TDC VISION TO MOMENTUM

# Understanding Your Capitalization Challenge

TCG Fall Forum | November 8, 2014

# The Next Step

- Talking about the under-capitalization of the arts sector for five years
- Organizational leaders and funders agree about the issue broadly
  - Unclear if donors and boards agree
- Understanding how to address the challenge at the organizational level is much harder

# Agenda

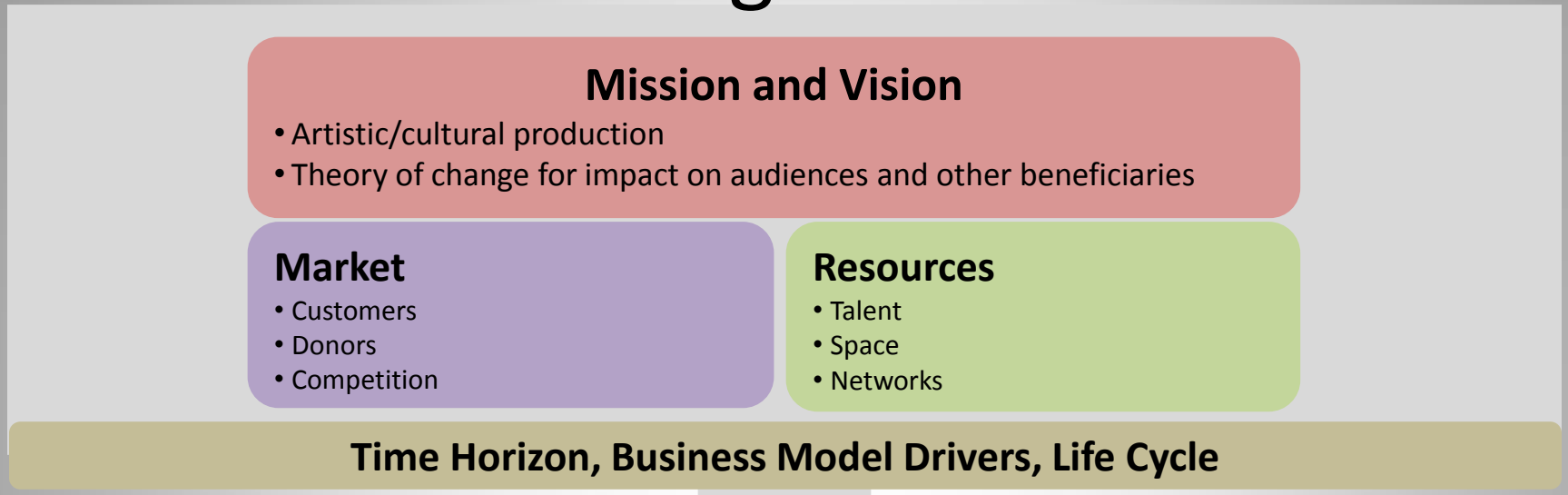
- How to diagnose your specific challenge based on the understanding of your:
  - Strategy
  - Business model
  - Risk profile
  - Where responsibility for the challenge lies

# DEFINITIONS

# Definition Revisited

- Capitalization is having the cash to do **what** you need to do **when** you need to do it
  - It connects organizational mission, vision and strategy
  - It creates investment in the art
  - It allows for the ability to take risk

