TDC *VISION TO MOMENTUM*

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

Grantmakers in the Arts | October 13, 2014

Capitalization – Take Two

- *Getting Beyond Breakeven* had two major findings:
  - Pervasive weak financial health
  - Strong financial literacy
- Why?
  - Strategic planning not grounded in external market.
  - Financial analysis not connected to organizational context.
  - Chaotic philanthropic markets.
- Five years of dialogue resulted in impetus for a more nuanced look:
  - What is adequate capitalization?
  - How does it change for organizations of different scale?
  - Which investments are supportive and which are counterproductive?
  - Can the capital markets support it all?
  - Can market players make more informed decisions?

A Study in Two Parts

Part I: Trends in the Greater Philadelphia Ecosystem

- How did organizations fare from 2007 to 2011? Who gained? Who lost ground?

Part II: Assessing Investments Toward Growth

- Has growth become the proxy metric for success?
- When is growth not advisable?
- How can organizations understand the feasibility for growth?

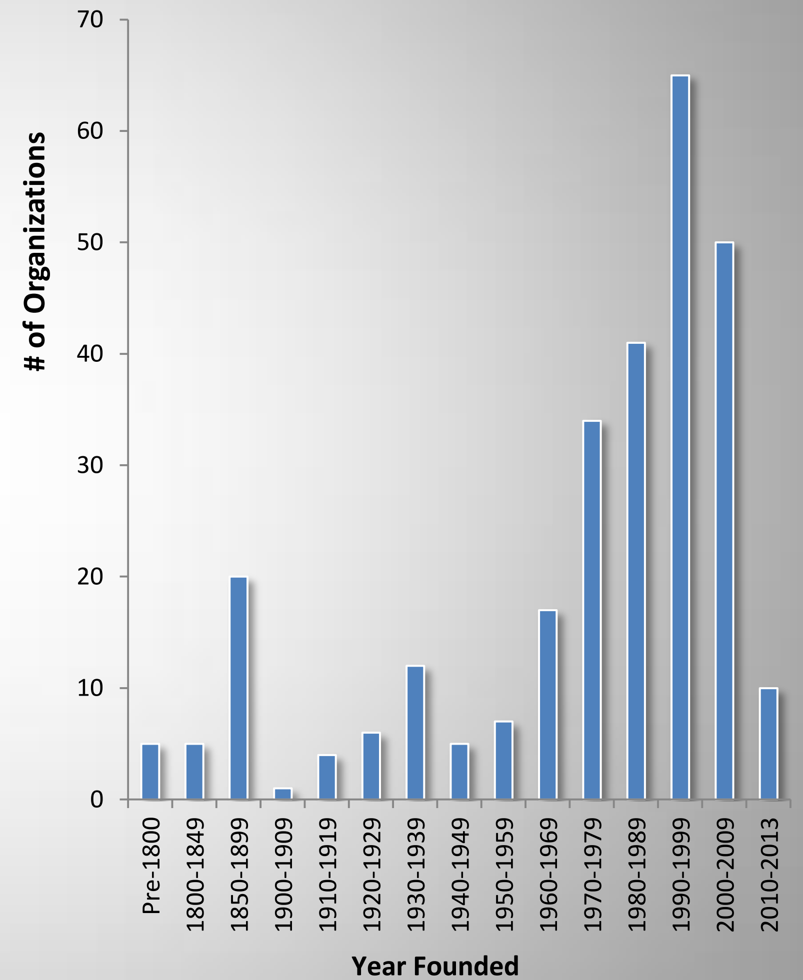
Methodology

- Analyzed CDP data from 2007 to 2011
  - Basic variables: budget size, age, discipline
  - Interpretive layers: revenue dependencies, financial health, efficiency of investment
  - Included about 300 arts and culture organizations in the Greater Philadelphia region
- Interviewed about 40 organizational leaders

