



Capitalization, Scale, and Investment: Does Growth Equal Gain?

A Study of Philadelphia's Arts and Culture Sector
2007 to 2011

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A Study of Philadelphia's Arts and Culture Sector, 2007 to 2011*

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The core of the data in this report was sourced from the Cultural Data Project, an invaluable resource for the field.

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In 2009, TDC published *Getting Beyond Breakeven*, a study commissioned by the William Penn Foundation and The Pew Charitable Trusts, which reviewed the capitalization needs and challenges of arts and culture organizations in Philadelphia. The study had two main findings:

- **Weak financial health.** Of 158 organizations, over 70% were living in a highly vulnerable state of capitalization, with weak or broken business models, limited access to unrestricted cash, and inadequate means to guard against risk.¹
- **Strong financial literacy.** Of 60 organizational leaders interviewed, 55% had a high level of financial literacy, 35% had a medium level, and only 10% had low financial literacy.

Financial literacy was not correlated with financial health. TDC posited two potential reasons for the disconnect between financial literacy and financial health. First, that organizations undertake planning efforts with an incomplete understanding of the external marketplace and a corresponding acceptance of norms based on comparisons with weak peers. Second, that organizations are often faced with a chaotic philanthropic market that does not encourage behavior leading to stronger financial health.

At its heart, *Getting Beyond Breakeven's* message about capitalization is simple: nonprofit organizations require adequate levels of capital to fulfill their goals, feasible strategies to access that capital, and control over how to spend it. Unpacking these ideas has been a leading focus of TDC's work ever since. In partnership with the Nonprofit Finance Fund, we engaged members of Grantmakers in the Arts across the country in a series of conversations about how funder practices can have unintended consequences for the organizations they support. We have had the privilege of working closely with a number of major foundations to both infuse thinking on capitalization into their grantmaking and provide technical assistance on capitalization strategies to their grantees. Lastly, we have partnered with associations, such as the League of American Orchestras, to catalyze capitalization-focused thinking among their members. To this end, TDC has developed tools, guides, presentations, and programs to build knowledge and prompt conversation promoting effective capitalization in the broader arts community.

As we reflect on our work over the past five years, we find that there are important nuances to *Getting Beyond Breakeven's* message that should be explored. Yes, it is true that nonprofits need adequate levels of capital to fulfill their goals. But, what is *adequate*? And, what exactly are the *goals*, anyway? We posit that adequate capitalization is necessary for great art-making. We see evidence of this hypothesis again and again in the field: poor capitalization forces organizations to make compromises and divert attention from art making. Yet, at the same time, these organizations – even the most financially distressed – persist and manage to produce art. While much of the art is good, very few organizations report that they can afford to be consistently great. TDC posits in *Getting Beyond Breakeven* that this state of affairs can change only if organizations understand their markets and size themselves accordingly, and if funders align their investments to support progress. But, what does it mean to *size to your market*? Which investments are supportive, and which are counterproductive? Can the capital market support all of these organizations? If not, who should get the capital and why?

As one of our key thought partners, the William Penn Foundation has pondered the same range of questions. Together, we decided to revisit and more deeply explore the themes present in the original *Getting Beyond Breakeven* study. It is a timely moment. Philadelphia is at a pivotal point. Over the past few years, the city has seen major institutions in crisis, high-profile mergers, and fundamental shifts in the philanthropic community. Scanning the ecosystem at this moment has yielded important insights that may be helpful as organizations and funders alike chart the course forward. While every community is unique, we believe that these findings are relevant to the arts sector beyond Philadelphia. The systemic findings are particularly pertinent to other urban centers with a densely populated market of organizations. And, in a similar way to *Getting Beyond Breakeven*, the organizational-level findings should be applicable to any manager that is concerned with sustainability, growth, and capitalization.

¹ The study was based on 2006 data.

The Study

The study is divided into two major sections.

Part I. Trends in the Greater Philadelphia Ecosystem.

In the first section, we aim to take the temperature of the Philadelphia arts ecosystem again, in order to see how organizations fared over the five year period of 2007 to 2011. Looking at the data through the lenses of budget size, age, discipline, and financial health, we explore questions such as: What happened to revenue and expenditures? What were the major drivers? Who gained? Who lost ground?

Part II. Assessing Investments Toward Growth.

The organizing principle behind the second section has evolved over the course of the study. Our intention was to identify factors that correlated with financial health. We hypothesized that sustained investments in program, marketing, and fundraising may predict gains to financial health. When we attempted to identify organizations that had made *sustained* investments, we found very few. At the same time, the data did show widespread growth. Through interviews and in our experience, TDC identified an assumption that growth is a proxy for health. We posit in this section that growth is complicated, and should not be viewed as a one-size-fits-all remedy for financial distress. While growth is a feasible aspiration for some organizations, it can be debilitating for others.

Details regarding our analysis can be found in the appendices to this report, which are posted at TDC's website at www.tdcorp.org.

Before diving into the findings, we will pause to define key concepts and to provide background on the data that underpin the report.

Key Concepts

There are a number of terms used throughout the report that warrant upfront definition.

Capitalization. Capitalization is the accumulation and application of resources to support achievement of an organization’s mission over time. Developing a capitalization strategy (i.e. setting capitalization goals) must be done with an understanding of an organization’s business model drivers, time horizon, lifecycle stage, and other factors that define risk and flexibility. TDC looks for seven different types of capital funds when reviewing an organization’s balance sheet and capitalization strategy. These funds each have a distinct purpose and thus should be thought of as separate reserves. It is important to note that not all organizations need all of these funds.

We encourage readers to review *Getting Beyond Breakeven* to gain a full understanding of TDC’s approach to capitalization.

Capitalization Stages. TDC has defined four capitalization stages, highlighting the dynamic nature of building (or losing) financial health. Each of the stages implies a different set of needs that an organization should consider when preparing its capitalization strategy. The four stages, At Risk, Vulnerable, Stable, and Sustaining, are defined in Table 2 below.

For more information on how we diagnosed financial health with CDP data, see Appendix III. For more on integrating capitalization into planning, please turn to Appendix V. Find appendices at www.tdcorp.org.

Table 1. Capital Funds

Fund	Description of use
1 Working capital	Working capital smooths cash flow bumps that arise from predictable business cycles.
2 Operating reserve	Unlike working capital, operating reserves are held in order to protect against unexpected downturns, i.e. the “rainy day.”
3 Facilities reserve	A cash fund that organizations with facilities or significant leasehold improvements maintain to realize facilities replacement plans.
4 Opportunity or risk capital	Opportunity or risk capital gives organizations the freedom to try out new ideas such as product extensions, new marketing campaigns, earned income ventures, major growth, or a new strategic direction. Risk capital should be used to address large environmental shifts that demand a change in strategic direction.
5 Endowment	Endowments ensure the longevity of organizations with long-term time horizons through investment earnings dedicated to ongoing fixed costs, such as labor agreements or maintenance of a historic building.
6 Recovery capital	Recovery capital is necessary for an organization with negative net worth and structural deficits to recover and maintain operations. Recovery capital provides interim working capital, moves unrestricted net assets out of the red, and enables the organization to pay off past debts.
7 Change Capital	Change capital is required to test and execute a new business model.

Table 2. Stages of Capitalization

Stages	Characteristics of capitalization stages			
At Risk	Broken operating model	Negative available URNA ²	Structural deficits	Negative cash
Vulnerable	Weak operating model	Thin balance sheet	Breakeven or deficit	< 1 month cash
Stable	Working operating model	Thin balance sheet	Breakeven or better	Undercapitalized
Sustaining	Stable operating model	Healthy balance sheet	Regular surpluses	Well capitalized

² TDC uses available unrestricted net assets as a simple measure of basic solvency. To calculate “available unrestricted net assets” (as opposed to total unrestricted net assets), we subtract equity in fixed assets from total unrestricted net assets, since fixed assets in general are illiquid. Please turn to the appendices for a precise definition of negative and marginal available unrestricted net assets.

Investments. TDC uses *investment* to signify an expenditure that is made with the goal of generating a return, be it financial or mission-based. This study looks specifically at the impacts of financial investments in the areas of marketing, programs, and fundraising. In this context, the term *investment* is not referring to the act of investing in financial markets in order to create capital gains.

Dependencies. In this report TDC discusses *dependencies* in terms of organizations' dependence on different revenue sources. For instance, an organization that raises more than 50% of its contributed revenue from foundations is highly foundation dependent.

Efficiencies. TDC uses this term to reference the ratio of expenditure to return on investment. For example, analyzing the ratio of fundraising expense to dollars raised through

contributed sources helps shed light on the payback of investment in this area. In this case, the lower the ratio the more efficient the organization's fundraising model. We also looked at the efficiency of spending on marketing and program.

Business model. In this report TDC uses the terms *business model* and *operating model* interchangeably. They refer to an organization's annual operations. The business model's financial results are reported on the profit and loss statement. The numbers, though, only reflect the underlying drivers, which generally include attendee demand (as measured financially in admissions and other forms of program-based earned revenue), donor demand, net income from enterprises, fixed and variable costs for programs, and overhead. The ability of the operating model to generate net income is what drives an organization's ability to amass adequate capital on its balance sheet.

The Data

As in the previous study, we pulled our core data set from the Pennsylvania Cultural Data Project (CDP). We chose two samples from the Cultural Data Project, which we call the CDP Population and the Study Sample. We used the former to understand aggregate trends in the ecosystem, and the latter to conduct more in-depth analysis at the organizational level.

CDP Population

TDC used the CDP Population dataset as a proxy for the Greater Philadelphia ecosystem as a whole. In forming this dataset, we began with the overall CDP universe of 595 organizations. We took advantage of the fact that CDP has matured since 2009 and chose organizations with five years

of data in order to review trends from 2007 to 2011. While we screened out organizations with erratic data, we kept the 20 that were newly established during our time frame of 2007 to 2011 in order to account for entrants into the system. Applying the screen of consistent data yielded a sample size of 282 organizations. As shown below in Table 3, the CDP Population is dominated by smaller organizations, organizations between 10 and 30 years old, and Philadelphia-based organizations.

We used the CDP Population to calculate aggregate numbers for revenue, expenditures, attendance, and donors. We also looked at change over time in the distribution of organizations with different budget size levels; new entrants and organizations of different ages; and organizations with inadequate levels of available and unrestricted net assets.

