin thinking of themselves as philanthropic banks that offer charities a menu of loans, loan guarantees, interest subsidies and related financial tools that use foundation assets to attract other private investment capital” (Salamon 2009).

There are several ways in which foundations have provided debt to nonprofits:

- Program-related investments (PRIs) in which an institution (typically a foundation) loans funds to an organization at a below-market rate. The funds for the loans come from the foundation’s grants budget, or it may be from the foundation’s own endowment corpus. The loans may have an extended payback period and/or be secured by assets (Emerson 1999). These types of loans are seen as a positive way to extend the value of funds. After repayment, the foundation can loan the money to more organizations (Salamon 2007).
The F.B. Heron Foundation and MacArthur Foundation use PRIs. However, PRIs are not widely used, perhaps due to the time required for foundations and nonprofits to conduct due diligence, structure deals and negotiate terms (Ryan 2001) and because they are “cumbersome and costly to set up” (Burd 2009).
- Revolving loan funds: The Marion I. and Henry J. Knott Foundation and the Eugene and Agnes E. Meyer Foundation have separately created revolving loan funds that aimed at helping nonprofits to address their cash flow needs (Burd 2009).
- Lending intermediaries: Funders also have many opportunities to provide loan capital to intermediaries who lend to nonprofit organizations. Burd cites as examples the Nonprofit Finance Fund and the Calvert Foundation’s Community Investment Notes, which allows funders to participate in a managed portfolio of loans (Burd 2009).

It should be noted that many nonprofits receive debt financing from the private sector. Emerson notes that the

private sector currently provides loans and lines of credit to finance cash flow and working capital requirements or the acquisition of property that are on standard terms and often secured by assets (Emerson 1999).

Endowment

Taylor notes that the Ford Foundation made restricted gifts to orchestras to build endowment during the 1970s, establishing an expectation in the field that endowment was the “handmaiden of perpetuity” (Taylor 2006). One of the key arguments advanced against funding endowments is based on Hansmann, who argued that when organizations put funds into an endowment, it implies a belief that the needs of future beneficiaries or organizational perpetuity outweighs current needs (Taylor 2006). Another argument against providing endowment is that because endowments reduce financial need, organizations will not develop a culture of frugality that leads to innovation (Hager 1989).

Still, Taylor notes that while endowment is a very “blunt instrument,” “arts funders should not consider endowment unnecessary in all cases” (Taylor 2006). As funders consider whether to make gifts of endowment, they are encouraged to talk with potential grantees to determine whether endowment is right for the organization by looking at issues such as capacity to manage an endowment, whether the organization has already gathered sufficient cash reserves for general operations, and whether an endowment supports the mission (Taylor 2006).

Direct funding of balance sheet

Another option that funders have is to give organizations dollars to create pools of money that are specifically meant to address some of the financing needs identified in the capitalization section above (working capital, operating reserves, risk funding and funds that can be earmarked for board designated funds).

One of the first notable attempts at implementing this strategy was by the National Arts Stabilization Fund in 1983 (with support from the Ford, Mellon and Rockefeller Foundations). The purpose of these types of stabilization funds is to provide organizations with necessary reserves in order to become more stable and improve the organization. As was true with the National Arts Stabilization, the money will often only be released when the organization reached predetermined and agreed upon milestones (Ryan 2001).

4. Funders as “investors” in organizations

In their search to assist organizations with financial sustainability, funders are sometimes encouraged to think of themselves as “investors” providing “capital” to organizations in any or all of the forms described above (project, general operating, debt, endowment, balance sheet). As noted earlier, we see a variety of ways in which authors in the literature are defining these terms. In this section, we will walk through some of the existing models for what it may

mean for a funder to act as an “investor.” We will conclude by reviewing some of the implications of the “investor” model that appear in the literature.

