A Conversation about Capitalization

Shakespeare Theatre Association Conference

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Presented by TDC

Why are we here today?

- A shared interest in the health and vibrancy of the performing arts sector.
- A recognition that many performing arts organizations are facing a number of challenges.
- A belief that capitalization principles are global, but that solutions must reflect your market realities.

The performing arts are facing multiple challenges

Strategic	Operational
• Shifting audiences, engagement patterns, and expectations • Increasingly competitive landscape • Changing philanthropic landscape	• Ever-growing core artistic and production costs, without a corresponding increase in revenue • High investment in facilities • Long-term dependence on sweat equity • Ongoing financial weakness

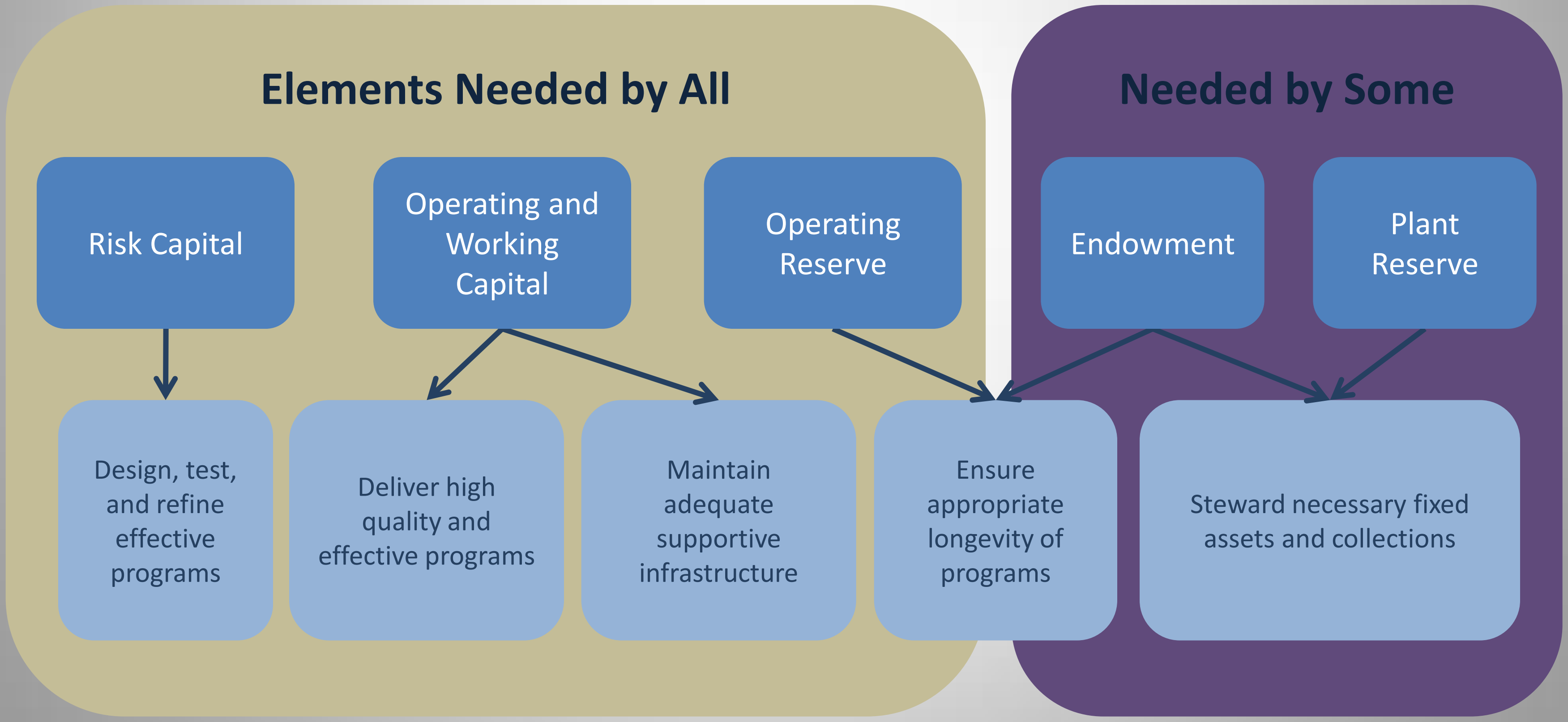
Why does capitalization matter?

- Healthy capitalization provides the resources to help organizations address these challenges.
- Capitalization is the glue that helps connect:
  - Organizational mission, vision, and strategy
  - Investment in the art
  - Ability to take risks

WHAT IS CAPITALIZATION?