# Capitalization Components: An Integrated Plan




## Integrated Strategy

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

# Business Model

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

# Revenue & Capital Serve Different Purposes

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

# Creating a Risk Profile

## Operational Risk

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

RISK MANAGEMENT

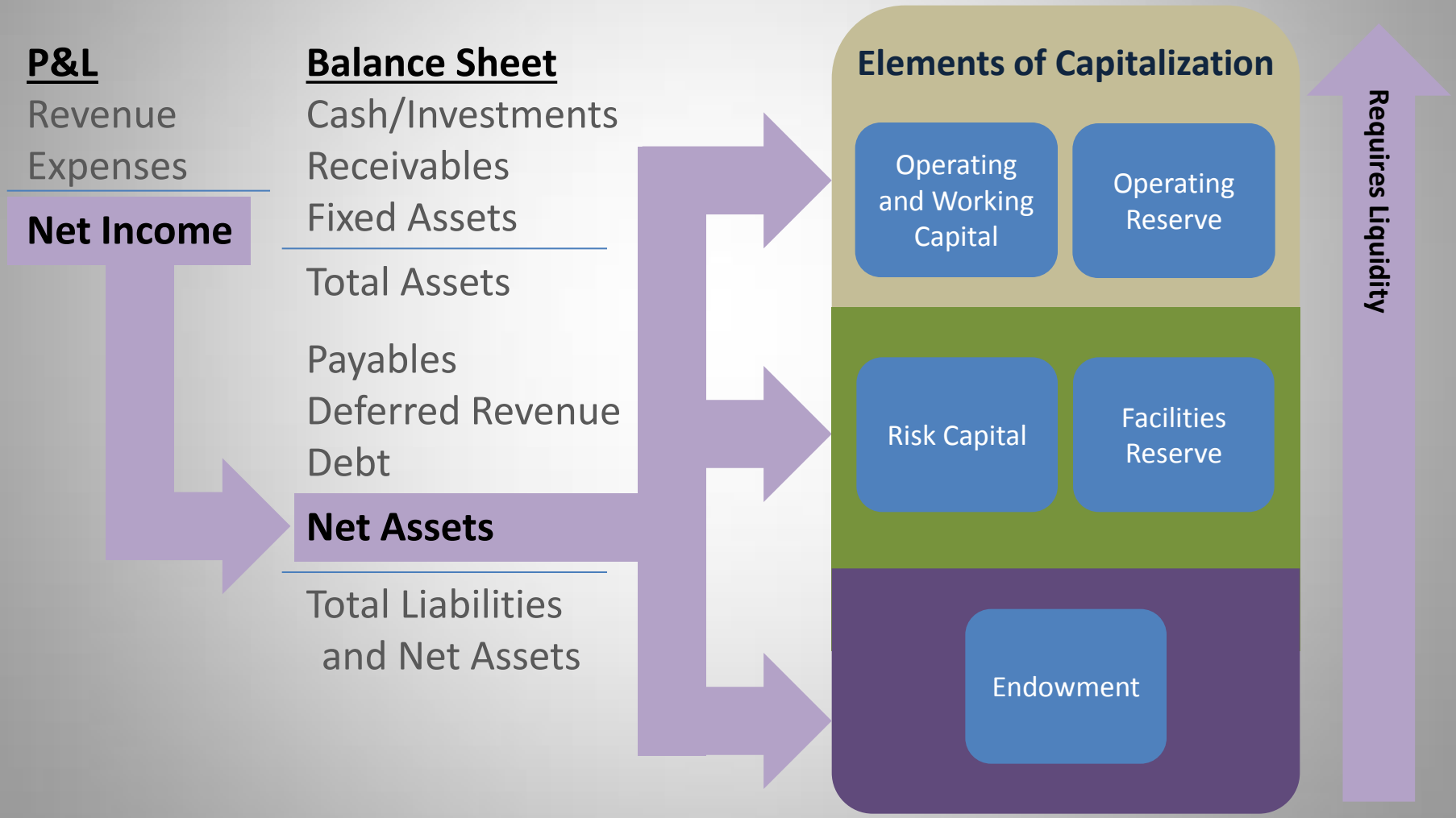
## Strategic Risk

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

RISK TAKING

# TYPES OF CAPITAL

# How Well Capitalized Are You Now?



# Baseline Capital Funds

| Fund | Purpose | Funded by |
|---|---|---|
| **Working Capital** | Mitigates everyday risk and normal cash flow bumps | Internal sources |
| **Operating Reserve** | Protects against unexpected downturns and operating risk profile (risk management) | Cash set aside |
| **Facilities Reserve** | Supports replacements of facilities or leasehold improvements | Funding depreciation or seeding new fund |
| **Opportunity or Risk Capital** | Can offset one-time big risks or support R&D (risk taking) | People who love you |
| **Endowment** | Ensures longevity of organizations with long-term time horizons | People who love you |

# Transitional Capital Funds

## Recovery Capital

- Pays off past debt
- Provides interim working capital
- Moves URNA out of the red
- “Can’t function until you clean it up” capital
- Funded by people who love you

## Change Capital

- Required to test a new business model
- Required to execute new business model
- Funded by people who love you

# Debt As Capital

- **Lines of credit** that can be used sporadically
- **Short/mid-term financing** that is supported by a high ratio of pledges
- **Low-cost short/mid-term financing** that can be paid for by the annual operating budget after appropriate reserves have been funded

# DIAGNOSING YOUR CHALLENGE

# Where You Start Matters

- Is your organization…?
  - **At risk**: no cash and high debt
  - **Vulnerable**: no cash
  - **Sustaining**: some cash
  - **Stable**: sufficient cash