PART I. TRENDS IN THE GREATER PHILADELPHIA ECOSYSTEM

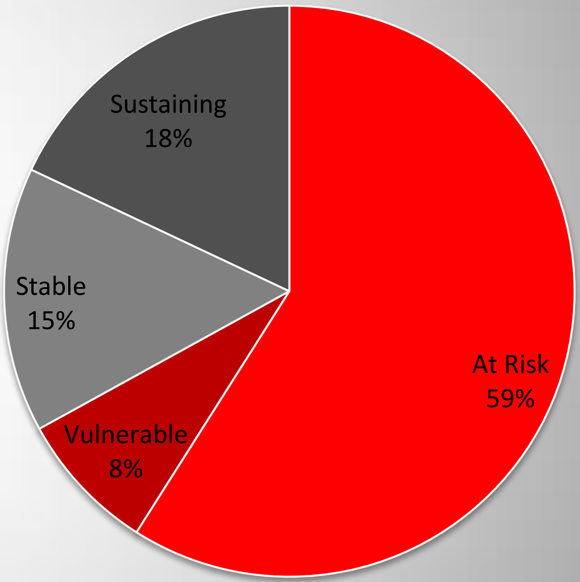
The Philadelphia Market Today

- Philadelphia's dense and mature arts market is result of deliberate and significant investment in past 20 years.
- Great for arts consumers but has not resulted in financially strong organizations.
- Competition has increased for ticket buyers and for philanthropic support.
- A market in transition means all bets are off.
  - Both audience and funders are changing.



Organizations remain financially weak.

- About 70% of organizations were At Risk or Vulnerable in financial health.
  - Defined as low or no available unrestricted net assets, low or no cash, and weak or broken business models.
- Approximately same rate as found in first study.

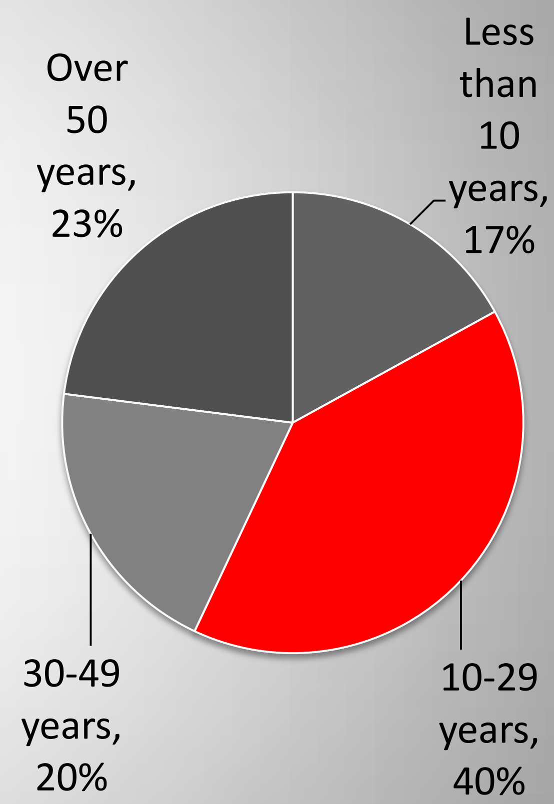


Competition increased.

- Many interviewees felt more intense competition, regardless of size or discipline.
- Three contributing factors:
  – Weak organizations didn't exit the field.
  – Large organizations, but not the largest, took a bigger slice of the pie.
  – The audience of paid patrons did not grow.

The weak did not exit.

- Did not see evidence of significant exits even after the recession.
- Did see logjam of weak teenagers.
- Closures slow in nonprofit sector.
  - In for-profit world, 80% of firms close in 10 years.
  - Only 17% of nonprofits close in first decade.
- Nonprofit barriers to exit include donors that subsidize inefficiency and volunteer labor.



Sources: Harrison and Laincz (2008); Chang and Tuckman (1991); Twonbley (2003).

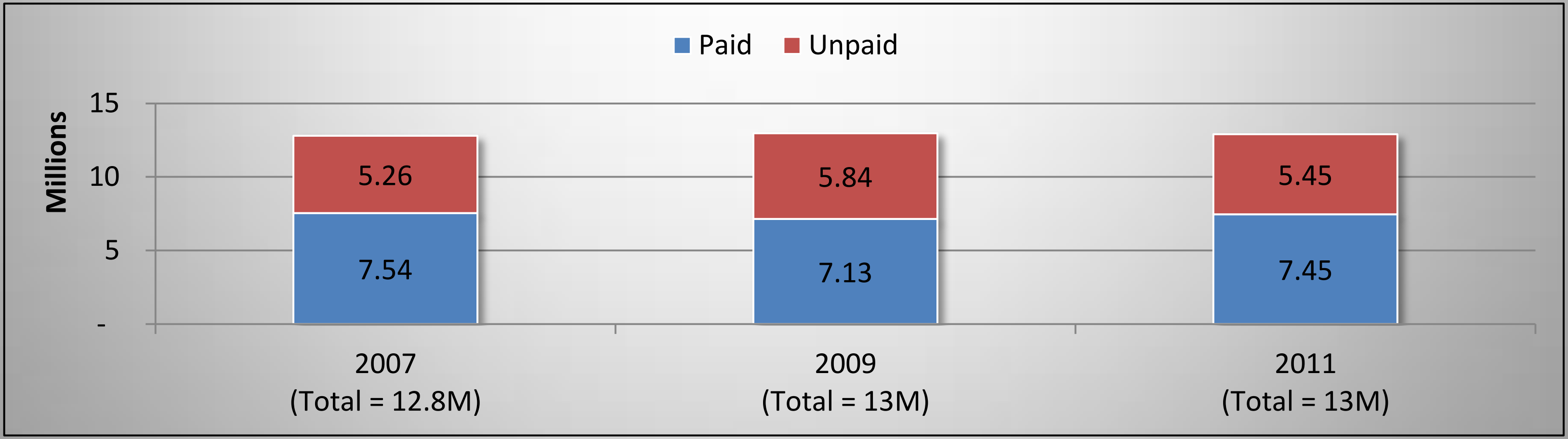
Large organizations took more.