Table 3. CDP Population Basic Distributions

Budget Size	Orgs	%	Age Range	Orgs	%	County	Orgs	%
>\$20M	7	2%	Less than 10 years	47	17%	Bucks	15	5%
\$5-20M	23	8%	10-29 years	114	40%	Chester	9	3%
\$1.5-5M	26	9%	30-49 years	56	20%	Delaware	16	6%
\$500K-1.5M	64	23%	Over 50 years	65	23%	Montgomery	18	6%
\$250-500K	40	14%	Grand Total	282	100%	Philadelphia	224	79%
<\$250K	122	43%				Grand Total	282	100%
Grand Total	282	100%						

Source: 2011 CDP Population data

Study Sample

We used the Study Sample dataset to conduct more in-depth analysis at the organizational level. The Study Sample differs in a few important ways from the CDP Population. We did not include organizations with budget sizes under \$150,000 or those embedded within larger institutions, reasoning that these groups' core capitalization issues are distinct from those of most organizations. We did, however, relax our rule about consistent data across all five years, in order to include a few market-making organizations. This left a sample of 163.

We viewed the Study Sample organizations through many different lenses in order to understand trends in the data.³ In addition to budget size and age, we looked at discipline. We reviewed the Study Sample organizations' expenditures in program, marketing, and fundraising, and measured indicators of success, such as growth in revenues and attendance, and improvement of financial health. We also looked carefully at these organizations' dependence on different types of revenue and the efficiency of their investments. Finally, we conducted deeper financial analysis of Study Sample organizations, sorting them into the four capitalization stages.

Table 4. Study Sample Basic Distributions

Budget Size ⁴	Orgs	%	Age Range	Orgs	%	Discipline	Orgs	%
>\$20M	7	4%	<10 years	10	6%	Arts Education	37	23%
\$5-20M	16	10%	10 to 30 years	66	40%	ASO	11	7%
\$1.5-5M	29	18%	30 to 50 years	40	25%	Multi-disciplinary	8	5%
\$500K-1.5M	59	36%	>50 years	47	29%	Museums/history	50	31%
\$250-500K	34	21%	Grand Total	163	100%	Performing arts	57	35%
\$150-\$250K	18	11%				Grand Total	163	100%
Grand Total	163	100%						

Source: 2011 Study Sample data

Qualitative Research

To further illuminate our quantitative analysis, TDC interviewed 38 leaders from organizations in the Study Sample that represent a variety of disciplines and budget sizes. We asked these individuals to provide us with a deeper understanding of the operating environment in which they exist and the important choices they made over the past five years.

Table 5. Interviewed Organizations

Budget Size	Orgs	Disciplines	Orgs
>\$20M	4	Arts Education	5
\$5-20M	10	Museums/history	14
\$1.5-5M	11	Performing Arts	19
\$500K-1.5M	7	Grand Total	38
\$250-500K	4		
\$150-\$250K	2		
Grand Total	38		

Source: 2011 Study Sample data

³ The appendices detail the many lenses through which we viewed the data.

⁴ Budget size in this table is based on the latest year of data available for each organization. 2011 is the most common last year, but some organizations had data for 2012 and others last reported in 2010.

A Note on the Data

We preface this report with several caveats about the data.

- First, we could only include organizations that entered data into CDP. As such, our samples are not drawn randomly from the universe of arts organizations in Philadelphia, and we cannot report the degree of confidence by which our analysis reflects the true whole.
- Second, the main portion of our analysis focuses on data from 2011. When the data were drawn, many organizations had not yet submitted 2012 information.
- Third, we drew the CDP Population sample so that we could have matching data in each year from 2007 to 2011. Unfortunately, organizations in Pennsylvania are not required to submit CDP data each year, and there were a significant number that did not have consistent annual data during this period. As a result, our sample only reflects organizations that consistently entered data each year from 2007 to 2011, or that were founded during that time. This choice may have introduced a positive bias to the data – favoring organizations with enough wherewithal to submit CDP data each year. On the other hand, organizations in financial distress may also have been highly motivated to submit data in order to qualify for foundation funding.
- Fourth, TDC's analysis is dependent on the reliability of CDP data, which in turn rely on the precision of organizations' data entry as well as the accuracy of the audits and financial statements from which data are drawn.

While we cannot take responsibility for the complete integrity of CDP data, we do acknowledge that any errors in the analysis of the data are our own. To this end, accompanying the main report is a set of appendices detailing how we used CDP data found at www.tdcorp.org. To unlock CDP's potential, we overlaid levels of interpretation on the data. For example, we created rubrics to diagnose financial health, determine efficiency of program investments, and understand revenue dependencies. We have attempted to make these interpretations of the data transparent in the appendices as a way to share our thinking with others using CDP to analyze the sector.

Part I: Trends in the Greater Philadelphia Ecosystem

In *Getting Beyond Breakeven*, TDC reported on 2006 data, providing a picture of the ecosystem prior to the 2008 recession. That picture was grim. Of the 158 organizations included, we categorized 77% as inadequately capitalized. As we took the temperature again, we were interested to find if things had changed. How did organizations weather the financial crisis? How did the system as a whole change over time? What is the current market context? Are organizations well positioned to face the future?

Overall, three major trends emerged from both the CDP data and our interviews with organizational leaders.

- 1. Organizations remain financially weak.** Organizations remained undercapitalized with approximately 70% meeting our criteria for poor financial health. In the aggregate, the distress was deeper: the total amount of negative available unrestricted net assets in the system grew from negative \$14 million in 2007 to negative \$25 million in 2011.⁵
- 2. Competition increased.** A theme that recurred during our conversations with organizational leaders was a sense of intensified competition in the Philadelphia arts community, particularly for contributed dollars. We noted a pervasive anxiety about how the markets for major individual donors and foundation dollars were changing simultaneously. Our look at CDP data backed up this perception and pointed toward three forces causing competition to intensify: a lack of organizational exits, a tendency toward growth especially among larger organizations, and a net decline in paid attendance.
- 3. The market is in transition.** Greater competition was only one element of change in the ecosystem. Like all arts markets, Philadelphia is experiencing consumer trends related to generational shifts: audience purchase patterns and donor motivations are changing. At the same time, Philadelphia's foundations are adjusting their approach to the arts. In *Getting Beyond Breakeven*, TDC found that such external market conditions were rarely considered in organizational planning. Today, interviews showed the opposite to be true. Organizations were highly attuned to changes in the market for both earned and contributed revenue. As a result, the prevailing question we heard was *how do we respond?* While organizations' answers to this question varied, the commonality was that they all need money to see their strategies through. It is a truism that organizations need more capital during moments of transformation. But what happens when the *entire market* is changing?

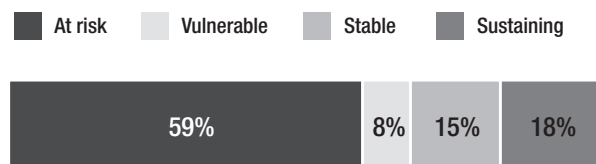
Below we discuss these three trends in more detail, illuminating the data and insights that illustrate each concept.

Trend 1: Organizations remain financially weak.

Analysis of both the CDP Population and Study Sample datasets showed weak financial health across Philadelphia's arts and culture sector.

For the CDP Population, TDC reviewed organizations' months of available unrestricted net assets as a basic measure of solvency. The 2011 results mirrored what we found in the past study – about 70% of organizations had negative or marginal unrestricted net assets, signaling they are in a precarious position of financial health. We conducted a finer-grained analysis of financial health using the Study Sample organizations, scoring organizations on multiple measures and grouping them into the four stages of capitalization described in Table 2.⁶ Like the CDP Population, approximately 70% were identified as having weak financial health.

Figure 1: Capitalization Stages



N=152

Source: 2011 Study Sample data

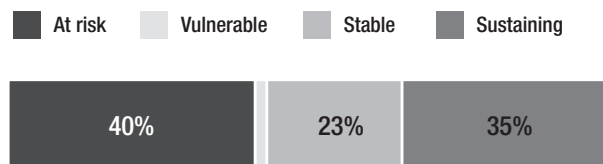
We reviewed the Study Sample more closely to determine whether certain types of organizations were more or less likely to experience poor financial health. Budget size was not correlated with financial health; we found poor capitalization among the largest and smallest organizations at approximately the same rate. However, we did find variations in three other factors reviewed below – age, growth in budget size, and discipline.

⁵ See Footnote 2 for an explanation of available unrestricted net assets. In general, an organization develops negative available unrestricted net assets when it has accumulated operating deficits that are larger than its accumulated surpluses.

⁶ Please review Appendix IV to see TDC's complete rubric for diagnosing financial health.

Age. The oldest organizations – those over 50 years old – were in better health than their younger counterparts.

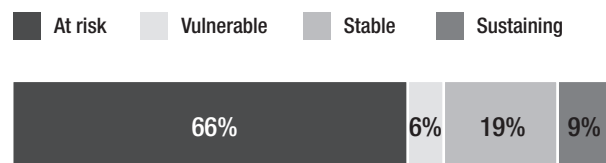
Figure 2: Capitalization Stages for Orgs 50+ Years



N=43
Source: 2011 Study Sample data

Budget Size Growth. We observed a higher prevalence of financial weakness among the 32 organizations that had moved into a larger budget size category over the five years.⁷

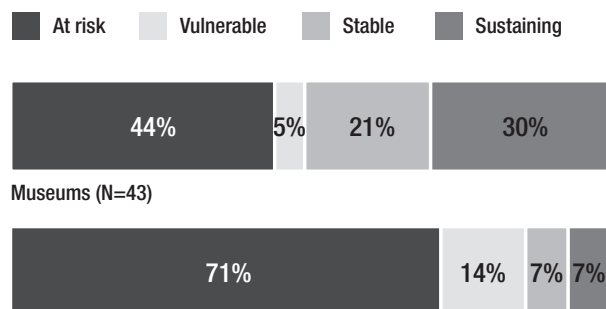
Figure 3. Capitalization Stages for Orgs that Grew Budget Size



N=32
Source: 2011 Study Sample data

Discipline. Museums were in better financial health than their counterparts in the performing arts. This finding was somewhat surprising, since we set higher liquidity thresholds in our financial health rubric for organizations with collections and facilities, which includes most museums. While we don't have a clear explanation for this difference, we note that museums in our sample were much more likely to be at the older end of the age spectrum than performing arts groups.

Figure 4. Capitalization Stages by Discipline



Performing Arts (N=56)
Source: 2011 Study Sample data

After reviewing organizations' change in financial health over time, we found that inertia was the predominant dynamic at play: 60% of organizations stayed in the same financial health category, and organizations in the poorest health were the most likely to stay that way. Of the remaining 40% that changed, about half improved and half declined. We saw few notable patterns among the groups that improved or declined in financial health. Interestingly, however, while museums as a cohort were in better financial health, they were somewhat more likely than the average organization (31% vs. 20%) to have declined in financial health during this period than to have stayed in the same category. Performing arts organizations conformed more closely to the average in this measure.