The models we will review are:

- “Venture philanthropy”
- “Buy” vs. “build”
- “Equity equivalents”
- “Negotiated general operating support”

“Venture philanthropy”

The use of the term “venture philanthropy” varies widely throughout the literature. As Ryan points out, it is “a catch-all phrase sometimes used to suggest strategic investment in organizational capacity, but often used much more generally to denote a results-oriented style or ambience” (Ryan 2001). Emerson offers a basic definition of venture philanthropy as (Emerson 1999):

- Multiyear funding support
- Attention to organizational capacity building
- Use of “new metrics” as a management tool to inform better practice
- Use of “new metrics to calculate a social return on investment (SROI) that focuses upon the outcomes resulting from philanthropic “investments”
- Awareness and pursuit of appropriate exit strategies
- Deeper, more engaged relations between the funder and practitioner
- A “portfolio management” as opposed to “isolated grantee” approach to grant making
- Awareness and application of grants as capital investments

Emerson cites as examples of venture philanthropy Social Venture Partners (Seattle, WA), The Roberts Enterprise Development Fund (San Francisco, CA), the Entrepreneurs’ Foundation (Menlo Park, CA) and the Robin Hood Foundation (New York, NY) (Emerson 1999).

“Buy” vs. “build”

NFF authors Overholser and Miller have put forward the concept of “buy vs. build” in recent years to help funders think about the role that their funding plays within an organization.

- Funders are “buyers” when they provide funds that are “buying services for a certain number of beneficiaries, or paying for items that are part of an organization’s cost structure.” (Miller, “Equity Capital Gap” 2008). “Buyers” provide the funds that are ongoing (Overholser, “Nonprofit Growth Capital” 2006) and “do not help nonprofits grow or change for the future” (Miller, “Equity Capital Gap” 2008).

- Funders are “builders,” when they provide funds to contribute “to build and maintain the entire enterprise.” Builders in effect, become “true equity holders” (Miller, “Equity Capital Gap” 2008), charged with “close stewardship” of an organization (Overholser, “Nonprofit Growth Capital” 2006).

Miller notes that standard definition of “equity capital” in the private sector – ownership, the distribution of profits to the owners, and the ability to exchange equity shares – does not apply in the nonprofit sector. However, Miller argues that the “notions of the equity ownership ethic and the skills and financial tools it requires” do translate (Miller, “Equity Capital Gap” 2008):

- “Equity capital” focuses on “creating and maintaining a lasting enterprise that will attract both reliable buyers ... and eventually, additional equity holders” (Miller, “Equity Capital Gap” 2008). “A critical ingredient is protecting the enterprise from destructive over-exploitation – too rapid growth, an overly low sales price and strained capacity for too long” (Miller, “More from nonprofits now means less in the future” 2008).
- “Equity holders” are “duty-bound to find other similarly minded investors with whom to pool their capital” if they do not have sufficient funds to build the enterprise (Miller, “Equity Capital Gap” 2008).
- Some “equity holders” supply funds for organizations to grow, and other will “essentially own the built enterprise, protecting it from harm or decline” so it can fulfill its promises and mission (Miller, “Equity Capital Gap” 2008). It is this stewardship piece that Miller sees as a useful translation from the for-profit sector of the “equity holder” idea, rather than the idea of control.
- “Equity capital” must be “substantial, long term and undesignated” and “large enough – typically in the tens of millions of dollars – to help scale an organization” (Miller, “Equity Capital Gap” 2008).

Overholser and NFF assert “equity investment takes more dollars than funders can ever give at one time” (Miller, “Equity Capital Gap” 2008). In response, NFF has developed NFF Capital Partners, which serves as an intermediary to connect funders with “interesting nonprofit investment opportunities.” NFF focuses its efforts on “later-stage” organizations that “require a less hands-on or less ‘high-engagement’ form of investor relationship” (Overholser, “Patient Capital” 2006).

“Equity equivalents”

Emerson posits that “those who support the operating expenses of nonprofit organizations (foundations, individual donors, etc.) are making investments in the nonprofit organization” (Emerson 1999), and that “all cash flows to the nonprofit will be viewed as ‘investments’ unless they are result of explicit contractual payments or the result of fees

for services rendered" (Emerson 1999). However, he also expresses the opinion that most funders do not see their grant making as an investment activity, but rather as a charitable donation (Emerson 1999).

In discussing "nonprofit equity," Emerson notes that private sector companies have access to both retained earnings and outside equity investments in the form of stock. In contrast, nonprofits do not issue stock, and have little capacity to generate sufficient cumulative net income to capitalize the organization or support expansion. "In many ways it is this 'double whammy' of an inability to secure outside equity investments together with the chronic inability of most nonprofits to generate internal equity that creates the 'equity gap' and is a central challenge to adequately capitalizing nonprofit corporations" (Emerson 1999).