- Generally, very large organizations swamp the system.
- In Philadelphia, large organizations have grown in size and number.
- More crowded playing field at the top, with large and very large organizations competing in same league.

	Number of Organizations			Aggregate Expense		
Budget Size	**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%)

Paid patrons were stagnant.

- Earned revenue beat inflation, due to increasing ticket prices.
- But, paid patrons did not keep pace with population growth, and actually declined.
  - Churn is an invisible factor.
- Overall patron numbers up by 1% because of growth of unpaid patrons.



Audience behavior is in transition.

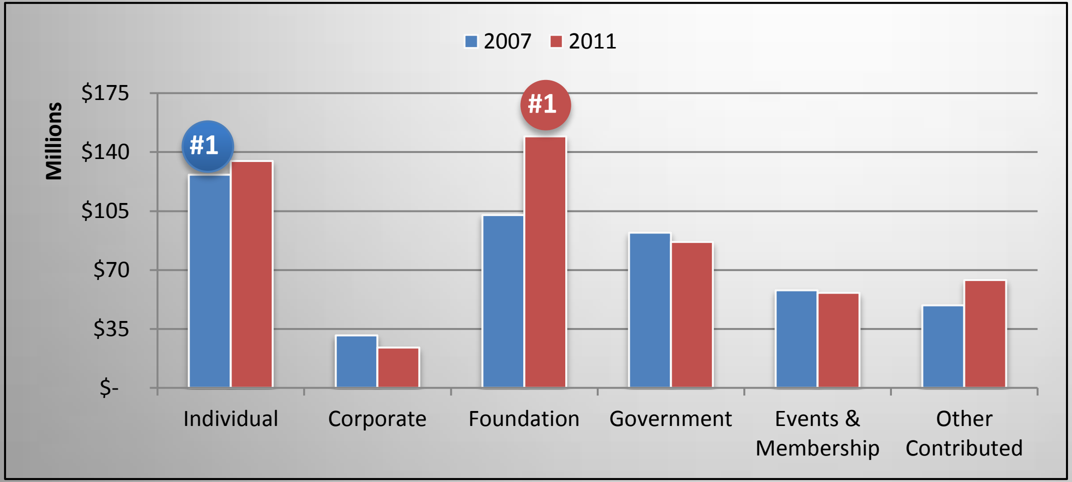
- Demographics and audience behavior are changing.
- Organizations know it and are planning for it.
- Exciting to see change in market knowledge.
- But, fundamentally reactive – chasing changes in the marketplace rather than evolution based on demand.

Serving a market in transition is hard.

- Organizations face a conundrum.
  - They must maintain current audiences AND shift dollars to attract and retain new audiences.
  - Funding often does not account for both needs.
    - 90% of interviewees had a strategy, but only 20% had the money to fund it.
    - Estimate at least $1.4 billion in capital campaigns.

The philanthropic market is in transition.

- Philadelphia's foundations and individuals led the way to growth.
  - Foundations tipped the balance and became the largest source of contributed revenue.
- Uncertainty about who will take up the lead.
  - Key major donors are retiring, and key foundations changing their policies and priorities in the arts.
  - Organizations not sure how to engage new generation.



Revenue Type	Philadelphia 2007-11 Trend	National 2007-11 Trend
Individuals	6%	(5%)
Foundations	46%	10%
Corporations	(24%)	15%
Government	(6%)	(11%)

Sources: Giving USA, Americans for the Arts

How should the sector respond?

- In a perfect world, funders would triage, identify the most valuable organizations, and coordinate decision making.
  - Coordination is politically hard to do.
- Also, hampered by imperfect ways to gauge success.
  - Sector struggles to measure intrinsic value and instrumental outcomes.
  - Growth and longevity have become the proxy for success.
- We need to start a sector-wide dialogue toward new shared cultural norms.
  - Growth does not always equal success.
    - When is growth appropriate and when is it debilitating?
  - The problem is not too many flowers blooming, but that the dying ones don't make room.
    - Is it right to think the mission of funders is to "save" everyone?