Other variations from the norm we found interesting yet somewhat inconclusive due to small sample sizes were:

- Half of the eight youngest organizations (less than 10 years old) improved in financial health.
- Organizations in the budget size categories of \$1.5M-\$5M and \$5M-\$20M were more likely to have improved financial health (39% and 33% respectively) than the norm of 20%; conversely, the \$500,000-\$1.5M cohort was somewhat less likely to improve (9%).
- Nine of the 10 organizations categorized as Vulnerable actually *improved* to get there, while 15 of the 22 organizations in the Sustaining category did the same.
- As a predictable corollary, nine of the 20 in the Stable category *declined* from Sustaining.

In summary, we found weakness to be the prevalent condition of financial health across the ecosystem, particularly for younger organizations, performing arts organizations, and those in growth mode. The ecosystem, therefore, remains poorly positioned to manage risk and implement change, and it continues to face the challenge of building adequate capitalization. What this means in practice is visionary leaders who are hampered from pursuing exciting directions because they do not have the working capital to secure a necessary contract. Or, organizations attracting strong attendance through engaging programs that still cannot keep up with the cash demands of a legacy building. Or, history institutions eager to build contemporaneous collections being hamstrung by the lack of capital to invest in more storage space.

⁷ The budget size categories are defined on page 5.

Trend 2: Competition increased.

We heard in interviews that competition for resources was felt keenly by organizations of all stripes – museums, performing arts groups, major institutions, and more modestly scaled operations. Looking at the numbers, we found that interviewees were not wrong in their collective perception that they are chasing a shrinking pie. TDC identified three factors that served to intensify competition:

- *Weak organizations didn't exit the field.*
- *Large organizations – but not the largest – took a bigger slice of the pie.*
- *The audience of paid attendees did not grow.*

Weak organizations didn't exit the field. Nonprofit startups linger longer than their counterparts in the for-profit world. A 2008 study found that 12% of nonprofits exit in the first 5 years and 17% in total exit after 10 years. In comparison, 60% of for-profit manufacturing firms close within the first 5 years and a total of 80% are gone within 10 years.⁸ Scholars have posited that nonprofits experience barriers to exit that do not exist in the for-profit world, such as donations that subsidize inefficiency and greater access to volunteer labor.^{9,10} We found supporting evidence of nonprofits' amazing tenacity, even when in distress, when we looked at arts organizations in Philadelphia.

Between 1995 and 2008, the number of nonprofit arts groups in Greater Philadelphia increased by 6%, from 1,669 to 2,740.¹¹ This growth was fueled by a city-wide revitalization strategy with the arts as its centerpiece.¹² During our interviews for the first study, some observers felt that a thinning of the herd might be healthy, and the phrase “don't waste a good crisis” was a common expression. As we revisited the ecosystem, we were interested to see if this phenomenon had in fact come to pass.

Unfortunately, CDP does not allow a straightforward look at insolvency and closures. Since Philadelphia organizations are not required to submit data every year, we could not interpret disappearance from CDP as proof that an organization had ceased operations. Lacking data on closures, we used indirect methods to investigate, and did not find evidence of a culling.

- First, we attempted to determine if any of the 158 organizations included in *Getting Beyond Breakeven* that had gone bankrupt. TDC and staff from the William Penn Foundation knew about only a tiny handful of organizations that had ceased operations.
- Second, as detailed above, we found that about 70% of organizations were in poor financial health which aligned to our findings based on 2006 data. Had weaker organizations exited the system, we would have expected remaining organizations as a whole to be stronger.
- Finally, we found evidence when we looked at the distribution of organizations by age. We separated the CDP Population organizations into four age groups.¹³ We found that the oldest group – those over 50 years of age – was a smaller cohort that tended to be financially stronger, implying that weak organizations had died off over time. However, the results were strikingly different for middle-aged (30-49 years old) and teenaged (10-29 years old) organizations. These cohorts were large, and weak organizations predominated, particularly among the teenagers.

This pattern – a logjam in the middle years – is exactly what you would expect to see in a system that encourages survival, despite poor financial health. Without timely exits, competition has no natural release valve.

Table 6. Age Distribution

Age Range	Orgs	%
Less than 10 years	47	17%
10–29 years	114	40%
30–49 years	56	20%
Over 50 years	65	23%

Source: 2011 CDP Population data

⁸ Teresa D. Harrison and Christopher A. Laincz (Drexel University), “Entry and Exit in the Nonprofit Sector” (2008).

⁹ C.F. Chang and Howard Tuckman, “Financial vulnerability and attrition as measures of nonprofit performance,” *Annals of Public and Cooperative Economics* 62, no. 4: 655-672 (October 1991).

¹⁰ Eric C. Twonbley, “What Factors Affect the Entry and Exit of Nonprofit Human Service Organizations in Metropolitan Areas?” *Nonprofit and Voluntary Sector Quarterly* 32: 211-235 (2003).

¹¹ Greater Philadelphia Cultural Alliance in Peter Dobrin, “Philadelphia's culture boom strains under the costs of upkeep,” *Philadelphia Inquirer* (September 23, 2014).

¹² Dobrin 2014

¹³ See Appendix I for a chart showing organizations by the year they were established.

Large organizations – but not the largest – took a bigger slice of the pie.

A corollary to a system with limited exits is a growth in demand for resources. The aggregate expenditures of CDP Population organizations increased by 11% from \$580 million in 2007 to \$643 million in 2011, beating the 8.3% total inflation rate over the same period.

However, after a deeper look at expenditures, we were startled to see a trend in Philadelphia that diverges from the pattern we have seen elsewhere. In most arts communities, the very largest organizations are the smallest in number but in aggregate make up the largest portion of sector-wide expenditures. Very large organizations (as we call those with budgets above \$20 million) attract the most attention, visitors, and donations.¹⁴ In 2009, we observed this trend in Philadelphia. By 2011, however, a different dynamic had emerged.

As Table 7 shows, the largest percentage growth overall was in the \$5M-\$20M group, which we refer to from this point on as *large organizations*. This cohort grew in number by 64% during this period, at a much higher rate than other groups. In aggregate dollars, large organizations added nearly \$60 million

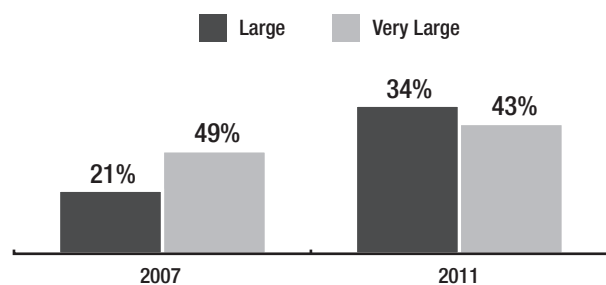
in operating expenditures to the ecosystem between 2007 and 2011 – a 37% growth rate, higher than the average growth rate of 11% and the 8.3% rate of inflation.

Figure 5 shows the shifts in aggregate expense over the five years of our study. In 2007, we see the expected distribution for the seven very large organizations, which make up nearly half of the total expenses in the system. In 2011, the slices of the pie are markedly different, with large organizations in aggregate spending a higher percentage of system-wide resources than five years prior.

At the organizational level, we noted that 15 of the 23 large organizations grew their expense base by at least 10%. Several of these organizations expanded much more than that: the top three gainers grew by 104%, 247%, and 480%, respectively. On average, large organizations' expenses of all types grew with the biggest driver being fundraising expenditures, especially among the fastest growers.

The magnitude of the large organization cohort's growth was further revealed when we looked at aggregate operating revenues (see Figure 6).

Figure 5. Change in Share of Total Expense



Source: CDP Population data

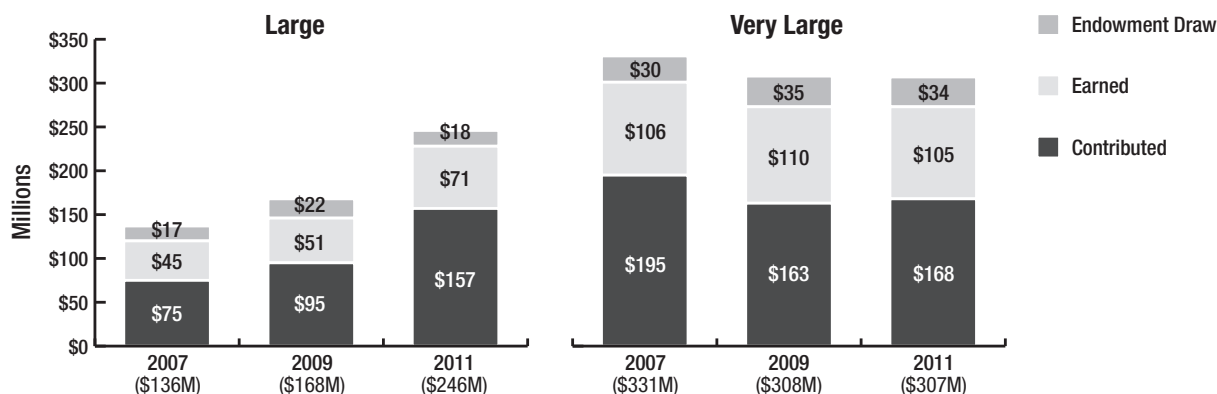
Table 7. Distribution by Budget Size

Budget Size	Number of Organizations			Aggregate Expense		
	2007	2011	% change	2007	2011	% change
<\$250K	118	122	3%	\$10M	\$10.8M	9%
\$250-500K	33	40	21%	\$11M	\$14.3M	30%
\$500K-1.5M	55	64	16%	\$51.5M	\$54.7M	6%
\$1.5-5M	35	26	(26%)	\$60.3M	\$65.7M	9%
\$5-20M (large)	14	23	64%	\$158.6M	\$218M	37%
\$20M+ (very large)	7	7	0%	\$289M	\$279.5M	(3%)

Source: CDP Population data

¹⁴ TDC, *Funding for Cultural Organizations in Boston and Nine Other Metropolitan Areas* (Boston Foundation, 2003).

Figure 6. Trends in Operating Revenues



Source: CDP Population data

Large organizations experienced aggregate growth to earned revenues of nearly 60% while the very large cohort stayed virtually flat, again in aggregate. Earned revenue growth among the large cohort was driven by greater than average increases in both paid attendance numbers and pricing. Paid attendance numbers among very large organizations *dropped* by a staggering 50%. (Presumably, revenue numbers remained constant with price increases or non-attendance related earned revenue.)

The picture is equally dramatic in contributed revenue.¹⁵ We reviewed total giving from individuals, membership, foundations, government, and corporate sources. On all measures except for membership, large organizations overtook the very large organizations between 2007 and 2011. Both foundations and individual donors drove the growth of the large organizations. Over three years, individuals contributed more than \$200 million to large organizations (compared to \$121 million to the very large) while foundations gave \$162 million (compared to \$89 million to the very large). Between 2007 and 2011, large organizations appear to have won the race for contributed revenue.

On an organizational basis, some members of the large cohort were the most successful in the quest for contributed revenue. In 2007, organizations had to raise at least \$17 million to be among the top five fundraising organizations. That year, two of the large organizations were part of the top five. In 2011, despite the fact that the ante was upped to \$25 million, there were three large organizations represented; one of them, the top fundraiser, raised more than double the amount of any other organization.