To fill the gap, Emerson posits the use of "equity equivalents," which he defines as "a grant made to a nonprofit with the provision that it is 'recoverable'" but does not require interest payments. Such recoverable grants are unsecured, "with payback usually pegged to the nonprofit enterprise achieving certain financial benchmarks at some agreed-upon future date." The return on "equity equivalents" for an "investor" is the principal plus social return on investment (SROI), while the return on a grant is SROI, and the return on a PRI is principal plus interest (Emerson 1999). Emerson notes that while PRIs can sometimes act as in a similar way to "equity equivalents," the expectation that PRIs are secured and will be repaid no matter what makes them fundamentally different (Emerson 1999).

"Negotiated general operating support"

Brest distinguishes between the "no strings attached" operating support and minimal donor engagement from what he refers to as "negotiated operating support." The distinguishing features of "negotiated operating support" are:

- Agreement based on a strategic plan with outcome objectives.
- Funder conducts due diligence on organization.
- Funder and organization agree about "what outcomes the organization plans to achieve, how it plans to achieve them, and how progress will be assessed and reported."
- Once agreement is reached, funder's support goes to organization as a whole rather than to particular projects, and the organization has autonomy in implementing the plan.
- General operating support typically consists of multi-year expendable grants.

While Brest does not specifically use the term "investment" as he writes about "negotiated operating support," we have included it here because the manner in which "negotiated operating support" functions is similar to elements of

"venture philanthropy" and also aligns with Emerson's view that all cash flows to a nonprofit are "investments."

However, it should be noted that Brest sees himself as practicing "strategic philanthropy" – an "emphasis on planned and measured progress towards clearly articulated goals" – an approach that he sees as suited to both project-based funding as well as "negotiated general operating support."

Implications of existing "investor" approaches

The range of approaches and ideas embedded in the four models above illustrates the extent to which the concept of making "equity investments" in nonprofits is a recent arrival. Within the literature, there is some agreement that while most funders have not fully taken on the role of "venture philanthropists" (Foster 2007; Porter & Kramer 1999) or make grants that act as investments in growing nonprofits (Foster 2007), some are adapting different aspects of venture philanthropy model, such as the focus on mission-related results (Young 2002). Based on our literature review, we would posit that there is a broad-ranging conversation as to how adapt the prevailing venture philanthropy model to the needs of different funders interested in acting as "investors."

- **Scale.** Organizations with the capacity to scale are seen as both more likely to achieve high SROI, as larger organizations are sometimes assumed to be more likely to be financially competitive (Ryan 2001). Several individuals have noted that the capacity to scale, in and of itself is not inherently better, and that because many worthwhile organizations cannot scale, the focus should be on helping each organization achieve an "appropriate scale" (Emerson 1999; Buechel, "Capital Ideas" 2007). Grantmakers sometimes encourage organizations to take programs to scale even when the organizations lack the infrastructure to do so (Burd 2009).
- **One-time vs. ongoing support.** The multiplicity of "investment" approaches above suggest a need to explore the concept of whether only one-time or short-run funding can be considered to be an "investment," or whether ongoing operating support is also an "investment." A greater clarity about the distinctions here would be helpful based on comments from Foster, who describes a "dance of deception" in which funders and organizations cannot acknowledge that what is positioned as investment funding is truly acting as operating support (Foster 2007); Overholser expresses a similar concern about the lack of nonprofit accounting systems to track the distinction between "buy" vs. "build" dollars (Overholser, "Patient Capital" 2006).
- **Funding stages.** Authors are discussing when funders could provide different types of "investment" at funding at different points along a continuum of a growth trajectory (Emerson 1999; Foster 2007; Overholser, "Patient Capital" 2006). For example, Emerson describes a

progression from “seed capital” to “start-up funding” to “growth capital” (Emerson 1999).