# Average Total Net Assets

| | All Theatres | Group 6 | Group 5 | Group 4 | Group 3 | Group 2 | Group 1 |
|---|---|---|---|---|---|---|---|
| # Theatres | 162 | 30 | 30 | 16 | 56 | 21 | 9 |
| **Working Capital** | **$(1,727,520)** | **$(6,393,260)** | **$(1,405,772)** | **$(1,217,242)** | **$(416,838)** | **$(163,957)** | **$41,612** |
| Fixed Assets | $7,404,358 | $27,156,645 | $7,235,683 | $3,383,599 | $1,820,480 | $553,452 | $3,245 |
| Investments | $3,930,493 | $16,202,108 | $3,818,856 | $1,040,569 | $324,676 | $60,954 | --- |
| Other Net Assets | $1,258,086 | $3,206,227 | $1,215,734 | $2,483,623 | $493,762 | $149,046 | $70,272 |
| **Total Net Assets** | **$10,865,416** | **$40,171,721** | **$10,864,500** | **$5,690,548** | **$2,222,081** | **$599,495** | **$115,129** |
| Total Expenses | $6,151,671 | $20,100,537 | $6,951,170 | $3,905,927 | $1,868,131 | $725,367 | $297,410 |
| Working Capital as % of Total Net Assets | -15.9% | -31.8% | -12.9% | -21.4% | -18.8% | -27.3% | 36.1% |

Source: Theatre Facts 2013, TCG

# Average Expenses & Change in Unrestricted Net Assets

| | All Theatres | Group 6 | Group 5 | Group 4 | Group 3 | Group 2 | Group 1 |
|---|---|---|---|---|---|---|---|
| # Theatres | 176 | 32 | 32 | 16 | 63 | 23 | 10 |
| Total Expenses | $6,015,988 | $19,792,613 | $6,998,565 | $3,905,927 | $1,887,499 | $735,673 | $316,854 |
| Change in Unrestricted Net Assets (CUNA) | $67,480 | $125,360 | $152,242 | $(48,049) | $73,291 | $(26,952) | $(23,548) |
| CUNA as a % of Total Expenses | 1.1% | 0.6% | 2.2% | -1.2% | 3.9% | -3.7% | -7.4% |

Source: Theatre Facts 2013, TCG

# Is It A Capitalization or A Business Model Issue?

| Moving From At Risk to Sustaining | | | |
|---|---|---|---|
| Improving Operating Model | Negative URNA | Breakeven or Deficit | No Cash |

| Moving From Vulnerable to Sustaining | | | |
|---|---|---|---|
| Improving Operating Model | Flat URNA | Breakeven or Better | Very little cash |

| Undercapitalized | | | |
|---|---|---|---|
| Working Operating Model | Thin Balance Sheet | Breakeven or Better | Undercapitalized |

| Considering Growth | | | |
|---|---|---|---|
| Stable Operating Model | Healthy Balance Sheet | Regular Surpluses | Well Capitalized |

| Broken Business Model | | |
|---|---|---|
| Negative URNA | Structural Deficits | Negative Cash |

# Moving From At Risk to Sustaining

## Research

- Two different studies demonstrate that improving financial health was hard
- Organizations struggled to make consistent investments in program, marketing and fundraising
- Those that changed obtained forms of recovery capital

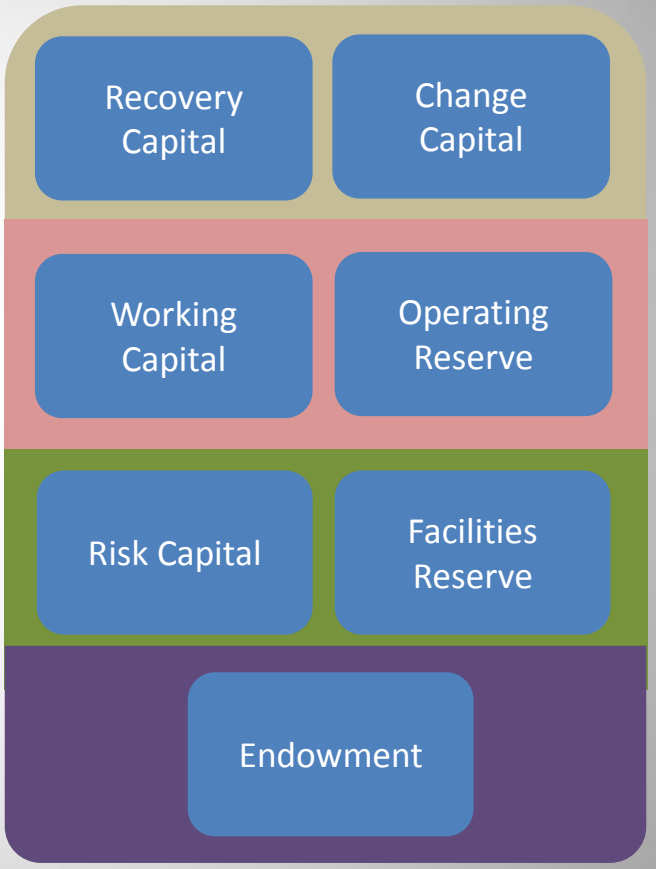
## Are You Ready To Do This?