These results may have been opportunistic: interviews indicated that very large organizations may have held back during the recession years, and intend to push harder going forward. The overall effect is a more crowded playing field at the top, with more large organizations competing in the same league as the very large players.

The audience of paid attendees did not grow.

So, fundraising was a highly competitive field, especially among the large and very large. But, what about earned revenue? It was heartening to see that in aggregate earned revenue grew by 11% in the CDP Population, beating inflation (8.3%) during these five years. However, upon closer inspection we found that the fundamentals under the sales were troubling. While earned revenue did grow, we did not see a commensurate increase in attendance. Overall, there was a 1.6% increase in all attendees, paid and unpaid. After separating the two groups, we found that paid attendees actually *fell* by 1% while unpaid attendees filled the extra capacity with 5% growth.¹⁶ The rate of population growth during this period was 2.2%; so even with the increase in unpaid attendance, the system was not able to keep pace with population growth. When we reviewed the patterns for museums vs. performing arts, we found that the performing arts outperformed museums in maintaining paying audiences, increasing by 2.8% vs. a 5% decline for museums. Even performing arts only kept pace with population growth.

Audience churn is an invisible factor driving this seemingly static attendance picture. CDP does not allow us to understand the rate of audience retention, since it does not track unique attendees. However, other studies have uncovered that arts organizations in Philadelphia and beyond successfully reach

¹⁵ See Appendix I for charts showing the shifts in contributed revenue streams for the large and very large organizations.

¹⁶ See Appendix I for a chart on paid and unpaid patrons.

new audiences but that these new attendees do not come back after the first visit.¹⁷ While churn analysis shows that the total number of unique attendees is on the rise, since repeat visitation is lower, the total attendance numbers have held constant. With the rapidly increasing speed of churn, coming out in a net neutral position on attendance could be perceived as a victory.

Implicitly, the system-wide decrease in paid attendees means that earned revenue growth was driven by increased ticket/admission prices. In imputing average prices, we observed an average ticket/admission price of \$18.33 in 2007, which grew to \$21.22 by 2011, a growth rate of 15%. This growth rate is comparable to movie ticket (14%) and Broadway show (11%) pricing shifts during the same period.¹⁸ Among theaters, we would posit that the higher rate of price growth may have been driven, at least in part, by the adoption of technology-based dynamic pricing policies among nonprofit theaters that Broadway adopted well before this period.

The price increase was mirrored in subscription revenue trends in the performing arts. While subscription numbers were down by 16% between 2007 and 2011, revenues were up by 10%. We posit that the increase in subscription revenues reflects the tendency for institutions to adjust subscription prices up with higher single ticket prices. This finding was at first counterintuitive because we know that the popularity of “pick 3” and other cheaper subscription packages are on the rise. However, interviewees noted that there is a confluence today of two purchasing patterns colliding – while the traditional subscriptions are on the wane, they still make up a major portion of many organizations’ earned revenue. The market is in a transitional stage.

Going forward, greater than average increases to ticket prices may quickly bump up against limitations. As more nonprofit theatres adopt dynamic pricing, the system will wring out all it can from closing that inefficiency. We also heard from interviews that the base price of \$21.22 in Philadelphia may be lower than comparable offerings in other cities. There are a number of market makers in the system who cut prices during this period or who set artificially low prices for mission-related reasons. As a result, other organizations feel that they cannot price higher. Another contributing factor is the effect of half-price tickets on the system, which may increase price sensitivity among the customer base.

Without growth in either prices or total attendees in the system, organizations may be stuck chasing occasional attenders who

churn out of the system and competing fiercely for repeat ticket buyers, with no net change to the system as a whole. This conclusion was supported by interviewees who use shared ticketing systems: they could see a zero-sum dynamic in action – one organization’s subscription gains mirrored the other’s losses.

Finally, it’s important to mention that for many organizations the end goal of increased attendance, subscriptions, or memberships is to create a pipeline of new donors. The data indicate that museums were successful at acquiring and engaging members. Membership counts at museums increased by 35% from 2007 to 2011 while membership revenue nearly doubled. The increase in unpaid attendees implies that museums were successful in encouraging repeat visitation from members, since member visits at museums are generally free. However, the next step of cultivating new donors and increasing contributed revenues from individuals may not have been met. Contributions from individuals to museums during this period declined slightly. It is hard to draw firm conclusions about the trajectory of individual giving going forward from these data. Perhaps it is too early to judge and museums are building a patron base that can be cultivated over time. Or are new donors stuck at a lower average gift rate? Or are members not converting into higher level donors at all?

Trend 3: The market is in transition.

We observed uncertainty and flux on all sides of the market. To a degree, this change is found across the arts sector nationwide – audience behavior is changing and organizations are struggling to keep up. Other dynamics are more specific to Philadelphia – namely, shifts in the philanthropic marketplace. Here, we review the changes we have observed from these two vantage points.

Organizations and Audiences

Interviewees expressed a common recognition that demographic trends imply a coming adapt-or-die moment for their organizations. The population in Philadelphia is changing, and many in the sector have not yet figured out how to reach and retain new audience members.¹⁹ For some leaders, especially those who spent the formative part of their careers in different market conditions, intuition is no longer sufficient.

At the same time, we spoke with many thoughtful individuals brimming with ideas about how to move the needle. They spoke about new ways to engage with audiences to boost relevance and impact, new ways to package their offerings to better align with consumer preferences, and new ways

¹⁷ Greater Philadelphia Cultural Alliance, *Research into Action: Pathways to New Opportunities* (2009);

Oliver Wyman Audience Growth Initiative of the League of American Orchestras, *Churning Butter into Gold* (2011); TDC research on churn for clients.

¹⁸ Comparative pricing data from the Motion Picture Association of America and the Broadway League.

¹⁹ Greater Philadelphia Cultural Alliance (2009).

to structure operations to increase capacity and encourage leadership development from within. It was exciting to hear these forward-looking concepts, and we left our interviews feeling more invigorated than our findings might imply.

On the other hand, there were several factors that tempered our excitement when we contemplated how these visionary leaders might fare as they take action to implement their ideas.

First, it gave us pause to realize that in many cases these strategies would add to an organization's existing slate of activities. Very few interviewees discussed replacing their fundamental model with the new vision. In interviews, leaders mentioned multiple factors that discourage cutting old programs to make way for new.

- Change is scary. It's often challenging to get sufficient support from board, staff, and other constituents around a truly revolutionary strategy.
- Organizations cannot abandon old programs when they remain dependent on old models even as those models are in decline. For instance, many interviewees acknowledged that the subscription model is becoming obsolete. However, with limited marketing resources, they felt it would be irresponsible to risk funding new initiatives at the expense of pushing subscriptions, which – although declining – remain their bread-and-butter.
- Finally, cutting programs often has the emotionally painful side effect of making some staff redundant, and many managers do not have the stomach to implement strategic layoffs.

Combined, these factors can create a paralyzing situation, where organizations feel that they must graft without a commensurate prune.

Second, while 90% of our interviewees could articulate a coherent strategy, only 20% had tangible access to funds to implement. Another 20% had thoughts about where to raise investment, but the remaining 60% had no real idea where the necessary funds would come from.

This troubling state of affairs may be a reflection of the reactive nature of current strategizing, where organizations are chasing changes to the marketplace rather than evolving based on actual demand. Among our interviews, we heard of only two cases in which organizations grew based on positive demand trends. Interestingly, these were both examples of organizations

that have been focused on innovative artwork for decades. One has recently seen the fruit of this commitment ripen into valuable intellectual property, while the other has watched its well of once-young supporters increase their giving as they grow older and advance professionally. Outside of these two, organizations were raising funds to *generate* demand, a much riskier prospect.

Finally, the total amount of funds to be raised is staggering. Just among our 38 informants, we tallied an estimated combined fundraising campaign goal of nearly \$1.4 billion. This prodigious number makes more tangible the price tag for a systemic shift in the marketplace. It is further bolstered by the large organization cohort's growth trend, which we noted in the section above. In the past, it was only the very largest organizations that required periodic campaigns with eye-popping goals to sustain operations. With the growth of large organizations, the number of organizations that regularly seek this level of support has increased.

While \$1.4 billion is a tremendous sum, TDC contends that it would not be enough to fully capitalize the system. It does not include the annual nut of operating money, which – given the undercapitalized nature of the system – should probably be larger. It does not include the full sum of recovery capital needed to correct for negative net assets, increased endowments that would cure some distressed institutions' business models, or the facilities investments needed to address pervasive deferred maintenance and lack of renewal capital. It does not cover the working capital and operating reserves absent from many balance sheets. What it gets us is a system ready to take the next step toward addressing a changing marketplace, but one that remains undercapitalized.

Philanthropic Marketplace

Foundations have always been a driving force in Philadelphia. From 2007 to 2011, their influence ballooned to even larger magnitude. As shown in Table 8, TDC looked at aggregate revenue trends in the CDP Population to see which sources of contributed revenue managed to keep up with inflation (8.3%) over the five years in question. The second column represents the aggregate change we found in Philadelphia, while the third column shows national trends for individual, foundation, corporate, and government giving. Foundations outpaced inflation in their giving to Philadelphia-area arts organizations as well as national averages in foundation giving growth. Individual giving and corporate giving in Philadelphia did not

keep pace with inflation, and corporate giving in Philadelphia far underperformed the national average.²⁰ The rapid increase in foundation funding – which occurred between 2010 and 2011 – was driven by bursts of fundraising success in three organizations in the large budget category.