- **Novel approaches vs. solid performers.** During the *Capital Ideas* conference, participants noted the need to pay greater attention to investing in older effective organizations rather than continually seeking start-ups with unique ideas, which tends to be the focus of venture philanthropists.
- **Take-out concept.** Emerson notes that venture philanthropists tend to see government as a key part of their takeout strategy, while government, in an age of financial pressures, tends to see private donors as a key element of the financing of social services (Emerson 1999). This speaks to the need for more inclusive conversations about the roles that public and private funders respectively can play.
- **Broad vs. deep giving.** The typical venture philanthropist focuses on providing high levels of funding for a small number of organizations. This runs counter to current practices of most foundations, which choose to “spread the wealth” among many organizations. Giving larger gifts implies that foundations must take a more selective approach to grantees and be more willing to say “no” (Foster 2007). In addition, funders must be prepared to ensure that the level of funding is significant rather than incremental (Burd 2009).
- **Changing skill sets.** Shifting to an “investment” model would require officers to acquire new skill sets. Beuchel notes that developing new grant making programs may require considerable staff time and expertise (Beuchel, “Capital Ideas” 2007), while others noted the need to boost financial literacy and ability to read and interpret financial statements (“Capital Ideas” 2007).
- **Linking funding to outcomes.** “Investors” seeking returns are interested in identify measures that will hold organizations accountable for achieving their overarching goals over a longer term time horizon (Foster 2007). Multiple authors posit that it is possible to evaluate non-program directed funds based on the intended social impacts (Brest 2003; Porter & Kramer 1999; F.B. Heron 2006). One helpful step in both achieving the impact and facilitating evaluation is to align grant requirements and funding processes with the size and expectations of the grant (Porter & Kramer 1999; GEO 2007).

There is an abundance of literature that focuses on effective philanthropy. While these articles tend to cover a broad range of practices that are not applicable to this conversation about capitalization, there exists the argument that effective philanthropy will achieve a social impact (Brest 2003) and that funders, due to their access to tremendous amounts of funds that could meet a current need, have a responsibility to ensure that their grants make a strong impact (Porter & Kramer, 1999).

A few examples of foundations that are employing “investment” approaches are:

- The **Edna McConnell Clark Foundation** (EMCF), which focuses on supporting low-income communities, has recently launched the Growth Capital Aggregation Pilot. EMCF and 19 other co-investors pooled a total of \$120 million dollars to support three organizations. The organizations must reach pre-determined performance milestones in order to receive money. Foster sees this project as leveraging both philanthropic and government resources (Foster 2007). Generally, EMCF makes long-term investments in organizations and support capacity building to make organizations – and the people they support – sustainable.
- The **F.B. Heron Foundation**, which also supports low-income communities in pursuit of wealth creation, focuses three-quarters of its grantmaking funds on general operating support. Additionally, the Foundation engages in mission-related investing. In particular, it uses three tools: PRIs (usually to grantees), market-rate insured deposits in low-income community banks or credit unions, and investments in private equity and fixed-income securities offering benefits to low income communities.

5. Overview of nonprofit capital markets

Authors are also attempting to adapt the concept of private sector capital markets to the nonprofit sector. In a private sector context, “capital markets” have two major contexts. First, they are the forum in which companies or businesses raise new funds for their operations, either through issuing new stock or a bond. Second, they are places in which investors can trade these stocks or bonds once they have been issued; investors expect that these stocks or bonds will generate some type of financial return on their investment.²

In the current nonprofit conversations, “capital markets” are used only in the first sense of organizations receiving new funds for operations (Miller, “Equity Capital Gap” 2008), and depending on the author may or may not be seen as encompassing both contributions from funders and loans from banks or funders. The second aspect of “capital markets” is not fully applicable within a nonprofit context since contributions are not tradable in the way that a stock is, and the types institutions issuing loans to nonprofits do not trade them. Emerson also notes that another distinction is that “nonprofit capital markets” seek social returns on investment rather than a financial return on investment (Emerson 1999).

The “investors” within the “nonprofit capital market” are individual donors, family foundations, managed foundations run by a philanthropic advisor, community foundations, major national foundations, corporate foundations, governmental funders and lending institutions (Emerson 1999). Emerson further notes that some types of intermediaries

act as funders in their role as regrantors to organizations (Emerson 1999).