PART II. ASSESSING INVESTMENTS TOWARD GROWTH

Growth in the System

- Wanted to look at outcomes from significant investments.
  - We found, instead, erratic investments with sample sizes too small to draw conclusions.
- Many organizations stayed in place during recession then grew past baseline.
  - Total of 11% growth to budgets (8% inflation).
  - Highest increases to non-program expenses.

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

What determines feasible growth?

- We found that organizations that grew the most were very likely to be financially weak.
- *Sustainable* growth is different from *significant* growth.
  - Easy to spend money but hard to predict the net profit from an investment.
- Effective investments consider organizational fundamentals.

Time Horizon	The time span needed for an organization to realize its mission.
Business Model Drivers	The presence of large fixed costs that 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, 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.
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.

Ignoring the Fundamentals

Common assumptions that ignore the fundamentals:

1. *If we (or they) could only get to scale, our financial problems would be solved.*
2. *More marketing means more people will come.*
3. *We need to invest more in fundraising staff because we need to find more individual donors.*
4. *If we invest more in the highest quality art and market it relentlessly, then everything will be okay.*

If only we could get to scale…

- Bigger is not necessarily better; small can be beautiful.
  - Very small organizations run on careful balance of goodwill and money.
    - Sweat equity is not scalable.
    - Even adding a single staff person can tip a functioning small organization out of whack.
  - These organizations simply need the funding to deliver programs for as long as their audiences want them.

If only we could get to scale…

- Organizations a step larger – beyond volunteer run – may be able to grow.
  - Need holistic planning that scopes the full operational need and that establishes tested audience and philanthropic demand.
  - Need strong leadership that can ask the tough questions during planning and take decisive action if not all goes according to plan.

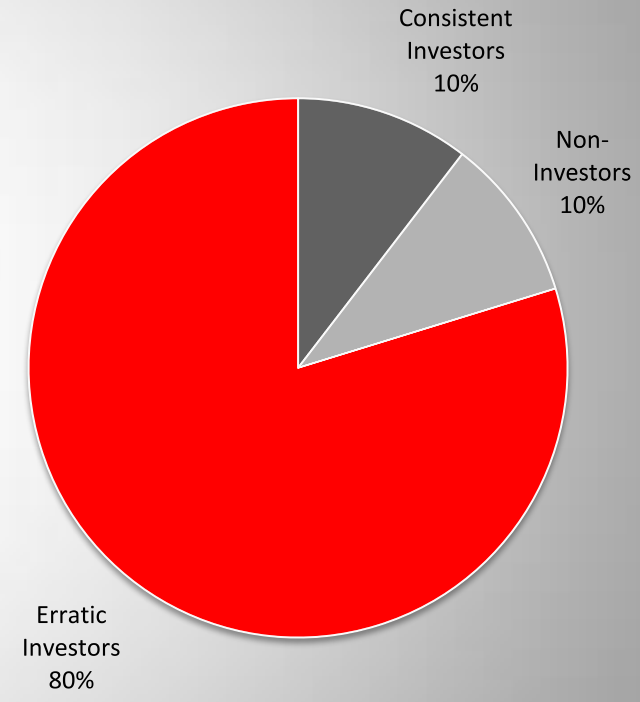
More marketing = more people

- Scale matters in marketing.
  - Doubling a small marketing budget won't make a difference.
- Earned income goals matter.
  - Increased marketing can outstrip earned income potential.

Budget Size	Average Marketing Budget
<$250K	$10,838
$250-500K	$31,964
$500K-1.5M	$68,665
$1.5-5M	$221,630
$5-20M	$752,014
$20M+	$2,928,429

More marketing = more people

- Even larger spends may not be enough.
  - Brand is not promoted; data implies that sales, rather than marketing, is the default investment.
  - Successfully reaching multiple audience targets requires a larger infrastructure than what currently exists.
  - New audience development requires consistent investment over time.