Table 8. Change in Giving by Contributed Revenue Source

Revenue Type ²¹	Philadelphia Trend	National Trend
Individual contributions	6%	(5%)
Foundation contributions ²²	46%	10%
Corporate giving ²³	(24%)	15%
Government grants	(6%)	(11%)

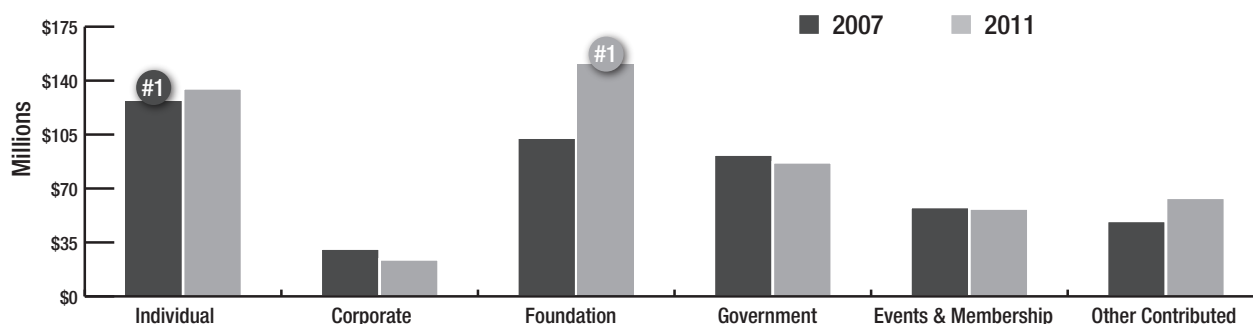
Sources for national trends: Giving USA 2013 (individual, foundation, and corporate), Americans for the Arts 2013 (government)

As Figure 7 shows, foundation giving grew so quickly during this period that the standard proportionality of contributions, in which the lion's share is provided by individuals, flipped. Nationwide, individuals generally provide about 70% of funding.²⁴ In Philadelphia, foundations were the major funders in 2011.²⁵

The picture is smoother when totaling the five years together but still demonstrates that foundations and individuals are both nearly equal drivers in Philadelphia's philanthropic system. Over five years, organizations in the CDP Population generated more than \$2 billion in contributed revenue. Over a third of that amount came from individuals – nearly \$775 million – and over a quarter from foundations – about \$573 million. We also looked at the set of 47 organizations that had received a total of \$1 million or more from foundations, individuals, or both in any of the five years. This group divided roughly into three equal groups – a third received over \$1 million in any one year from only foundations, another third received support from only individuals, and the remainder received support from both. It remains to be seen if 2011 was an anomaly in terms of the flip flopping of foundations vs. individuals as the leader. However, it is clear that foundations and individuals jointly drove the system from 2007 to 2011.

It is a truism about foundations that the only thing certain about their giving priorities is that they will change. The outlook for foundation giving to Philadelphia's arts sector has changed dramatically in the past few years, and the burst of growth in foundation giving may not be sustained. Major foundations have refocused their giving away from the region or away from the arts; key giving initiatives have been discontinued; and formerly reliable sources have dried up.

Figure 7. Total Contributed Revenue Breakdown



Source: CDP Population data

²⁰ This observation is different from findings regarding the relative scale of individual and foundation giving in the Greater Philadelphia Cultural Alliance's publication, *Portfolio* (2011). It's important to note that the *Portfolio* data were from 2007 to 2009. Our findings were consistent with *Portfolio*'s for that period, but during the additional two years we analyzed, 2010 and 2011, the giving patterns changed dramatically. Foundation giving grew by 78% from 2009 to 2011, reaching its peak in 2011, while individual giving dropped by 17% between 2009 and 2011. The peak of individual giving during the five year span was 2008.

²¹ The contributed revenue referenced in this table includes both restricted and unrestricted giving, and may include amounts intended to be released in future years.

²² Both CDP and Giving USA include family foundations in this category.

²³ Giving USA includes corporate foundations in this category. CDP leaves this decision up to organizations as they self-report data, so may not be consistent in where corporate foundations are included.

²⁴ Giving USA 2013.

²⁵ See Appendix I for contributed revenue breakdown pie charts.

It is unclear if individual donors will step in to keep total funding level going forward. Our interviewees sketched for us the dynamic that is playing out: a generational shift taking place among major donors in Philadelphia. Stalwart community leaders who drove individual giving are retiring. While wealth continues to exist in the region, arts organizations have not yet cultivated close relationships with the next generation. The question remains – who is on the other end of the arts community's \$1.4 billion call on philanthropic capital and how will they be engaged?

How should the sector respond to the trends?

Philadelphia's arts ecosystem is one of the most vibrant in the nation. The city has become known as a destination for the highest quality arts experiences across many disciplines. The evolution of an arts market with such depth and breadth is no accident. It was the result of years of investment, which developed a cohort of organizations – particularly at the larger end of the spectrum – that have grown in sophistication, quality, and size. Sustaining this variety, however, requires a scale of resources that is currently not in evidence.

TDC has observed a parallel story in other communities, where the leaders in a funding ecosystem got out in front and the pack did not follow. Whether it is a public funding agency, a core group of major donors, or major foundations, the lead drivers of a local philanthropic marketplace can shift a system but are often not prepared to sustain that shift over the long term. This dynamic in philanthropic markets is not unique to Philadelphia, and the lack of coordination has often resulted in unsustainable investments, unfunded mandates, and distressed organizations.

To respond, we highlight two of the forces driving increased competition. We posit that these may be places to press in order to remedy this untenable situation.

Lack of exits. Arts leaders have been concerned about the phenomenon of many flowers blooming for a long time. Is it a good thing that there are so many organizations out there? Should we be staunching the flow of new organizations? Is fiscal sponsorship the answer to keep artists from taking on unneeded institutional trappings? TDC contends that it is not the volume of flow *into* the system that is the problem. The birth of new organizations is a healthy sign, indicating that young artists are present in the community and that they are implementing new approaches to art.

The problem, as we see it, is the lack of flow *out* of the system. Scholars have posited that inefficient nonprofits survive because they are subsidized by committed donors. Unfortunately, this support – however well-meaning – is often bestowed without a triage process. Triage would assess individual organizations within the context of the wider system. It would also identify a total pricetag to heal the patient, rather than providing indefinite life support with no clear path toward health. This process is complicated by the presence of multiple funders: even if one *does* triage and decides “no,” without coordination, another funder may come to another conclusion, allowing a distressed organization to live to fight another day.

Drive to growth. Growth is a common metric for success, for organizations and funders alike. On one level, if you're not growing, you're shrinking. Without some expansion, the simple effects of inflation will erode an organization's resources and ability to compete. In the period we reviewed, 2007 to 2011, keeping up with inflation meant realizing at least 8.3% growth during that period – or about 2% a year. This modest scale of growth, however, is not what we saw in the CDP Population dataset. On average, organizations beat inflation in terms of expenses, and about a quarter of them grew more than 50% of their expense base from 2007 to 2011.

What is propelling this growth? We know that it was not (on average) a push from audiences – those numbers remained stagnant.²⁶ We know, of course, that these organizations don't have stockholders pushing for earnings. One explanation is artistic ambition. Artists want to realize their artistic visions, and push for more: more elaborate sets and costumes, more gallery space, more expensive performers. This is not to say that artists are spendthrifts – in fact, artists are often quite resourceful when presented with budget constraints. On the other hand, sometimes more *is* better, and many organizations get to the point where they want to give their artists a freer rein to spend toward the artistic mission. As one interviewee quipped, “*There are only so many plays with a cast of one to three actors and a minimalist set that I want to do!*”

And, this is a cause that funders and supporters can get behind, to give an organization more resources to realize its mission and evolve artistically. Where this kind of growth can get untenable is when it is pursued by an organization that can't cover its core overhead expenses. To raise the money they need, organizations feel like they need to present a fundraising case that involves the exciting and the new, and that sustainability will somehow follow. The result that shows up on balance sheets is the widespread practice of spending restricted funds and deferred revenue on current operations.

²⁶ It is true, however, that the churn effect may be pushing organizations to increase marketing budgets just to stay in place.

Growth in the ecosystem was largely driven through investment from a relatively small group of philanthropic investors. While organizations were pushing for growth, they were stating this case for a market of philanthropic investment and that market said “yes.” When taken in isolation, each organization that raised significant funding appears to be a special case. There were some that had new leaders with new visions. Others were once-in-a-lifetime opportunities to transform a major institution. In the aggregate, however, they added up to a marketplace newly dominated by large institutions but that remained financially weak.

It would be easy to offer the recommendation that funders think more systemically. Everything is interconnected, and some investments – made without looking at the larger context – can push the system in an unhealthy direction. Funders should work together to get behind good investments and pass on bad ones. This is easier said than done. Determining which funding opportunities will be beneficial for the whole is difficult, and then coordinating the philanthropic decisions of multiple funders based on that analysis is nigh on impossible.

A more productive (though still hard) route might be to encourage a sector-wide conversation about exit and growth – among managers, funders, and boards. How can you tell when an organization’s mission is no longer relevant *enough* for support? Is it possible to conceive of exit as something other than failure and rather a natural phase in the life of an organization? What kind of incentives might encourage managers to consider exit as a viable option and a cause to rally their boards around? Does growth indicate success? When does growth make sense, and when is it going to make an organization less sustainable? Have mature arts markets like Philadelphia reached a saturation point where significant audience growth is not possible?

Exploring such questions might foster a cultural shift, making it less extraordinary for organizations to consider exiting and making it less common for organizations to strive for unsustainable growth. For their part, funders then might be less likely to encourage all grantees to strive for growth, or may offer distressed organizations support to consider the option of exit. Unfortunately, we cannot begin the conversation about closures in this study, since CDP does not offer a clear window into exploring this topic. However, we do have thoughts to offer about growth, which we explore in Part II. When is growth the right decision? When might it lead to problems?

Part II: Assessing Investments Toward Growth

In our original study design, TDC intended to test our hypothesis that organizations could make investments toward better financial health. We posited that organizations have the choice to make changes in their program, marketing, fundraising, or all three in order to generate regular surpluses and achieve better financial health. To test this theory, we would mine CDP data to identify organizations that had made significant investments over time in program, marketing, or fundraising. We then planned to look at whether these investments were correlated with positive financial health indicators.

When we actually dove into the data, what we found was erratic investments. While many organizations made sporadic increases to their expenditures, only a very few organizations made sustained investments in marketing (21), fundraising (17), or program (10) during this period. We did not think the sample sizes we found would allow us to report conclusive findings on our original hypothesis. In retrospect, it may have been overly optimistic to expect that organizations would be able to make and sustain investments during the recession years. As we heard from interviewees, it was a struggle to keep program spending level during the depths of the downturn, and salaries in many institutions were frozen during that period. The goal after the worst was over was to get back to baseline.

When we looked at the data, however, the system did more than get back to baseline. In aggregate, total expenditures grew by 11%, beating inflation by 3%. While program spending remained relatively stable over the period, marketing and fundraising expenses surged up in 2011. (In a few years' time, we may be able to revisit our original hypothesis.) In all, of 262 CDP Population organizations, over 50% grew by over 10% over five years; of these, 75% grew more than three times the rate of inflation (25%).²⁷ On the other hand, we saw less evidence for organizations seeking to shrink to an appropriate size. While it is impossible to understand intentions from the data, less than 15% of organizations had budgets decline by over 25%.