There is some agreement that thinking through the lens of a “nonprofit capital market” is helpful in identifying the gaps in funding for nonprofits and the challenges they face in securing funding:

- While investors in the private sector capital market are primarily motivated by financial returns, funders in the nonprofit sector give money for a wide variety of reasons, and the funding types may influence the activities of organizations (Foster 2003). Emerson perceives that funder interest in supporting new approaches and innovative ideas creates a pull to start-up organizations (Emerson 1999). Similarly, participants at the Capital Ideas saw a lack of “patient capital” that would help nonprofits through a more extended process of change (“Capital Ideas” 2007), an insight shared by Overholser (Overholser, Patient Capital” 2006).
- Within the private sector market it is often clearer which investors are more willing to supply certain types of investments. For example, new companies go to venture capitalists for money, whereas more established companies issue stock to bring in new dollars. In the nonprofit sector, it is less clear to whom an organization would go for certain types of funding (Emerson 1999) and nonprofits may be unaware of the available funding options (Salamon 2006). Emerson believes the lack of clarity creates a funding system that is geared to people in the know, which poses a barrier to new people and ideas (Emerson 1999).
- These comparisons to private sector capital markets raise the issue of what level of funding organizations can reasonably expect to receive. An example of this would be the future of government funding levels (Emerson 1999). Foster notes that as funders consider where to put their dollars, they ought to assess whether the broader society views various areas as a need that will attract funding at all (Foster 2007).
- Private sector capital markets are perceived as having the types of widely available information that are needed for investors to make accurate assessments of which companies will provide the greatest returns. Concerns are raised about the limited information flows within the nonprofit sector, such as a lack of willingness among funders and organizations to share lessons learned and admit failure. This lack translates into poor decisions that do not allow funds to flow to the best performing organizations (Emerson 1999). Access to better data would allow funders to make the best possible decisions for their funding dollars (Ryan 2001)
- The market framework also allows a deeper analysis of the dynamics between producers and consumers; the two main types of actors in the “nonprofit capital market” would be funders and organizations. Observers

note the fragmented nature of the nonprofit market, meaning that there are many small actors rather than a few large ones. This fact makes it substantially harder for high performing organizations to float to the top and attract large levels of funding. For example, Foster asserts that equivalent organizations in the for-profit world would more easily attract significant funding than their nonprofit equivalents (Foster 2007). In addition, the multiplicity of actors in the “nonprofit capital market” makes it harder for funders to find the types of organizations they would like to fund, and for organizations to find enough funders to cobble together the money they need (Emerson 1999), leading to higher transaction costs as managers spend more time on fundraising (Ryan 2001).

- Framing the conversation about the “nonprofit capital markets” encourages funders and nonprofits to think about the competitive nature of the market place, such as how “grants are sought and allocated competitively on the basis of the donor’s view of their productive potential” (Miller, “Equity Capital Gap,” 2008).
- The broader concept of “nonprofit capital markets” allows for an inclusion of for-profit organizations (banks insurance companies and bond placement agencies) that provide debt financing to nonprofits, rather than limiting it to just funders (Miller, “Equity Capital Gap,” 2008).
- The concept of a “nonprofit capital market” also leads observers to reflect on whether the nonprofit sector could borrow a page from the private sector and develop new “financial instruments” that would attract capital for nonprofits. Most examples of “financial instruments” cited by authors that we found were focused on encouraging private sector players to provide debt to nonprofits (usually engaged in housing or community real estate development) or to social enterprises that had the long-term capacity to pay back the loan (Ryan 2001; Salamon 2006; Emerson 1999).
- Last but not least, the concept of a “nonprofit capital market” is meant to highlight the idea of funders as “investors” who focus on putting their dollars into organizations that will create the highest “social return on investment.” While the concept is viewed generally in a positive light, Emerson makes an interesting point that holding organizations too accountable for SROI may discourage innovation if organizations believe it is more important to deliver SROI to funders than experiment with untested but potentially promising approaches (Emerson 1999).

6. Funder strategies to impact capital markets

Foundations clearly play a role in the nonprofit capital markets, and authors have posited various ways in which foundations can help to address the concerns and

challenges identified above. Foundations are seen as being a potential force for change. Keating notes that funders can play a special role in identifying crucial problems and allocating resources (Keating, "Capital Ideas" 2007), but because they form only 3% of the overall revenues in the charitable sector, Boris posits that their "influencing and leveraging is often at the margins, but can be critical" (Boris, "Capital Ideas" 2007).

Joint grants

Given the fragmentation of the funding markets, several authors have posited that foundations should pursue some type of joint grant making effort. The main model advocated is built on the private sector model of syndication, in which several investors provide money to the same organization at the same time for the same purpose, either as a loan or equity investment. The perceived advantage to syndication is that investors can provide a larger amount of money together than they could independently.³ Miller posits that in order to be impactful, equity investments would need to be larger than what a single funder can generally give, making syndication an attractive solution (Miller, "Equity Capital Grant" 2008).