- Does your model have the ability to do better than breakeven?
- Do you understand your risk profile?
- Do you have a good understanding of demand?

Sources: *Getting Beyond Breakeven*, TDC (2009) and *Capitalization, Scale and Investment*, TDC (2014)

# Moving From At Risk to Sustaining

- What types of capital should you consider?
  - First focus on improving negative net assets through surpluses
  - Recovery capital
  - Change capital
  - Working capital
- Should you pay down debt?
  - No



# Moving From Vulnerable to Sustaining

## Research

- Boards struggle to understand why this is important
- Organizations that changed made it a goal and made attendant investments and choices

## Are You Ready To Do This?

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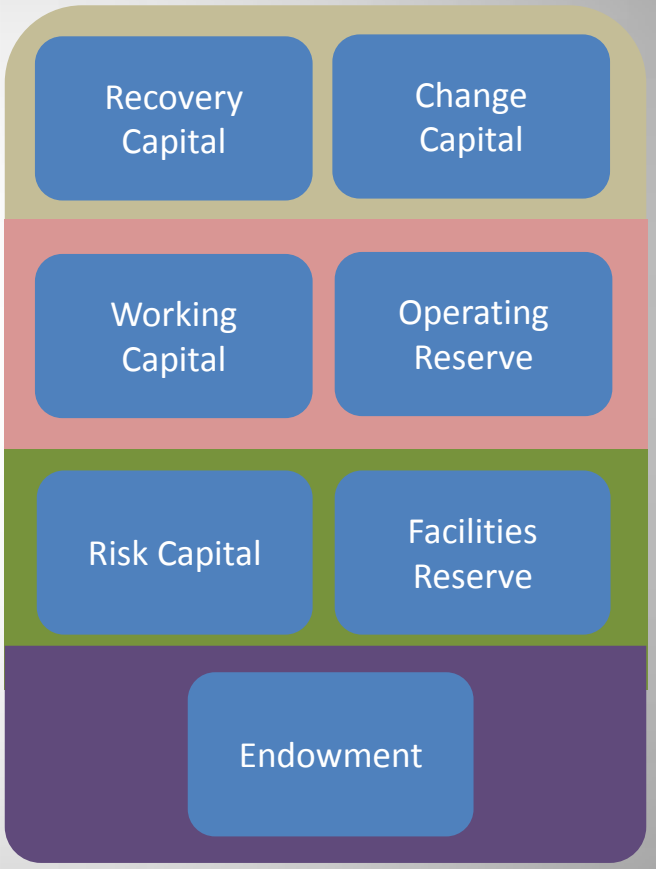
Sources: *Getting Beyond Breakeven*, TDC (2009) and *Capitalization, Scale and Investment*, TDC (2014)

# Moving From Vulnerable to Sustaining

- What types of capital should you consider?
  - Working capital
  - Operating reserves
  - Facilities reserve, where appropriate
- Should you pay down debt?
  - Maybe



# Undercapitalized

## Research

- A minority of organizations actually sit in this category
- Boards and funders struggle to understand why this is important
- Organizations that have created appropriate capital funds (such as operating & artistic reserves) have benefited organizationally and artistically