Table 9. Expenditure Growth by Type

Type	2007	2011	Growth
Program	\$432M	\$463M	7%
Marketing	\$36M	\$43M	20%
Fundraising	\$48M	\$55M	15%
Administrative	\$65M	\$82M	26%

Source: CDP Population data

The arts sector has long struggled to define quantitative measures of success in artistic quality, audience engagement, or learning outcomes. Without tangible ways to show progress on intrinsic value, growth becomes the proxy goal – growth in attendance, in donations, in space, in dollars. On one hand, it is natural to assume that under-resourced organizations need to grow to become more stable – *you have to spend money to make money* is a commonly used expression. On the other hand, it is much easier to spend money than to predict how much money you'll make as a result, and there are too many examples of expansion efforts based on illusory ideas of attendance and capital campaigns that were never completed. Large budget size is not a characteristic we found correlated with financial health. And, the data suggest that the process of getting bigger itself is stressful. Of the ten organizations in the Study Sample that grew by 100% or more, eight fit criteria that placed them in the At Risk category of financial health and none met criteria for the Sustaining category. TDC has observed the same phenomenon in our practice. Transitional stages of growth – such as capital campaigns – can be all absorbing and debilitating to the organization as a whole.

Since growth is so common yet so potentially problematic, we focused our analysis on unpacking it. Our qualitative research yielded insights about growth, which were further enriched by the financial data. TDC contends that it is important to have a clear vision of why significant growth will create a stronger organization before making the decision to expand. This section of the report pulls apart the core assumptions behind a vision for growth, and attempts to provide a deeper understanding about when it is appropriate to invest toward growth and when it is not.

First, it is important to clarify what we mean by *growth*, *significant growth*, and *sustainable growth*.

Very simply, *growth* occurs when an organization spends more in one year than it did in the previous year. Incremental growth is necessary and healthy to account for inflation (usually about 2-3% a year), assuming the organization is pursuing the same scope of activities. As one of our interviewees put it, *"Our organization has stayed at the same budget for the past decade. That means we've actually shrunk."*

- *Significant growth* is something else. It results from an organization making a deliberate investment in new or enlarged activities. For example, an organization can invest in increased facilities, more staff, larger media buys, more productions, or more expensive production quality.²⁸

²⁷ Twenty organizations in the full sample of 282 did not exist in 2007, so could not be included in this calculation.

²⁸ TDC defined a significant investment as a jump in spending three times over inflation, which was sustained over two subsequent years.

- In the best cases, these investments are driven by a strategy with a clear and tested hypothesis for success. TDC posits that successful strategies achieve the classic dual bottom line: maximized impact of the mission and better than breakeven financial results. This is what *sustainable growth* looks like. Unfortunately, among the 101 organizations in the CDP Population sample that grew more than three times inflation from 2007 to 2011, over 60% had less net operating income in 2011 than in 2007.

The chances of success are reduced when an organization is driven to make investments based on assumptions that do not account for key factors related to its mission and business model. In *Getting Beyond Breakeven*, TDC identified three key factors: *time horizon*, *business model drivers*, and *organizational lifecycle*. Our work for this study has crystallized three more key factors: *scale*, *revenue dependencies*, and *strategic goals*. These six factors, defined in Table 10, determine how much and what types of capital investment are necessary and appropriate for an organization to be financially healthy in the long run.²⁹

All too often, however, TDC has seen cases where a growth strategy was not grounded in a clear analysis of these factors. To illustrate our findings, TDC has framed four common assumptions that organizations (and their supporters) make when rationalizing a strategy for financial sustainability or growth. We heard some version of these assumptions in our interviews, and have seen them play out in our own practice advising funders and organizations.

- *Assumption 1: If we (or they) could only get to scale, our financial problems would be solved.*

- *Assumption 2: Spending more on marketing means more people will come.*
- *Assumption 3: We need to invest more in fundraising staff because we need to find more individual donors.*
- *Assumption 4: If we invest more in the highest quality art and market it relentlessly, then our organization will thrive and grow.*

When not rooted in a fundamental understanding of an organization's business model and market environment, these kinds of assumptions can get in the way of envisioning strategies that will lead to sustainable growth (or simply sustainability).

We acknowledge in advance that some of these lessons will be hard to hear. Running an arts organization is not for the faint of heart, and in today's tough operating environment having the courage to take the next step forward is sometimes only possible when managers put on the blinders. This analysis is not meant to dampen optimism, but to give managers and their supporters more information before they take that step.

Assumption 1: If we could only get to scale, our financial problems would be solved.

Sustainably growing a nonprofit is complicated. A healthy organization is more like a well-balanced ecosystem than a cash crop; a radical change to scale has the potential to tip the system out of whack, especially when an organization is small. On the other hand, as an organization matures, it often begins to make sense to take on greater degrees of infrastructure. It feels unsustainable for staff to wear multiple hats indefinitely, especially if a program is growing. In considering growth options, we would ask: what is fueling the engine driving the organization forward, and is that fuel source constrained?

Table 10. Factors that Determine Necessary and Appropriate Capital Investment

Factor	Definition
Time Horizon	The time span needed for an organization to realize its mission. Time horizon is not necessarily related to an organization's lifespan: a current-day organization can persist for decades.
Business Model Drivers	The presence of large fixed costs, such as owning a facility, stewarding a collection, or having long-term labor contracts, which constrain an organization's ability to be flexible based on available resources.
Organizational Lifecycle	Organizations go through a developmental lifecycle, much like living organisms. At points of transition – such as start-up, growth, decline, or renewal – organizations require more capital.
Scale	The budget size of individual organizations, as well as the magnitude of their investments.
Revenue Dependencies	The mix of revenue streams fueling an organization; for example, an organization highly dependent on earned revenue receives a significant portion of annual funding from ticket sales.
Strategic Goals	The motivations that drive an organization's investments. It's important to understand when financial return is the primary motive and when it is not.

²⁹ Appendix V offers advice to organizations that wish to use the key factors to shape a capitalization strategy.

Consider, for example, a volunteer-run choral ensemble that consistently produces small surpluses on a season of two concerts a year. Would it be better off doubling the number of concerts? When considering an increase to scale, organizations need to take into account the cost of increased production as well as the possibility of cannibalization of demand. For instance, additional surplus from adding concerts might be negated if the group had to take on paid staff to manage the increased activity. Or, the additional surplus might never materialize at all. It may be that the group's natural audience is friends and family of ensemble members. While this audience is willing to pay for two concerts a year to see their loved ones perform, they may not be willing to pay for four. In turn, if the ensemble members are the group's core donor base, they may balk at requests to donate more on top of paying dues and selling tickets to friends and family. Lastly, what if an increase in concerts demands more rehearsals each week? For a volunteer-driven organization, a cost increase of time can be dearer than money. The heart of the group – the volunteer singers – might begin to leave.

For small organizations run on a careful balance of goodwill and money, an increase in size runs the danger of swamping available goodwill. Over 60% of the smallest organizations had no more than one paid staff person. These organizations are fueled by the passion of their supporters, and unfortunately, sweat equity is not scalable. Shifting to a model that requires paid staff makes sustaining an organization significantly harder, and a system that worked smoothly under one set of conditions may falter when placed under another.

TDC contends that for most of these organizations small is beautiful. They run at a scale feasible and fun for volunteers, delivering the intrinsic benefits of engagement with the arts to their communities in spades. In volunteer-driven organizations, the impact and true costs are not reflected in the financials, and sustainability is maintained with a small amount of cash and a lot of sweat equity. If they run an occasional deficit, the gap is generally narrow enough to be covered by a handful of supporters. Organizations like this don't need complicated strategic business plans or 20-year vision statements. They need the resources to deliver their programs for as long as their audiences want them.

Among organizations that are a step larger and less driven by sweat equity, growth may be a feasible aspiration. Their mission may have the potential to make a broad impact and attract major support, and the capacity constraints of a small-scaled staff may be holding the organization back from fulfilling this promise. It is important to distinguish between an organization that needs more capacity to meet increasing demand and one that simply feels constrained. Those in the latter category may feel internally generated growing pains; however, without increased resources to support more infrastructure, budget growth becomes unsustainable.

Organizations considering growth need holistic strategic planning that articulates:

- A coherent programmatic vision that identifies the target audience, the need being addressed, how the organization will meet that need, why this organization will be able to deliver that value, and who cares enough to pay for it;
- Market research that is scoped to the correct geography and audiences and that involves testing the vision directly with potential supporters and audience members;
- An operations strategy that includes the full scope of staffing, facilities, and other resources required to implement the program; and,
- A capitalization strategy that maps the one-time and ongoing investments sized to support the program and operation, and a business model that generates regular surpluses to replenish adequate working capital and reserves.

In short, an organization needs a plan that answers four questions: What are you doing? Who are you doing it to? How much does it cost? Who cares enough to pay? If the answers to these questions cannot be supported by market research, then it may mean that an organization cannot grow sustainably.

Even with a tested plan, growth may not be in the cards. Funders may balk at a realistic idea of full cost; leadership may not be up to the challenge of implementation; audience behavior may change. It is when a grand plan is not quite realized that careful decision-making needs to happen to avoid a downward spiral. Is there a way to sustainably implement a smaller version of the grand vision? Is it possible to liquidate fixed assets or unwind unsupportable overhead expense? It can be painful – and sometimes uncomfortably public – to have these conversations, a stark contrast to the excitement inherent in pursuing a shining vision. The ability to raise the tough questions is a quality that leaders of organizations contemplating growth need to have.

Assumption 2: Spending more on marketing means more people will come.

When TDC reviewed expenditures by type we found that while organizations spend more absolute dollars on overall programs, they were more likely to *increase* spending in marketing. In aggregate, institutions maintained fairly steady spending to programs. The pattern for marketing spending however was volatile – with a massive cut in 2009 and a spending surge in 2011 that ended up beating inflation over the period. While in aggregate, organizations were willing to cut marketing during the lean years, they clearly understand that awareness is important to driving attendance. If we spend small amounts today, doesn't it stand to reason that more people will come if we spend more tomorrow? There are a number of conditions under which this assumption might be false or, at least, not so straightforward.

More people may not come if you don't know which marketing strategies work.

The first problem we uncovered is that many organizations don't know *how* or *where* to put more dollars into marketing. In interviews, we asked organizational leaders to describe how they spent their marketing budgets.

In a field dominated by leaders from the baby boomer generation, we heard genuine confusion around which marketing strategies are effective in today's shifting, highly competitive environment. Many could discuss what no longer works; for instance, the days of putting an ad in the newspaper and waiting for lines to form are over. But, what are the *right* investments to make? We heard varying levels of comfort with online strategies. Some leaders are focused on getting press in neighborhood tabloids; for others, outdoor advertising is a must. As one person said: *"I've tried everything, but do you know how I got my largest ROI? Mailing the postcard!"*

Even in the most highly resourced organizations, there's little testing (or even tracking) going on. Organizations are trying many strategies, but without testing the outcomes they cannot know which of these strategies work. Since shifts in consumer behavior mean that inherited wisdom is no longer valid, testing is the only way to get a degree of certainty around which strategies are worth investment.

In our practice, TDC has observed organizations deciding that a particular strategy didn't work after an inadequate investment. Of the 163 organizations in the Study Sample, we found only 21 that had made a significant investment in marketing that was sustained over three years. A marketing strategy aimed at reaching a new audience segment or countering a long-standing perception in the marketplace requires consistent investment to stand a chance of success. It may take longer than a year to see results, and without a multi-year investment, there is a danger of finding a false negative.