Within the nonprofit sector, the concept of syndication is used within the context of grant making rather than lending. Because of this, varying forms of the syndication model include "co-investing" (Foster 2007), "side by side investing" (Bradley 2003) or "strategic co-funding" (REDF, cited in Burd 2009).

The Nonprofit Finance Fund Capital Partners program is a form of syndication. In the program, NFF identifies more established nonprofits that require significant up-front dollars to underwrite growth plans, and then identifies a group of funders who can provide that level of dollars as a group. Overholser notes that a key advantage of syndication models within the nonprofit sector is that it ensures that an organization will make the same case to funders rather than take time to reposition their plans multiple times to attract funders (Overholser, "Patient Capital" 2006). Another key advantage of the joint grantmaking model is that it could allow a group of funders and an organization to develop one set of measures that could be used by all (Miller, "Equity Capital Gap" 2008).

Other authors promote joint grant making, though their suggestions are couched in a conversation about effective philanthropy, rather than the fragmentation of the capital markets. However, many of their suggestions, such as match or challenge grant making, which "signals" other funders that organizations or projects have been vetted drive toward the same goal: grants that achieve greater social impact. (Porter & Kramer 1999; Burd 2009).

Joint lending entities

The nonprofit housing sector has established many financial intermediaries that provide better access to larger amounts

of debt financing. This is particularly prevalent in the community development field, where Ryan notices the establishment of organizations that are willing to make the high-risk loans to certain nonprofits (Ryan 2001). Salamon believes that foundations could play a role extending this concept to more nonprofits by encouraging large scale private sector investors like pension funds and insurance companies to lend money to nonprofits, thus tapping additional sources of capital in the form of debt financing (Salamon 2009).

In their study "Aggregating Impact," Cooch & Kramer explored the various mission investment intermediaries that are at funders' disposal. Their study revealed that while many foundations make mission investments (most commonly PRIs), few invest through intermediaries, which can offer greater expertise, lower transaction costs, and the ability to collect capital from multiple sources – all driving towards a greater impact. The authors identified six types of intermediaries in which foundations could invest: community development banks and credit unions, loan funds, venture capital and private equity funds, fixed income funds, real estate funds, and public equity mutual funds (Cooch & Kramer, 2007).

Mission investments have the dual goal of furthering a foundation's mission and recovering the principal funds invested (and occasionally earning a return). Money invested in intermediaries may not necessarily go to nonprofit organizations, but could instead benefit a for-profit organization or an individual that will achieve a social impact. While nonprofits (and foundation grantees) may be the beneficiaries, mission investments are also seen as tools for funders to maximize both impact and the value of their funds. (Cooch & Kramer, 2007)

Larger grants and/or increased payout

Another way to reduce fragmentation would be for foundations to increase grant size, which would reduce the need for organizations to spend time cobbling together grants and therefore improve efficiencies. Bradley cites the Gates Foundation as an example of a foundation that has focused on making significant grants in a few areas, which further allows the foundation to have greater impact (Bradley 2003).

Bradley argues that funders should increase their payout rates in order to push more funding into the system (Bradley 2003), again on the grounds that funds spent for social good today achieve greater impact.

Advocacy for government funding

Several speakers at the Capital Ideas forum noted that foundations could advocate for policy changes to either expand the levels of government funding, encourage government to provide a sufficient level of overhead to cover an organization's overhead costs, and/or advocate for regulatory changes (Beuchel "Capital Ideas" 2007; Cherna, "Capital Ideas" 2007; Feldstein, "Capital Ideas" 2007; Miller, "Equity Capital Gap" 2008). In his literature review and interview

project, Ryan found advocates of tax policies that would make investing in community development organizations more attractive to corporations (Ryan 2001).

There has already been some movement in the nonprofit sector to encourage the government to take steps that would help the sector: in 2004, Independent Sector convened a Panel on the Nonprofit Sector at the “encouragement of the leaders of the Senate Finance Committee.” Their report includes a number of suggestions to Congress and the IRS around laws and policies that inhibit effective nonprofit performance (Brest & Wheeler, 2008).