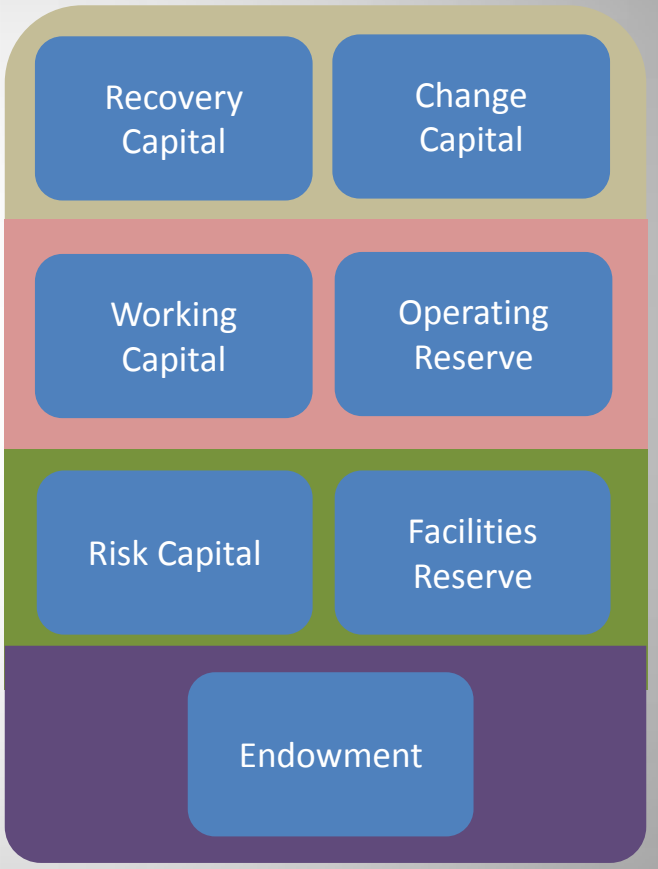
## Are You Ready To Do This?

- Is your business model working?
- Do you generally have annual surpluses, with just occasional deficits?
- Do you have a clear and agreed-upon definition of operational and artistic risk?
- Do you have a clear and agreed-upon way to communicate how capital will increase impact?

Sources: *Getting Beyond Breakeven*, TDC (2009) and *Capitalization, Scale and Investment*, TDC (2014)

# Undercapitalized

- What types of capital should you consider?
  - Increased working capital
  - Reserves
  - Risk capital
  - Facilities reserve
  - Endowment, potentially
- Should you pay down long-term debt?
  - Maybe
- Should you use debt?
  - Lines of credit for working capital



# Considering Growth

## Research

- Organizations that don't start from strength do not get stronger. Many get weaker.
- In a recent study, it was found that few organizations grew from demand

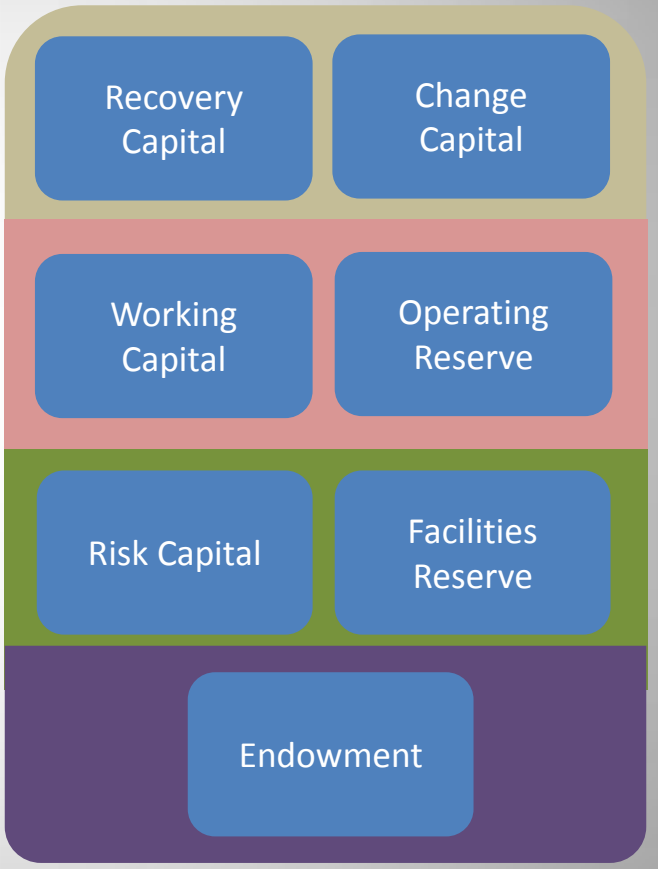
## Are You Ready To Do This?

- Do you have a solid donor base?
- Do you have a working balance sheet?
  - The ability to repay credit lines?
  - Growth may not fix a weak operating model. Rescaling or right-sizing might.
- Do you have a data-driven growth plan?
  - The ability to increase demand of both audiences and donors?