More people may not come if you appeal to a niche audience. Many organizations consider themselves an "undiscovered gem." These groups (or their supporters) can harbor the belief that all they need to do to boost attendance is increase their marketing budget.

However, no amount of marketing spend will grow attendance for an organization that has already saturated its market. In interviews, we heard that many organizations are currently making this determination on a production-by-production basis. For instance, marketing directors decide every season which productions warrant a big marketing push and which do not. This thinking can, and we argue should, be applied at the institution-wide level as well. Without changing its fundamental artistic offering, a niche-serving organization may see little impact from increased marketing expenditures and is therefore best served investing that money elsewhere.

Organizations can also hit barriers related to capacity and utilization constraints. For example, a small museum with two 2,500 square foot galleries can only accommodate so many visitors, or an afterschool art program cannot increase space utilization because potential students are only available between 3 and 6 p.m. (Note: The answer to this problem is not necessarily to build or rent a larger facility! See Assumption 1.)

More total people may not come, unless you spend on maintaining the current audience, too.

We heard in interviews that arts organizations in Philadelphia are hard pressed just to maintain their current audiences. If an organization puts significant resources towards audience expansion, it stands the chance of seeing no net gain in attendance unless it keeps the existing audience base. Since old and new audiences often have different profiles, the same marketing strategies may not serve both, and audience expansion may require *more* spending not just *re-allocated* spending.

More people may not come if you can't spend enough.

To study a broad range of organizations, we often attempt to normalize data from differently sized organizations to a common scale in order to compare apples to apples. However, when weighing investments, a relative scale is not helpful on its own. For example, when we look at marketing expenditures as a percentage of the total budget, there is little variation across budget size cohorts.

Table 11. Average Marketing Expense by Budget Size (2011)

Budget Size	Average of Marketing Expense as % of Total Expense	Average Marketing Budget
\$150–250K	7%	\$10,838
\$250–500K	9%	\$31,964
\$500K–1.5M	8%	\$68,665
\$1.5–5M	8%	\$221,630
\$5–20M	8%	\$752,014
\$20M+	6%	\$2,928,429

Source: Study Sample data

That said, what that percentage buys you when you translate it back into dollars is the real question. The purchasing power of the very large organization's average \$3 million marketing budget is profoundly different from a \$10,000 spend or even a \$220,000 spend. Unfortunately, marketing costs are rarely pro-rated by scale of organization. The cost of a full-time staff person does not vary tremendously from organization to organization, and advertising costs are based on the scale of the media's reach, not the scale of the organization's audience goal.

To illustrate this point, let's consider an example. What if a theatre group with a total budget of \$600,000 received a grant to double its marketing budget from \$50,000 to \$100,000 for one year? With an extra \$50,000 in the marketing budget, perhaps this organization could work to dispel the notion that its plays are only for aficionados and expand its audience. In the process, perhaps it could also move from its current venue, a 150-capacity black box, to a 1,000-seat venue.

TDC would argue that while percentage-wise \$50,000 is a significant investment for this organization, the total marketing dollars available may not be enough to buy the results this organization desires. It takes a critical mass of messaging over a concerted period of time to move public opinion, build awareness, and change behavior. The additional funds – although a substantial relative increase to the organization's current marketing budget – are not enough in absolute dollars to hire dedicated marketing staff or invest in a new branding campaign. These funds are also not enough to tap into mass media, like television or outdoor advertising. Lastly, assuming this funding is a one-time grant, it is not enough to sustain the organization's marketing message over the multiple years it takes to cement a shift in brand. In short, the increase would likely not be enough to make a real difference, and the group may end up losing money on the venue while at the same time, perhaps, alienating its most loyal patrons by going after new audiences.

Sometimes, more people coming is not the only goal.

In our interviews, we heard that most organizations focus their marketing dollars on *sales* rather than *marketing*. A sales-focused approach changes tactics and messages from show to show, with the end goal of selling tickets. Marketing addresses the organization's broader brand, and aims to communicate it to target audiences. In the sales-focused approach, an organization often opportunistically changes its target audiences based on the content of each show, and may have no overarching audience development strategy. An investment in marketing can make the sales process easier, by warming up customers' knowledge of and connection to the organization.

The exception we saw to the favoring of sales over marketing was in small organizations that present exclusively new work. These organizations often focus marketing efforts on building trust in their brand in order to cultivate patrons willing to take a risk on unknown works. For the majority of organizations, however, few have the time or money for organizational branding after selling shows. While a sales-focused approach may be the best way to boost earned revenue in the short term, it does not build brand equity for the long term.

Although organizations rarely invest in branding, they often need it. In our practice, TDC hears many organizations discussing marketing issues that are bigger than selling a single production. These larger branding issues are often related to changes in the marketplace, and can include:

- Changing long-standing public misperceptions (e.g., *they think we're elitist, they think we never change*, etc.).
- Reaching new types of customers and diversifying audience segments.
- Expanding geographic reach.
- Raising the organization's profile so that donors consider them a legitimate investment.

The only way to achieve these results is through steady, clear messaging communicated in multiple ways over a long period of time. A small organization with a focused audience could do this in low cost ways by reaching out one-on-one to opinion leaders in the community and building word of mouth. A larger institution, however, will generally need to pursue a multi-pronged strategy that involves significant expenditure over multiple years. They will need to pursue this wider initiative *in addition* to their normal sales-focused marketing.

Is the investment worth it?

The core concepts of marketing don't necessarily require a monetary investment to be effective – to a point. A savvy leader can identify what makes her organization valuable to its audiences and can communicate the message consistently and over time in low cost ways. Sweat equity can come into play here – with volunteers serving as community ambassadors. However, if the goal is to grow audiences exponentially, low cost methods will only go so far, and significant investment in marketing will be required to match the aspiration.

Growing an organization through a marketing-based strategy is expensive because of:

- The need for sustained investment over time.
- The need to maintain current audiences while reaching out to new ones.
- The need to maintain sales-focused marketing while pursuing organizational marketing.
- The fact that some costs do not vary based on the scale of goal (e.g. staff, media).
- The need for testing.

This list is not an a la carte menu. An organization needs to be able to cover *all* of these costs to grow audiences and the scale of an organization's impact. The implication is that the investment may not be worth it unless the organization can afford the *prix fixe*.

How an organization judges success will depend on its goals. Is the organization seeking to increase attendance to improve the bottom line or because of a mission-related outreach goal? Justifying a marketing initiative with a positive return on investment is less important if the organization's primary goal is outreach, and having a long-term fundraising strategy to pay for marketing seems appropriate.

Finally, investing in marketing pre-supposes that the program can deliver on the marketing message. A cheeky marketing campaign meant to draw millennials will fall flat if they show up and can't connect with the programmatic experience. No amount of marketing will fool people into thinking you have changed if you haven't.

Assumption 3: We need to invest more in fundraising staff because we need to find more individual donors.

Philadelphia's arts organizations and funders are both highly cognizant of the system's dependence on major foundations. There is a collective perception that the city's arts organizations do not excel at raising money from individuals and are therefore holding themselves back from more sustainable growth. While the answer may be bringing in more experienced fundraising professionals, there are a number of conditions under which this assumption does not hold.

There is no point hiring more boots on the ground if there is no donor pipeline for them to work.

Our interviews uncovered a prevalent anxiety about the seismic shifts taking place in Philadelphia's major donor and foundation communities. While philanthropic need has not abated, the

known sources to meet that need have shrunk and continue to shrink. Even among organizations with well-resourced development departments and high-powered boards, there is uncertainty around who will replace the civic leaders preparing to retire from the system and concern that the pipeline for new money is thin. As the 38 organizations we interviewed collectively gird their loins to raise \$1.4 billion, we were stunned to hear that less than half had pledges in hand or even a coherent strategy about where they will prospect. The majority of our informants had no idea where the money would come from, which drives our primary point – without early reconnaissance, there is no point in bringing infantry onto the payroll.

This lesson holds for smaller organizations aspiring to grow larger. There is no point in bringing on development staff if your organization's donor pool doesn't have the capacity to give larger gifts. Building initial relationships with a wealthier donor base needs to happen *before* bringing in the major gifts officer. If wealthy donors are not engaged by the vision in some measure, then an expensive major gifts officer is not going to change that fact.

For some organizations, raising money from individuals is beyond their reach.

We found that about half of organizations depended on foundations for at least 20% of their contributed revenue. The prevalence of foundation dependence goes up among the \$250,000-\$500,000 and \$500,000-\$1.5M size cohorts to more than 70%.³⁰

Raising money from individuals is challenging. To illustrate the challenge, we designed a thought experiment that asks: What would it take for organizations of different budget sizes to transform their contributed revenue mix so that individual donors are the sole source? In other words, what would it take for organizations to replace foundation giving with individual giving? The experiment has two parts – we first looked at the rate of growth in individual giving needed to maintain the same budget size (let alone grow), and we then turned to the role of fundraising efficiency.

Table 12 shows fundraising data representing the experience of the average organization in each budget size. The table provides the average board member gift, total individual giving, and total contributions from other sources. For example, an average small organization (with budget under \$250,000) receives \$624 from each board member, and raised a total of \$11,643 from individuals and another \$53,396 from other sources.

³⁰ See Appendix I for a graphic illustrating the breakdown of foundation dependence by budget size.

Table 12. Statistics on Average Individual Giving by Budget Size (2011)

Budget Size (a)	Average Gift Per Board Member (b)	Total Individual Contributions (c)	Total Other Contributions (d)	Estimated new donors needed ³¹ (e)	% growth of donors (f)	% growth of dollars from individuals (g)
\$150-250K	\$624	\$11,643	\$53,396	86	121%	459%
\$250-500K	\$1,418	\$56,586	\$161,047	114	52%	285%
\$500K-1.5M	\$2,334	\$123,377	\$354,926	152	35%	288%
\$1.5-5M	\$5,348	\$460,463	\$1,216,807	228	27%	264%
\$5-20M	\$16,821	\$3,293,890	\$8,377,388	498	4%	254%
>\$20M	\$72,242	\$5,073,962	\$17,208,692	238	6%	339%

Source: Study Sample data

The data in the shaded columns represent the thought experiment. We ask simply: how many new donors does the average organization need to shift its revenue to 100% support from individuals (i.e. for individuals to cover the dollar amount in the Total Other Contributions column). In most organizations, the board includes the major donors. We therefore used average board giving as the proxy for the size of a major individual gift. For instance, the first row shows that the example \$150,000-\$250,000 organization could replace the \$53,396 coming from non-individual sources if it could identify 86 new donors giving \$624 apiece. This would require a 121% increase in the number of individual donors and 459% increase in dollars from those donors.