Information sharing

The Cultural Data Project initiated by the Pew Charitable Trusts and William Penn Foundation developed an online tool for grant applicants that created a centralized database of financial and programmatic information now used by fifteen funders and the State Arts Council (Burd 2009). The model has already been replicated in Maryland, California, Illinois, Massachusetts and New York (Burd 2009). CDP improved data quality as part of this effort by adding a call desk to answer questions from organizations about how to complete the form (Lippman, “Capital Ideas” 2007).

Bradley also noted that efficiencies could be created through affinity groups of associations that share knowledge among donors, research issues and develop potential solutions (Bradley 2003).

Streamlined grant making processes

In the writings on nonprofit finance, several authors are also promoting the idea of streamlining foundation grant making processes as another way to save costs both for grantees and for the sector. Miller notes that greater attention should be paid to “net grants,” noting that the time and effort required for some grant applications may not cover the costs of completing and submitting the application (Miller, “Capital Ideas” 2007; Burd 2009).

Specific recommendations to lower transaction costs include simplifying and standardizing grant applications (Beuchel, “Capital Ideas” 2007). Streamlining the grant making process is advocated in the literature on effective philanthropy as well (GEO 2008). Porter & Kramer, in their article “Philanthropy’s New Agenda: Creating Value” encourage foundations to align their operations and grant making processes with their giving strategy (Porter & Kramer, 1999).

Articles that focus on the grant making process often discuss additional effective philanthropic practices. Suggestions include: staff and board members with nonprofit experience (GEO 2008); granting general operating support; soliciting feedback from grantees (Burd 2009); multi-year funding that increases “value of accumulated learning” (GEO 2006); reducing uncertainty about decision-making responsibilities (in the event of a contracting situation); a trusting and honest relationship between funders and grantees (GEO 2006;

Brown & Troutt 2004; Burd 2009); and “paperless giving” (Burd 2009).

7. Measuring sustainability and impact

The use of metrics is a thread throughout many of the articles on business models and capitalization. In this section, we will briefly explore the ways in which the field is discussing metrics:

Metrics as a predictor of financial vulnerability

Tuckman and Chang defined financial vulnerability as the likelihood that an organization will “cut back its service offerings immediately when it experiences a financial shock” (Tuckman 1991). The authors assessed this by looking at an organization’s financial flexibility, which they assumed to exist when organizations had access to equity balances, many revenue sources, high administrative costs and high operating margins (Tuckman 1991). Hager built upon this work by narrowing the scope of analysis to arts and cultural organizations and focusing in on the ability of these measures to predict organizational demise:

- Low equity balance was found to be a viable predictor of demise among art museums, theaters and music organizations (Hager 1989).
- Low operating margin was related to the closure of theaters and generic performing arts organizations (Hager 1989).
- As noted earlier, high revenue concentration was predictive of organizational failure for visual arts, theaters, music organizations, and generic performing arts organizations; low administrative costs were associated with the loss of theater and music organizations (Hager 1989).

Metrics as an assessment of financial position

Another challenge taken up by various authors is the question of metrics that could be used to assess the financial position and capitalization of nonprofit organization. Chabotar (1989), Greenlee (1998), Keating (2005) and Tuckman (1991) all review a variety of metrics and posit ways to interpret them. For example, Greenlee argues that a high level of accounts payable aging indicates that the organization is having a hard time repaying its debts and may have future credit problems, while low values may indicate poor cash management practices (Greenlee 1998).

Chabotar notes that a financial ratio by itself almost never “almost never provides sufficient evidence for panic or pride” but ratios rather comprise an “early warning system” for management (1989). Chabotar also cautions against the assumption that a particular financial ratio is “good” or “bad” because “few solid standards exist and those that do may not be relevant” (1989). For example, “a national average is not a standard as much as it is a reflection of prevailing, and sometimes undesirable, financial conditions,” he writes (1989).

Metrics as part of the “nonprofit capital market”

Metrics also come into play during conversations about nonprofit capital markets. If the goal is for funders to “measure the impact of their philanthropic dollars,” then providing information evaluate organizational effectiveness is needed (Emerson 1999). As Emerson notes, “If the sector is to create a more effective capital market, the challenge of standards will have to be addressed successfully” (Emerson 1999). To that end, authors suggest extending metrics beyond financial ratios to include relevant measures about programs and input/output measures (Keating 2003, and, Tuckman 1991), traditional program and evaluation assessment tools, and continuing to evolve methods to evaluate social return on investment (Emerson 1999).