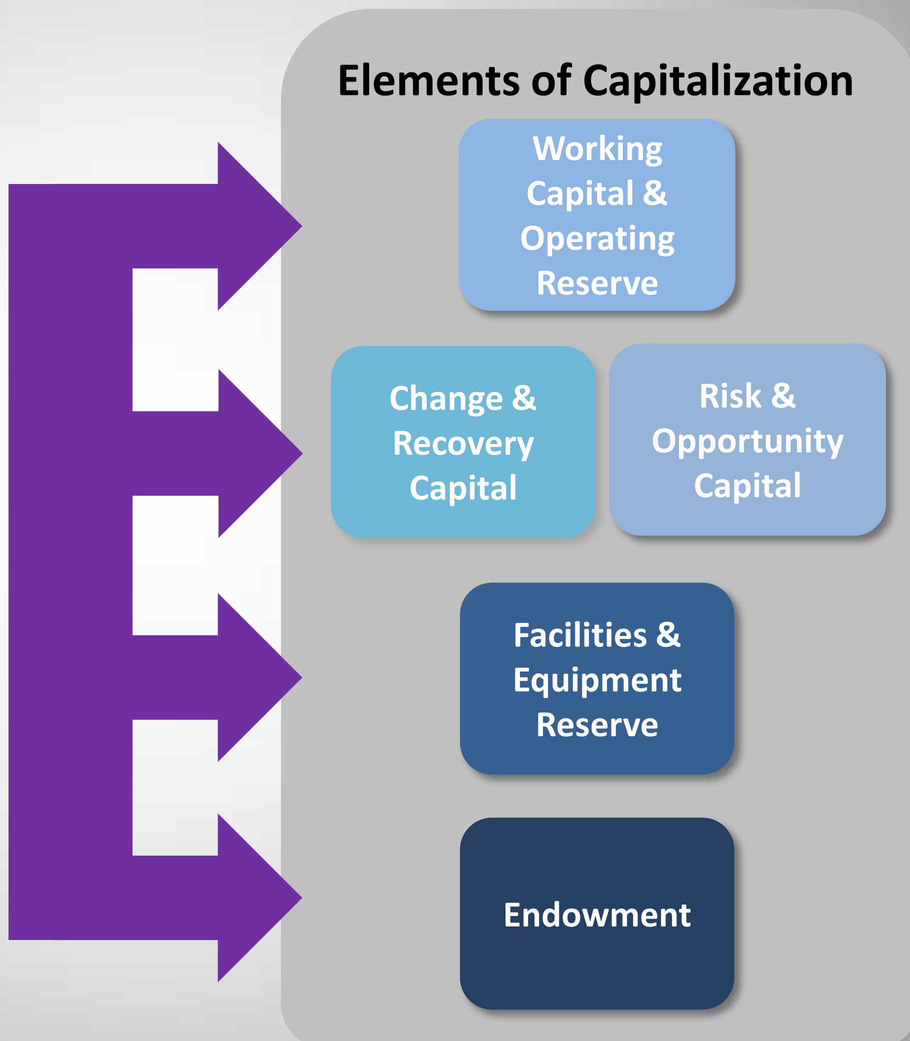
What is capitalization?

Capitalization is the accumulation and application of resources to support achievement of an organization's mission over time.



Elements of effective capitalization

P&L	**Balance Sheet**
Op. Revenue	
(Op. Expenses)	Assets
Capital Infusions	(Liabilities)*
Net Income	**Net Assets**



* Some elements of capitalization can be financed through strategic use of debt

Key terms

- Business model: how an organization makes and spends it money in service of its mission.
- Influenced by:
  - Artistic vision and strategy
  - Local market
  - Time horizon and lifecycle
  - Business drivers (audience, facility, collections, and other fixed costs)
- Comprises:
  - Revenue composition
  - Revenue predictability and reliability
  - Expense composition
  - Surplus size and reliability

Revenue and capital serve different purposes

- Revenue funds regular operations
  - Covers annual, full costs of programs & operations
  - Pays your organization to do what it does
- Capital provides liquidity, reserves and the ability to take a risk

What does effective capitalization look like?

- Operating revenue regularly exceeds expenses
- Risks are appropriately managed
- Fixed asset investments are funded predictably
- Innovation and change are possible
- High-quality programs are delivered consistently

PERFORMING ARTS IN CONTEXT

How well are arts organizations capitalized?

- Arts sector is under-capitalized and inappropriately capitalized
  - Proven by studies from NFF and TDC, and our work with organizations across the country
  - A specific analysis of the Philadelphia, Boston and Detroit sectors showed that, on average, 70% of organizations were inadequately capitalized

Elements needed by all

Working Capital & Operating Reserve	Risk & Opportunity Capital
Inadequate/ not present	Not present

Needed by some

Facilities & Equipment Reserve	Endowment
Not present	Inadequate / Inappropriate

It’s not about knowledge!