Marketing Implications

- At the organizational level, marketing investment needs to be based on each organization's mission, size, and strategy:
  - *What is the organization chasing?*
    - *Stability (retention, attraction, diversity); or*
    - *Growth (all the above plus increased market share)*
  - *And to what end?*
    - *Net revenue? Donor pipeline?*
    - *Validation of the art? Of the organization?*
- The smallest organizations need to size investment to defined goals.
- Mid-sized to large organizations may need significant investment to deal with audience shifts.
- Foundations need to grapple with their desired outcomes.
  - *Is there one meta audience goal?*
  - *A community vibrancy goal?*
  - *Or, are we supporting the aims of individual organizations?*

Fundraising staff = more donors

- No need for more solicitors if there is no pipeline established.
  - Many interviewees, even the largest and most established, were not sure of new donor sources.
  - An organization's networks matter.
    - Organizations identified new wealth through extensive research, but actual connections to new generations of donors were weak.

Fundraising staff = more donors

- Raising money from individuals is too expensive for some organizations.
  - Small and mid-sized organizations cannot afford skilled, dedicated development staff.
  - Board gifts are leading indicators of individual success.
  - And, many rely on foundations as the more efficient source.

Budget Size	Average Board Gift	Total Individual Contributions	Total Other Contributions	2011 Average Fundraising Spend	Average Fundraising Efficiency	Efficiency with staff*
<$250K	$624	$11,643	$53,396	$3,992	0.06	1.60
$250-500K	$1,418	$56,586	$161,047	$23,330	0.11	0.57
$500K-1.5M	$2,334	$123,377	$354,926	$81,488	0.17	0.38
$1.5-5M	$5,348	$460,463	$1,216,807	$242,101	0.14	n/a
$5-20M	$16,821	$3,293,890	$8,377,388	$1,171,678	0.10	n/a
>$20M	$72,242	$5,073,962	$17,208,692	$2,199,328	0.10	n/a

*Assumes $100K for full cost of one dedicated development staffer

Fundraising Implications

- Organizations of a smaller scale need to assess their market and their ability to grow individual support by asking:
  - *What are we chasing?*
    - *Major donors that can provide net income?*
    - *Broad-based retail giving as demonstration of community support?*
  - *Can our board support this?*
- Larger organizations seeking to diversify an already established donor base require investment in creating new networks before they build staff capacity.

Fundraising Implications

- Foundations should consider:
  - Where in the capacity building cycle do we want to invest?
  - What do we want our investments to stimulate?
    - New networks, community buy-in, increased net income?
  - What is our role in supporting small to mid-sized organizations over time if they cannot increase their individual donor base in a manner that provides net operating income?

Quality + marketing = success

- Quality and engagement are necessary yet insufficient factors for success.
- Scale matters in marketing – See Assumption Two.
- Program coverage is eroding.
  - The amount of program costs plus marketing covered by earned income is declining year over year. The pressure is exceptionally high in the performing arts.
  - Increasing investment often creates greater contributed revenue need.
    - Increased reliance on contributed revenue in Philadelphia supports this hypothesis.

Quality + marketing = success

- The data demonstrates that contributed revenue success was a *leading* rather than trailing indicator of program investment.
  - This implies that funding is available for *new* programming, but not as result of programming.
- It also reveals that obtaining increased funding may not always fix the problem.
  - Funder tastes may not align with that of the rest of the audience.
  - Increased investment in programs could exacerbate the program coverage problem.

Program Implications

- Organizations’ priority is putting art and culture into the world.
  - However, the economics make them beholden to two masters when making investments in program.
    - Program expense covered by earned and contributed.
  - Increased quality and improved marketing will often result in the need for increased contributed revenue.
  - Increased contributed revenue is often more easily obtained for new programming rather than sustained programming.
- Donors need to understand that their tastes may not drive earned income and therefore their investments should consider those implications.

Conclusion

- We found a system that:
  - Has grown unexpectedly, fueled by foundation dollars.
  - Remains fragile and requires external investment to address a changing environment.
- Heightened pressures on capital market expected over next 5 to 10 years:
  - $1.4 billion to address changing market, fund new visions, finish transition of $5-20M cohort, support re-entry of $20M+ cohort;
  - $25 million in recovery capital (conservative); and,
  - Annual operating revenue nut.

Conclusion

- Both funders and organizations need to understand how to balance and integrate where they choose to invest and why.
  - *What are we chasing when we invest in marketing and fundraising? Are we after stability or growth? Are we seeking an enhanced bottom line or validation of the art?*
  - *What is the role of growth in program in fueling mission and sustainability? When does it make sense to replace old programs rather than simply adding new?*
  - *How do the answers change for organizations at different scales, business models, and revenue dependencies?*

Conclusion

- Investments should also be considered in the context of the larger ecosystem.
  - *Where do funder and organizational priorities align? Do those priorities align with those of the audience?*
  - *How should funders position their investments in the context of others in the ecosystem?*
  - *When is it better not to invest?*
  - *Is it time to consider closure?*