Streamlined or common metrics is seen as another avenue to greater efficiencies in the “nonprofit capital market” because they can be a way to avoid the costs incurred by having funders and organizations develop measures independently (Miller, “The Equity Capital Gap” 2008; Buechel, “Capital Ideas” 2007). Miller cautions that metrics that only focus on short-term outcomes can be “problematic,” as many of the outcomes hoped for by nonprofits and their supporters are achievable in the long-term (Miller 2009).

Metrics, data quality and availability

There is a belief that access to better data can help funders make decisions about the best use of their philanthropic dollars. However, data quality appears to be a barrier to the effective use of metrics. Data from nonprofit tax filings with the IRS 990 forms that are now widely available on Guidestar are problematic due to the prevalence of data errors and misunderstandings about how to complete the forms (Keating 2003). Data available from nonprofits’ own audits has its own set of drawbacks, such as variations in accounting practices (Chabotar 1989).

Authors have posited a variety of recommendations to improve data quality, including greater dissemination of audits, changes to the IRS 990 forms (Keating 2003), development of a uniform chart of accounts (Boris, “Capital Ideas” 2007). Keating and Frumkin explore the concept of addressing data concerns by establishing a new regulatory agency that would draw on both the Securities and Exchange Commission (SEC) and federal oversight of credit unions (Keating 2003).

Keating and Frumkin also note that it is the relevance rather than the existence of data that translates into effective decision making (Keating 2003). Another challenge is that while data can be provided to the public, stakeholders process information with different levels of expertise (Keating 2003).

8. Concluding questions

In looking back at the results of the literature review, we would pose the following questions:

- Given what we have seen in TDC’s practice, the creation of art is nearly always a subsidized business. What expectations should funders have about arts organizations’ reliance on contributed income? What expectations should funders have about when arts organizations are positioned to engage in income generating activities that may generate a profit?
- Given the needs and business models of art organizations, would it be more helpful for foundations to increase arts organizations’ access to debt or to funding that would help them build their cumulative net income over time? Is restricted endowment funding a priority need, and if so, in what circumstances should foundations seek to support it?
- Operating support is seen as highly beneficial. If the goal is long-term sustainability, how should foundations define “multiyear grants”? Should foundations commit to provide operating support indefinitely to key grantees? If so, what are the implications?
- What constitutes an “investment” in an organization? What intent or practices must be in place for dollars given to an organization to qualify as an “investment”? Is an “investment” defined by the size of gift? Are “investments” only one-time, or may they be ongoing?
- Is taking the role of an “investor” the best way to support the financial sustainability and capitalization of nonprofits? What are the benefits and drawbacks? What skills would foundations need to undertake this role successfully on their own?
- In a human services context, organizations with scalable models that lead to financial sustainability and high social return are seen as desirable “investments.” Are these the right characteristics for the arts and culture sector given that many arts groups do not have a scalable model and have missions that are focused on hard-to-measure artistic quality?
- What does it mean to be an “equity holder” making an “investment” in a nonprofit? How is the role distinct from that held by major donors in the past? Within the arts and culture sector, what does it mean to be an “equity holder” in an organization that is likely to always require significant levels of contributed income? Do all nonprofit “equity holders” seek to be rapidly “taken out” of a financing mix?
- What is the potential for foundations to make direct investments in the balance sheets of arts organizations by supplying dollars that could be used for working capital, operating reserves, risk capital or to support other board-designated funds?
- What potential exists for building on the models of joint grant making and joint lending relative to better meet the capitalization needs of arts and cultural organizations?

- Increasing organizations' ability to generate regular net income is a very straightforward way to help improve their capitalization. How might funders work together to support this goal?
- Advocacy for increased government funding was mentioned by several authors, most often in the context of encouraging the government to provide sufficient levels of overhead to organizations with government contracts. Is there a potential or need for funders to collaborate around this or similar issues within the arts and culture sector?

NOTES

1. <http://encyclopedia.thefreedictionary.com/retained+earnings>
2. <http://financial-dictionary.thefreedictionary.com/capital+markets>
3. <http://financial-dictionary.thefreedictionary.com/syndication>

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