Sources: *Getting Beyond Breakeven*, TDC (2009) and *Capitalization, Scale and Investment*, TDC (2014)

# Considering Growth

- What types of capital should you consider?
  - Resizing the balance sheet appropriately: work capital and reserves
  - Change and growth capital
  - Facilities reserve, where appropriate
- Consider sweat equity
- Should you use long-term debt?
  - Only to bridge pledges
- Should you use short-term debt?
  - Lines of credit for working capital



# Broken Business Model

| How Do You Know? | What Does It Mean? |
| --- | --- |
| • Consistent losses over a multiyear period<br>  – Sometimes covered by one-off events<br>• Fully borrowed lines of credit and inability to pay debt out of annual operations<br>• Significantly changing budgets or productions during a budget year<br>• Inability to invest in staff; frozen/diminishing pay levels | • Retest your vision and mission<br>• Understand and scale to your market<br>• Create a new capitalization plan that includes transition capital |

Sources: *Getting Beyond Breakeven*, TDC (2009) and *Capitalization, Scale and Investment*, TDC (2014)

# SCALING TO THE MARKET

# What Does It Mean to Scale to Market?

- Scale is determined by market relevance
- Market relevance tells you if your business model works and effects your strategy
  - It is tested through the ability to increase **net** revenue
    - Earned revenue through marketing
    - Unearned revenue through fundraising

# More Marketing = More People?

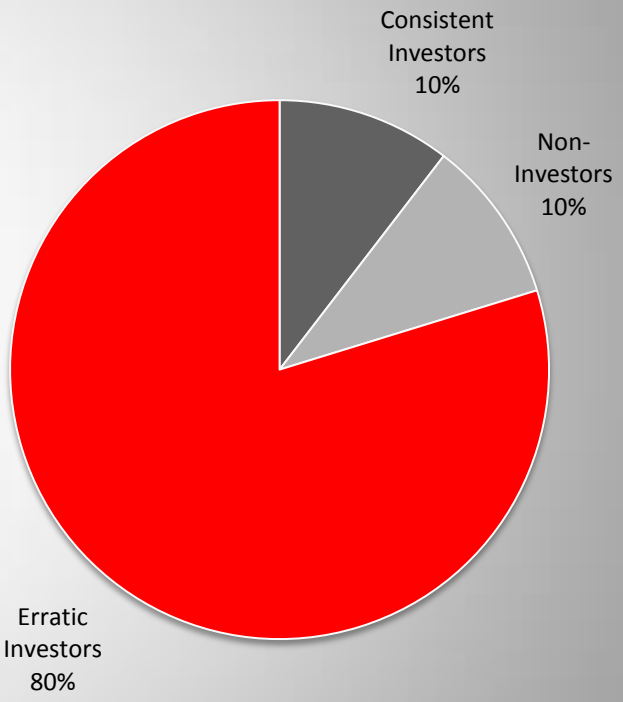
- Scale matters in marketing.
  - Doubling a small marketing budget won't make a difference.
- Market size matters
  - Increased marketing can outstrip earned income potential.

| 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 |

Source: *Capitalization, Scale and Investment*, TDC (2014)

# 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.




Source: *Capitalization, Scale and Investment*, TDC (2014)

# Marketing Implications

- At the organizational level, marketing investment needs to be based on each organization's mission, size, market potential, 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.

# Fundraising Staff = More Donors?

- Board gifts are leading indicators of individual giving.
  - Individual giving is what drives long term growth
  - Networks matter
  - Smaller organizations may not benefit from major gift officers

| 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 |

Source: *Capitalization, Scale and Investment*, TDC (2014)



*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?
  - Is this a Executive Director/Managing Director function? Do I need a Director of Fundraising?
- Larger organizations seeking to diversify an already established donor base require investment in creating new networks before they build staff capacity.

# Business Model and Scale

- An honest discussion of net revenue available allows you to understand if you can:
  - Adjust your current business model
    - More focused choices of programs
    - Reconfiguration of organizational model
  - Change the core model
    - Identify new ways to offer your art
    - Create a new organizational model

# THE PLAYERS

# Who Needs To Be Involved?

- Capitalization is a board issue
  - It effects impact and outcomes
  - It is at the core of fiduciary responsibility
  - It grounds strategy
- Successful organizations have board alignment and commitment to the integrated view of program, operations and capital

# Summary

- Know where you stand
- Know the difference between a capital problem and a business model problem
- Diagnose the right capital challenge
- Understand your market
- Understand your risk profile
- Raise the right capital first
- Don’t confuse growth with success
- Do an honest appraisal of net revenue
- Don’t divorce capital from mission, vision and strategy.  It IS a board issue.