- We found that the majority of nonprofit leaders understand their financial position.
  - Neither discipline nor budget size is a factor.
- Many can point to the corrosive effects of poor capitalization, but feel powerless to address it.

Where's the disconnect?

- Internally focused planning.
- Incentives of funders/supporters and organizations are often misaligned, undermining the goals of solid capitalization.
  - Structural barriers
  - Behavioral barriers
  - Communications barriers

An Integrated Plan

Mission and Vision
- Artistic/cultural production
- Theory of change for impact on audiences and other beneficiaries

Market
- Customers
- Donors
- Competition

Resources
- Talent
- Space
- Networks

Time Horizon, Business Model Drivers, Life Cycle

Integrated Strategy

- **Programmatic strategy** maximizes artistic quality and impact, scaled to demand and available resources
- **Organizational strategy** includes adequate human and other resources to manage program and support activities (e.g. marketing, development, finances, facilities)
- **Capitalization strategy** articulates size and shape of capital needs to support programmatic and organizational strategies

Structural

- Chaotic capital markets result in an environment in which funders and donors do not support program and capitalization alignment.
  - Limited understanding of what drives individual business models
  - Absence of an “equity ethic” means limited investment dollars for R&D, risk, and change
  - Funders seek to support programmatic outcomes, not organizations

Behavioral

- Poor best practices, perpetuated by organizations and funders alike, hollow out already lean balance sheets:
  - Surpluses and reserves perceived as lack of need
  - Projects rarely cover full costs
  - New ideas supersede business as usual
  - Expectations of success stymie risk-taking

Communication

- Misaligned incentives create conditions in which it is often difficult for organizations to be transparent.
  - Did we manage the money as we said?
  - Are we hiding financial performance?
  - Are we perpetuating broken business models?

HOW DO WE CHANGE THIS?

Creating an integrated plan

Mission and vision

- Organizations must have a clearly articulated mission and vision.
- They should have a well-defined approach and methodology to fulfill that mission.
- Board and staff must agree upon the mission and approach.
- Once defined, the mission and vision must be considered through the following lenses…

What are your business model drivers?

Audience

Audience + facility

Audience + high fixed costs

Audience + facility + high fixed costs

What is your time horizon?

Immediate (Individual View)

- Highly specific artistic expression – often focused on a particular artist
- Rented or borrowed facilities
- Highly flexible with limited fixed costs

Medium Term (Organizational View)

- Artistic expression fulfills established brand identity
- Facility ownership may or may not be supportable
- Fixed costs must be tightly controlled

Long Term (Institutional View)

- Obligation to persist as civic anchor or long-term stewardship of collection or an art form.
- Facility ownership often necessary
- Fixed costs extensive and multi-faceted

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

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

Importance of the marketplace

- A thorough understanding of the marketplace tests the mission and vision and predicts the resources available:
  – Definition of audience
  – Demand/pricing
  – Support
  – Competition
- These questions can only be answered in the context of the local community and are particularly important during periods of program or facility expansion.

Resources

- Analyzing the marketplace also helps determine the cost of doing business:
  - Talent
  - Fixed costs
  - Marketing and development investments
- Organizations with facilities must also define long-term systems replacement needs and funding requirements.

Integrated holistic planning

Time Horizon, Business Model Drivers, Life Cycle

Mission and Vision
- Artistic/cultural production
- Theory of change for impact on audiences and other beneficiaries

Market
- Customers
- Donors
- Competition

Resources
- Ongoing resources to sustain operations and fixed costs
- Human resources
- Key investments

Planning process is informed by the above data and analysis, and engages board, staff, partners, and supporters to have a shared and holistic understanding of the organization.

Integrated Strategy

- **Programmatic strategy** maximizes artistic quality and impact, scaled to demand and available resources
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HOW DO WE CHANGE THIS?

Determining the necessary capital

Sizing and funding capital needs

		1 Sizing the Need	2 Funding the Need
		Predict scale of each fund, based on review of below factors. Pay attention to how needs might change over time.	Prioritize implementation of capitalization strategy based on hierarchy of needs and feasibility in the market.
Operating and Working Capital	Operating Reserve	• Talent and fixed costs • Predictability of annual revenues	3 Fund through annual operations that generate adequate operating surplus
Risk or Opportunity Capital	Facilities Reserve	Dependence of program strategy on: • Innovation • Facility	4 Fund via surplus as above, but can use non-operating fundraising to “catch up” or seed new
Endowment		Dependence of mission on access and stewardship of collection or other perpetual asset	5 Scale generally necessitates non-operating fundraising

Sizing transitional capital needs

Recovery Capital:

"Can't function until you clean it up" capital

- Pays off past debt
- Moves URNA out of the red
- Provides interim working capital
- Funded by people who love you

Change Capital:

Required to test and execute a new business model

- Covers planned deficits and one-time expenses <u>temporarily</u> until revenue reliably covers full costs
- Funded by people who love you

Prioritization depends on your capitalization stage

Recovery

Broken Business Model	Negative URNA	Structural Deficits	Negative Cash

Transition

Weak Operating Model	Thin Balance Sheet	Breakeven or Deficit	<1 Month Cash

Strengthen

Working Operating Model	Thin Balance Sheet	Breakeven or Better	Undercapitalized

Deploy & Maintain

Stable Operating Model	Healthy Balance Sheet	Regular Surpluses	Well capitalized

What capital funds are needed at each stage?

Recovery

- Recovery Capital
- Change Capital
- Working Capital

Transition

- Change Capital
- Working Capital
- Endowment (if applicable)

Strengthen

- Working Capital
- Operating Reserve
- Facilities Reserve (if applicable)
- Endowment (if applicable)
- Risk or Opportunity Capital

Deploy & Maintain

- Working Capital
- Operating Reserve
- Facilities Reserve (if applicable)
- Endowment (if applicable)
- Risk or Opportunity Capital

HOW DO WE CHANGE THIS?

Integration through the risk lens

Risk in the context of capitalization

Operational Risk	Strategic Risk

Operational Risk

- Program Risk
- External Risk
  - Audiences
  - Funders
  - Shifts in the economy
- Human capital
  - Loss of leadership

RISK MANAGEMENT

Strategic Risk

- Programmatic
  - Pilots
  - New opportunity
  - Change in core offerings
- Organizational
  - Marketing/development
  - Facilities
  - Change in scale or size

RISK TAKING

Risk in the context of capitalization

Risk management is about…

- the liquidity and flexibility of your balance sheet, and the role of your reserves in achieving your mission.

Risk taking is about…

- change through thoughtful planning, research and development, and making investments.

Risk in the context of capitalization

Risk aversion is about…

- living in the recovery stage, paralyzed and unable to think about change…stalled or diminishing vision
- living in the transition stage, on the cusp, hoping but now knowing if the market is there for you…stalled vision
- living in the strengthening stage, overly cautious because of the communal memory of scarcity…stalled vision

Risk management questions

Flexibility and liquidity: operating, facilities and risk reserves

- What are the core expense drivers that we must continually invest in?
  - What is the balance between essential artistic/programmatic costs and fixed costs?
- What are the core income drivers, and what is the risk associated with each?
  - How much is artistic risk a part of our business model?
  - How do we account for external forces?
- What reserves do we need to establish and replenish—and when?

Risk management questions

Organizational risk and change & recovery capital

- What is the scale of the organizational change that we are undertaking?
  - Small vs. large programmatic risk
    - Could use risk capital but may need change capital
  - Targeted organizational risk
    - Same as above
  - Significant organizational risk
    - Change or recovery capital

Risk avoidance questions

- Recovery
  - Is our business model working against us?
  - Is what we do relevant and fundable in this market?
  - What capital funds will stabilize us?
- Transition
  - How do we implement changes to our business model?
  - What market testing do we need to do?
- Strengthen/Deploy & Maintain
  - Are we communicating our capital needs clearly enough?
  - Have we identified and sized the risks associated with the projects we wish to undertake?
  - Are our financials clear, and our policies transparent?

HOW DO WE CHANGE THIS?

Messaging the need – changing the conversation with funders

Crafting and disseminating the message

- How do these four factors—your capitalization stage, the capital funds you require, the mechanisms for raising capital, and your donor/funder audience—shape your:
  – Internal and external message content?
  – Communication tools to reinforce the message?

Taking the lead

- All messaging begins with these questions:
  - Why does it matter?
  - How do I know it will work?
  - How much money do I need?
- The answers are reflected in your strategy
  - Why does it matter?
    - Mission, vision, programmatic design
  - How do I know it will work?
    - Market and resource testing
  - How much money do I need?
    - Operating needs (program and operating strategy)
    - Capital needs (cash, reserves, risk, investment, endowment)

Concluding thoughts: moving toward effective capitalization?

1. Evaluate your strategy and business model in the context of your marketplace and financial reality.
2. Engage everyone—staff, board, funders—in integrated planning.
3. Determine appropriate types and amounts of capital to support your liquidity, adaptability, and durability.
4. Distinguish capital from revenue in organizational plans, financial reporting, and fundraising strategies.
5. Remember, supporters give to mission, not balance sheets.
6. Manage costs in the context of revenue and capital realities.
7. Focus on enterprise health as a means to artistic vibrancy.