At first, this sounds feasible. Finding 86 or 152 or even 498 new donors seems within the realm of possibility. However, with a little more thought, several factors give us pause.

First, what rate of growth for individual donations is actually achievable? Over the five year period of 2007 to 2011, the total amount of giving from individuals in Philadelphia grew by 6%. Nationwide, the amount actually declined by 5%.³² Even with Philadelphia's above average growth rates, increasing individual giving at the rates shown above appears to be a 200 to 400 year job.

Second, how does fundraising efficiency come in to play? We expect foundation fundraising to be more efficient than individual giving. Foundations often give larger grants than individuals, and writing a grant proposal is less time consuming than cultivating a major donor over time.

The data bear out this hypothesis. When we reviewed efficiency of fundraising spend against foundation dependence, we found that organizations with a higher dependence on foundations also tend to be more efficient fundraisers. For example, among organizations with a budget size of less than \$250,000, those that were over 80% dependent on foundations spent 2 cents on each contributed revenue dollar raised (marked with an asterisk). In contrast, more inefficient rates tend to correlate with lower rates of foundation dependence (indicated with shading).³³ For example, for organizations in the \$5-20M budget range, those less than 20% dependent on foundations spent 26 cents on each contributed revenue dollar raised (marked with two asterisks).

Table 13. Fundraising Efficiency by Budget Size and Foundation Dependence (2011)

Budget Size	Foundation Dependence ³⁴			
	<20%	20-49%	50-79%	80%+
\$150-250K	0.06	0.31	0.05	0.02*
\$250-500K	0.13	0.18	0.05	0.06
\$500K-1.5M	0.25	0.22	0.15	0.07
\$1.5-5M	0.23	0.21	0.14	0.08
\$5-20M	0.26**	0.19	0.05	n/a
\$20M+	0.10	0.08	n/a	n/a

Source: Study Sample data

³¹ This column was calculated by dividing the number in column (d) by the number in column (b).

³² Giving USA 2013.

³³ At TDC, we consider 15 cents spent per dollar raised to be an acceptable fundraising efficiency rate. We have marked the most inefficient rates in bold.

³⁴ Foundation dependence is determined by calculating what percent of total contributed revenue comes from foundations.

Table 14. Fundraising Efficiency by Budget Size

Budget Size	2011 Average Fundraising Spend	2011 Average Fundraising Efficiency	Imputed spend with staff	Updated Efficiency
\$150K-250K	\$3,992	0.06	\$103,992	1.60
\$250-500K	\$23,330	0.11	\$123,330	0.57
\$500K-1.5M	\$81,488	0.17	\$181,488	0.38
\$1.5-5M	\$242,101	0.14	\$242,101	0.14
\$5-20M	\$1,171,678	0.10	\$1,171,678	0.10
>\$20M	\$2,199,328	0.10	\$2,199,328	0.10

Source: Study Sample data

In Table 14, we take the thought experiment one step further by considering potential costs for the individual giving strategy. We made the (arguable) assumption that an individual giving strategy requires dedicated fundraising staff to implement. While an artistic director can dash off grant proposals periodically, the amount of coordination, research, and expertise required to pursue a broad base of individuals requires development staff. When we look at average spend for the three smallest groups, we posit that those amounts are not enough to support dedicated fundraising staff, and that these organizations would need to add staff in order to pursue a successful individual giving strategy. As such, we increased the fundraising spend to reflect increased staffing. We heard in our interviews that competition for fundraising staff is particularly fierce since development talent is in demand from universities and hospitals. Therefore, we assumed that the full cost of this individual would be at least \$100,000, including salary, fringe benefits, and taxes. We did not change the average spend for the three larger categories, reasoning that their budgets already accommodate dedicated staff.

The addition of this new cost pushes the three smallest groups' fundraising efficiency (shown in the shaded boxes) into untenable territory.

That said, in the real world, there are small organizations that are successful at raising money from individuals. How can they afford to do this? In interviews with smaller and mid-sized organizations, we heard about struggles to find a good development director at a price point they can afford. Others were lucky enough to have landed the perfect person – talented, experienced, and willing to take a cut rate for an idiosyncratic reason. These leaders live in fear that their golden goose will get poached.

The most common story we heard was of organizations settling for an inexperienced development coordinator with a passion for the mission, and accepting the fact that at least 50% of the director's job at a small or mid-sized arts nonprofit is raising money. While this staff structure is sustainable at a smaller scale, to achieve growth, more investment is typically required. However, this investment would only be warranted if the organization had the opportunity to bring its average gift size up to the scale necessary to support a larger institution. Board giving is a critical leading indicator of this ability. Running a \$5 million organization on average gifts of \$624 is not feasible. Organizations with boards that give at the lower end of the spectrum may not have the wherewithal to access the individual contributions necessary to grow.

Assumption 4: If we invest more in the highest quality art and market it relentlessly, then our organization will thrive and grow.

TDC fully endorses the view that an arts organization must be producing high quality work to succeed. We also believe that having an engaged audience is another precursor to organizational success. However, does it then follow that if you invest in the highest quality art and market it relentlessly, that your organization will thrive and grow? TDC contends that these are necessary yet not sufficient factors.

First of all, scale matters. As detailed in the section on Assumption 2, effective marketing costs a lot, and does not always yield sustainable growth.

Secondly, audience behavior is not always tied to perceptions of quality. In our practice, TDC has observed that lapsed attendees sometimes report high satisfaction. They enjoy the experience, feel goodwill toward the organization, actively recommend it to others, and may even report an intention to return. However, none of this changes the factors in their lives that get in the way of repeat attendance. Quality is not always the barrier.

Finally, increased spending on programs is complicated by the reality of *program coverage*. TDC defines program coverage as the proportion of an organization's program budget that is covered by program-based earned revenues. For the majority of arts nonprofits, the nonprofit paradigm is necessary because they cannot live off of earned revenue alone. Some groups do not make a profit on earned revenues even when they achieve a 100% fill rate.

On average, Study Sample organizations covered only 41% of program costs with program-related earned revenues. Performing arts groups were better than museums at covering programmatic cost, but still could earn only 55% of program costs (as compared to museums' coverage rate of 31%). Of the 163 organizations in our Study Sample, only 11 could claim the distinction of covering 100% or more of program costs with revenues earned from programmatic activities. Besides these 11, all others must find another means to cover the full cost of programming. Thus, for most organizations, investing more in productions and marketing initiatives means that the hole for the development department to fill only gets bigger. The idea that an organization can earn its way out of a financial hole with no subsidy from contributions is usually not realistic.

But maybe investment in high quality art has a less direct route to financial sustainability. If an organization achieves the pinnacle of artistic quality, then won't donors pay to make it keep happening? Interestingly, when we looked at instances of significant investment in program in the data, we noticed that the year of initial investment often correlated with a bump in fundraising success. So, rather than fundraising success being a trailing indicator of past achievement, it was more commonly a *leading* indicator of investment. Interviews helped to explain this finding. We found that organizations planning a major programmatic initiative generally raised the money to invest upfront.

A potentially complicating factor arises from significant program investments driven by contributed revenue. Funders' and donors' tastes and motivations are not necessarily aligned with those of an organization's audience, and can result in them supporting programs with less commercial potential. When a funder chooses to underwrite a production with limited public appeal, program coverage drops as ticket sales go down, and the organization becomes even more dependent on contributed revenues. As this dynamic is repeated over time, we would expect to see higher dependence on contributed revenues and negative trends in the attendance, which is exactly what we see in the ecosystem today.

Conclusion

Growth impacts the arts sector at multiple levels. In Part II, we explored how to navigate the question of growth for an individual organization. To invest in growth that will contribute to sustainability, TDC contends that organizations and their supporters need to challenge their core assumptions and be relentlessly honest about their goals, what kind of investment it will take to actually achieve those goals, and whether the goals are achievable. The key lies in honest conversations that are focused on the right questions, such as:

- What are we chasing when we invest in marketing or fundraising? Are we after stability or growth? Are we seeking an enhanced bottom line or validation of the art? Or a wider pool for major donors? Or a more vibrant neighborhood?
- What is the role of program growth in fueling mission and sustainability? How will we pay for more program investment? Are we clear about the revenue goals? The artistic goals? When does it make sense to replace old programs, rather than simply adding the new?
- How do the answers change for organizations with different scales, business models, and revenue dependencies?
- Where are the points where funder and organization priorities align? Do those priorities align with those of the audience?

The answers to these questions will be different for every organization. However, perhaps most importantly, the conversation prompted by these questions will yield the insights necessary to focus investments in the right places, scale the investments to produce positive outcomes, and – in some cases – make the decision not to move forward with an investment at all.

Investment comes down to choice – the choice to do something and the choice to pay for it. The motivation to make a particular choice can be grounded in values or aesthetics. For example, some donors and grantmakers are motivated by a belief that the arts support a diverse array of non-arts outcomes, from youth education to economic development to healthy communities. For others, it's about civic pride and supporting their community's cultural assets; for yet others, it's about expressing their artistic preferences. Similarly, organizations have diverse motivations. Some bring a world of creative expression to their communities; others are there to express the creative vision of a particular artist. Some preserve a specific art form; others explore the edges of new ways to create art.

These motivations are all valid, rooted in the visions and values of each organization and funder that holds them. With such a diverse range of motivations, however, it is challenging to get to a point of alignment, and organizations face the seemingly impossible task of articulating a strategy that will respond to emerging audience trends, stay true to their artistic missions, *and* address the cacophony of funders' objectives.

This challenge of alignment is a difficult one. It takes leaders with vision, smarts, and creativity to come to solutions that will work for their institutions and their communities. Layering on a directive to grow that is not true to an organization's business model and marketplace is counterproductive. TDC hopes that this report will help to clear the decision-making set of inappropriate growth assumptions so that organizations and their supporters can focus on aligning mission and values at a sustainable scale.

Pulling up to a systemic level, what does it mean when organizations are aspiring toward growth en masse? Part I traced some of the trends in the ecosystem that can result – increased competition, widespread financial weakness, and organizations without the resources to meet the demands of a changing marketplace. The collective price tag in Philadelphia is high, and may result in some winners and some losers. We hope that an informed conversation about when growth and investment will truly lead to sustainability and success will help to shape the decisions to be made in the coming years.

Finally, a looming topic that deserves more study and more sector-wide conversation is that of organizational exits. The arts sector needs constant renewal and innovation to stay relevant to society, and the ecosystem today has little room to allow new entrants to make their mark and thrive. Can we develop a sector-wide culture that can celebrate an organization, its achievements, and its artistic progeny when it closes?

TDC remains in awe at the commitment, courage, and sophisticated thinking we found in every corner of the ecosystem in Philadelphia and in our engagements across the country. While the challenges are many, we are assured at the ability of the sector to deploy all the skills and smarts it has at its disposal to continue making dazzling art and to progress to a state of stronger financial health.